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REGULATION AND TAXATION OF THE VARIABLE ANNUITY

Introduction

The variable annuity, a hybrid retirement planning device which combines many of the features of life insurance and equity investment, has been proposed by a sizable segment of the life insurance industry as the answer to that industry's problem in maintaining its share of the nation's retirement-planning dollar. The proposal has erupted into a controversy which has split the otherwise staid industry into two even camps, pro and con, as to whether the insurance industry should market the variable annuity. Virtually all of the nation's major mutual funds, investment bankers and stock brokers have joined in condemning the plan, which poses one of their greatest potential sources of competition to appear in years.

This note is intended to present a basic outline of the purpose and nature of the variable annuity and of some of the many problems to which it gives rise. The areas of regulation and taxation, which should be of especial interest to the legal profession, will be treated in detail.

Purpose of the Variable Annuity

The basic objective of the typical American's retirement planning is to amass a capital fund before retirement that will suffice to provide him with enough funds, over and above receipts from social security and pension plans, to maintain a predetermined standard of living for the remainder of his life. He may seek to attain this objective during his productive lifetime by means of personal savings, personally managed investments or a commercially managed investment fund. However, the principal disadvantage of these methods is that the retired individual may outlive his accumulated capital, either because of the necessity of earlier and increased withdrawals of capital because of its decreased buying power or, even more probably, because he simply lived longer than he had planned upon.

Traditionally, the life insurance industry has supplied the solution to the problem of outliving retirement capital through the sale of its conventional annuity. This contract, however, has fallen prey to inflation. During the last decade the inflexible periodic payments, probably planned and established twenty to thirty years ago, have proved inadequate in practically all instances to maintain the individual's desired standard of living and in some cases even to meet the basic needs of the annuitant, because of the declining purchasing power of the dollar.[1] The solution to this problem, according to proponents of the variable annuity, is a retirement program which

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[1] See Schechter, *Variable Annuities—Boon or Bane?*, 1956 INS. L.J. 764, 766-67.

supplements the conventional annuity contract with variable annuities. Ideally, the variable annuity would provide the annuitant with periodic payments, the dollar amount of which would fluctuate in close relation to the fluctuations in the dollar's purchasing power. The conventional annuity would continue to provide a guaranteed fixed dollar-income. It is hoped that the combined income of the two plans will provide a fairly constant amount of purchasing power which in turn would enable the annuitant to maintain the desired standard of living, during good times or bad, for the remainder of his life.

Description of the Plan

The variable annuity is probably best explained by comparing it with the conventional annuity. Under the terms of the present or conventional annuity, the annuitant either makes a single lump-sum payment or contracts to make a series of fixed-premium payments to the insurer during his income-producing years. In return, the insurer guarantees to pay the annuitant, beginning at a stated future date, a fixed number of dollars at set periodic intervals for the remainder of his life.

The variable annuitant also contracts to make a fixed series of premium payments over the span of his productive years, but here the similarity ends. Most of the premium payment is invested in common stock. Each premium payment, after the deduction of a specified amount for loading charges, is credited to the annuitant's account in the form of "accumulation units." The number of "accumulation units" to be credited is determined by dividing the net amount of the premium payment by the current value of an "accumulation unit." The basic value of an "accumulation unit" is arbitrarily established at the initiation of the program. At stated periods thereafter, usually monthly, the basic unit value is adjusted dependent upon the current investment experience of the common stock portfolio, including income and both realized and unrealized capital gains and losses. The unit value is not affected by the mortality experience or current operating expenses of the program. These factors are assumed by the insurer, who is compensated by the loading charge.[2]

[2] A simplified numerical example may best illustrate these computations.

A. Assume that the variable annuity fund is established in December, 1958, with initial premium payments, after deduction of the loading charge, of $10,000 and that such payments are then invested. Assume further that the value of an "accumulation unit" is fixed at $100. As of December 31 each annuitant will be credited with one "accumulation unit" or part thereof for every $100 or fraction thereof that he has paid in premiums.

B. Assume that the market value of the initial $10,000 fund has increased to $10,200 at the end of the first monthly period. As a result each "accumulation unit" will now be worth $102 and a like premium payment will be required to purchase a unit during the month of January.

The insurer makes no commitment to pay a fixed dollar-amount to the annuitant during the payout period. Rather, each periodic payment obligation will be determined by the number of "annuity units" in the annuitant's account multiplied by the current value of an "annuity unit." At the beginning of the retirement period the "accumulation units" which have been credited to the annuitant's account are converted into "annuity units." This calculation, which is basically the same as is used in the conventional annuity payment tables, would be based on the current value of the "accumulation units," the expected average return of the portfolio, and the annuitant's life expectancy as determined by the standard mortality tables. The number of "annuity units," once determined, would remain the same for the entire payout period. Each periodic payment, however, would be dependent on the current value of an "annuity unit," such value being calculated in the same manner as the value of an "accumulation unit." [3]

Thus, the essential difference is that under the conventional contract the insurer's obligation is fixed and stated as an exact number of dollars, whereas under the variable annuity contract the insurer's obligation is expressed in terms of a number of units, each payment varying in accordance with the current performance of a common stock portfolio.

The proponents of the variable annuity, armed with an array of studies on past long-term trends in stock prices, living costs and dollar purchasing value, claim that over the years the yield from common stock investments has more closely reflected the changes in the dollar's purchasing power than any other form of investment.[4] Seeing no reason for this performance to change, they feel that a variable payment plan centered about a common stock portfolio will solve the annuitant's inflation problems. Theoretically, at least, as consumer prices rise the value of the portfolio will increase by a relatively simi-

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For a detailed explanation and illustration of the computations involved, see Day, *A Variable Annuity Is Not A "Security,"* 32 NOTRE DAME LAW. 642, 647-50 (1957).

[3] Another simplified example may serve to illustrate these principles. Assume that the annuitant has 1,000 "accumulation units," the current value of which is $120,000, in his account at the time of conversion. Further assume that the standard net annuity factor for a person his age is 9.6 per month per thousand dollar investment, and that the current value of an "annuity unit" is $125. Basically, the dollar amount that would be received monthly under a conventional annuity is first determined. The monthly payment would be 120 (thousands of dollars in current value) multiplied by 9.6 or $1,152. The number of "annuity units" is then determined by dividing the monthly payments under a standard annuity by the current value of an "annuity unit." Thus $1,152 will be divided by $125 and is found to be 9.216. Each monthly payment thereafter will be determined by multiplying 9.216 by the current value of an annuity unit. For a detailed explanation and complete illustration of the computations involved, see Day, *supra* note 2, at 650-53.

[4] See Johnson, *The Variable Annuity: What It Is and Why It Is Needed*, 1956 INS. L.J. 357, 358-61.

lar amount. As a result, the periodic payments to the annuitant would also increase in dollar amount, thus protecting his purchasing power during an inflationary period. Stress is placed on what the dollar will buy rather than on the number of dollars received. In theory, the annuitant would also be protected from the common hazards of equity investment. The annuitant will be paying premiums over a long period of time and will probably receive his annuity payments over another substantially long period. Therefore, the portfolio would be in a position of long-term buying and selling at varying prices rather than at any one market level. Likewise, under the theory of dollar-cost averaging, which comes into play whenever an equal number of dollars are invested at regular intervals in a particular commodity at fluctuating prices, the average cost per share in the fund should be lower than the average price over the buying period.[5] This below-average cost would be reflected by an increase in the annuitant's number of "accumulation units." The main difficulty in this area is that premium payments must be regular. Inability or unwillingness to make the premium payment when the price of common stock is low, which is very likely since the annuitant's income might also be depressed, would negate and might even reverse the dollar-cost averaging aspects of the program.

The natural objection to the variable annuity is that the variable annuitant would receive little, if any, income should there be a depression or serious fall in the price of common stocks. While it is true that the cost of living would also drop during such a period, past experience has shown that the value of common stocks drops much faster and deeper than does the cost of living.[6] It is conceivable that the value of an "annuity unit" would be practically nothing during a depression period. The annuitant, however, would still have to expend a minimum amount of money for the bare essentials of life. This is why the proponents of the variable annuity urge it only as a supplement to, rather than as a substitute for, the conventional annuity program. The Prudential Life Insurance Company, a leading proponent, has announced that in order to provide its policy holders with a retirement plan which will protect them in good times and in bad it will require, as an underwriting policy, that the annuitant allocate approximately fifty per cent of his total premium payments to conventional annuity policies.[7] In times of high prices the variable policy would provide high purchasing power, while this would be pro-

[5] See Morrissey, *Dispute Over the Variable Annuity*, Harv. Bus. Rev., Jan.-Feb. 1957, pp. 75, 78-79.

[6] Address by Frederic W. Ecker, President of the Metropolitan Life Ins. Co., at the Texas Life Convention, October 19, 1956.

[7] See Melnikoff, *Thinking Clearly About Variable Annuities*, 61 LIFE INS. COURANT 32, 34 (1956). An examination of the policies and sales literature of the three companies presently issuing variable annuities reveals that none of these companies impose balance requirements in the terms of their policies or as a matter of underwriting policy.

vided in times of low prices by the fixed guaranteed return of the conventional annuity. It is felt, therefore, that by complementing one plan with the other, the annuitant will fare better in terms of actual buying power than a person restricting his retirement planning to one particular vehicle. By such balancing it is contended that a certain standard of living, which presumably is the end the retired individual is desirous of attaining, will be assured for life.

Regulation—Federal or State?

When the variable annuity was first proposed there were many academic discussions as to the nature of the controls which might be placed upon their sale. The issues were joined late in 1955 when the Variable Annuity Life Insurance Company,[8] under license from the Insurance Commissioner of the District of Columbia, made the first public offering of a variable policy. The Securities and Exchange Commission,[9] after a hearing held at the urging of the National Association of Securities Dealers,[10] issued a pronouncement that the variable annuity is a security and subject to the registration requirements of the Securities Act of 1933.[11] It also ruled that VALIC, as issuer of the security, is subject to the provisons of the Investment Company Act of 1940.[12] VALIC refused to abide by the determination and continued issuing the contracts without compliance, contending that the variable annuity is an insurance contract and that VALIC is an insurance company and therefore exempt under the terms of the statutes themselves and under the terms of the McCarran-Ferguson Act.[13]

Shortly thereafter, the SEC and NASD (who joined in the action as a plaintiff intervenor) set the current legal controversy in motion by seeking an injunction restraining VALIC from selling or

[8] Hereinafter referred to as VALIC.

[9] Hereinafter referred to as SEC.

[10] Hereinafter referred to as NASD.

[11] The Securities Act of 1933 defines a security as: "Any note, . . . certificate of interest or participation in any profit-sharing agreement, . . . investment contract, . . . or, in general, any instrument commonly known as a security." 48 STAT. 74 (1933), 15 U.S.C. § 77b(I) (1952).

[12] The Investment Company Act of 1940 defines an investment company to be a company which "is engaged . . . in the business of investing, reinvesting, owning, holding or trading in securities. . . ." 54 STAT. 789, 797 (1940), 15 U.S.C. § 80a-3(a)(3) (1952).

[13] The Securities Act of 1933 specifically exempts from its provisions "any insurance or endowment policy or annuity contract . . . issued by a corporation subject to the supervision of the insurance commissioner . . . or any agency or officer performing like functions, of any state. . . ." 48 STAT. 76 (1933), 15 U.S.C. § 77(c)(a)(8) (1952). The Investment Company Act of 1940 specifically exempts from its provisions a ". . . company which is organized as an insurance company, whose primary . . . activity is the writing of insurance. . . ." 54 STAT. 798 (1940), 15 U.S.C. § 80a-3(a)(3) (1952). The McCarran Act exempts "the business of insurance" from federal regulation. 59 STAT. 33 (1945), 15 U.S.C. §§ 1011-15 (1952).

offering for sale its contracts until they were registered and until the firm had complied with the Investment Company Act.[14] The proceeding was based on the premise that the proper interpretation of the relevant statutes was the only question involved. VALIC, stressing the guaranteed mortality and many other insurance features of the contract, contended that the contract is one of insurance and therefore exempt from regulation under the Securities Act. The SEC, pointing to the fact that the units credited to the annuitant are in effect an interest in the company's common stock portfolio and in the gains and losses therefrom, urged that the contract was a security and subject to federal regulation under the Securities Act.

It is most likely that neither side is entirely correct, and that in reality the problem is legislative rather than judicial. Neither the contract in question nor any contract resembling it was in existence or contemplated at the time the statutes were enacted.[15] As can be readily seen from the pleadings of both sides, the contract is a hybrid which combines many of the features of both insurance and a security.[16] The contract as a unit is truly novel and will not fit exactly within the terms of any of the statutes involved.

The SEC decided to attempt to impose the federal securities regulations upon the sale of the variable annuity through the judicial process. In *SEC v. Variable Annuity Life Ins. Co. of America*,[17] the district court held that since VALIC was chartered as a life insurance company, and since it had denominated the contract an annuity, the federal government was precluded from exercising regulatory control over the sale of such contracts under the terms of the McCarran-Ferguson Act. The court of appeals affirmed, on the basis that if the insurance commissioner of a state considers the variable annuity business as coming under his supervision, it is the business of insurance and exempt from federal regulation.[18] The decision may have accomplished a desirable result. By refusing to issue the restraining order the courts have indirectly referred the problem to the legislature, a more appropriate forum for its solution. As a result of this decision the states which do permit or intend to permit the issuance of the variable annuity have been given time to investigate, draft and possibly enact new and comprehensive regulatory statutes specifically applicable to variable annuities. If the states take advantage of this opportunity it will then be squarely up to Congress whether to continue to abstain or to enter the field by enacting new regulatory legislation.

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[14] 54 STAT. 789 (1940), 15 U.S.C. § 80a (1952).

[15] The first variable annuity contracts were issued by the College Retirement Equities Fund in 1952. See Morrissey, *Dispute Over the Variable Annuity*, Harv. Bus. Rev., Jan.-Feb. 1957, pp. 75, 78-9.

[16] See Day, *A Variable Annuity Is an Annuity*, 1955 INS. L.J. 775.

[17] 155 F. Supp. 521 (D.D.C. 1957).

[18] SEC v. Variable Annuity Life Ins. Co. of America, 257 F.2d 201 (D.C. Cir. 1958), *cert. granted*, 27 U.S.L. WEEK 3111 (U.S. Oct. 13, 1958) (No. 237).

It is probable that the federal government has the power to subject the variable annuity to its regulation, whether it be a security or insurance.[19] It would appear therefore that the proper question is not which sovereignty can regulate the sale of these contracts but rather which body or bodies should regulate their sale. Exclusive regulation of these contracts under either the present securities laws or the present insurance laws would be inadequate. Most state insurance statutes were designed basically to preserve the solvency of the insurance companies in order to guarantee the fulfillment of their obligations.[20] The federal securities statutes have as their main purpose the protection of investors against imposition and fraud in selling tactics.[21] However, because of the hybrid nature of the variable annuity, a combination of the features of both these types of protection will be required in order to protect the consumer public adequately.

The main argument put forth for federal control is uniformity of regulation. In this way, it is argued, all variable annuitants will be afforded the same and supposedly complete protection. The NASD also points to its 1957 survey of the state insurance commissioners, which indicates that the commissioners are about evenly split on the question whether to permit the sale of variable annuities as insurance.[22] Therefore, the Association contends that confusion would prevail under state control and the sale of some of the policies will eventually fall under the SEC anyway.[23] But it is conceivable that many of the insurance commissioners were being overly cautious or overly strict in construing their present state statutes. Amendment of these statutes can certainly cure this defect.

Primary among the arguments in favor of state control is the avoidance of dual federal-state control over the insurance companies issuing both conventional life lines and the variable annuity. Such dual regulation would undoubtedly lead to many administrative difficulties and duplication of effort where federal and state regulations conflict.[24] The policy set forth in the McCarran-Ferguson Act must also be considered. The act clearly expresses the congressional belief that it is in the best interests of the nation that the federal government abstain from enacting statutes regulating the insurance industry and that such regulation should continue to be a state function

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[19] United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

[20] See Funston, *The Case Against Variable Annuities*, Dun's Review & Modern Industry, Oct. 1956, pp. 41, 42. However, some states have recognized the need for protection against misrepresentation and have added such protection to their insurance statutes. See, *e.g.*, N.Y. INS. LAW § 127.

[21] See Oklahoma-Texas Trust v. SEC, 100 F.2d 888, 891 (10th Cir. 1939).

[22] 1 CCH BLUE SKY L. REP. ¶ 4711.

[23] It is generally conceded that if the insurance commissioners classify the contract as not being insurance, the courts would hold it to be a security and subject it to regulation by the Securities and Exchange Commission.

[24] For a discussion of some of the areas in which a conflict might arise see Day, *A Variable Annuity Is an Annuity*, 1955 INS. L.J. 775, 784-85.

exclusively.[25] If the federal government enacts regulations affecting the variable annuity, it would certainly violate the spirit, if not the letter, of the act, assuming that the variable annuity is insurance.

Regulation of the Sale of Variable Annuities

No matter which jurisdiction eventually obtains control over the regulation of the issuance and sale of variable annuities, there are several important interests of the individual purchaser and of the public which should be protected. The enactment of comprehensive new statutes specifically relating to the variable annuities would be the ideal solution; supplementation of present insurance or securities codes the minimum.

Since the variable annuity salesman must possess a full understanding of the contract and be capable of conveying this understanding to the prospective purchaser, the regulations should require that all salesmen be licensed. Eligibility for the license should be grounded upon the passing of a special examination on the theory and explanation of the variable annuities. The statute should also provide for prior approval of all sales literature. In this way the regulatory agency could prevent the distribution of deceptive literature to the sales force or to the prospective purchaser. So also could the danger of misleading projections based on probable past performance be greatly averted, since the agency could judge whether it was made reasonably clear to the reader that such projections are hypothetical only and not predicted or guaranteed in the future.[26] Contract forms and applications should similarly be subject to prior approval, predicated upon the normal standards of fairness plus the inclusion of a clear statement of the essential features of the contract on the first page. An indication of the unguaranteed and variable nature of the contract should be required to appear in bold type at the head of the policy. If properly enforced and supplemented by the regulatory agency these prerequisites should preclude any public misunderstanding as to the nature of the contract.

Certain standards regulating the permissible investments of the fund should be established in order to protect the contract holder from extremely speculative investments. The National Association of

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[25] The McCarran-Ferguson Insurance Regulation Act, which was passed shortly after the decision in the *South-Eastern Underwriters* case, provides: "Congress . . . declares that the continued regulation and taxation by the several states of the business of insurance is in the public interest. . . ." 59 STAT. 33 (1945), 15 U.S.C. § 1011 (1952).

[26] One of the strongest arguments against those favoring the plan is that the public might be misguided as to the true nature of the contract. Most variable annuity sales literature issued up to this time contains charts illustrating the yield in past years of annuity holders and the yield that they theoretically would have received from a variable annuity under specified conditions.

Insurance Commissioners has recommended that such regulations include provisions, among others, limiting investment in the shares of any one corporation to three per cent of its total outstanding shares; prohibiting the purchase of shares not registered on a national securities exchange; prohibiting the purchase of shares in a corporation not meeting earning and dividend requirements; and prohibiting conflicts of interest between officers and directors of the insurer and the corporation whose stock is purchased.[27]

The issuers of such contracts should also be subject to the usual procedural provisions imposed upon insurance companies, such as annual examination, standardized reporting, service of process and limitation of expenses. In order to keep the annuitant informed, an annual report on the operations of the firm, in a form approved by the regulatory body, should be provided each annuitant. A statement of the annuitant's accumulation of units and their present value should also be provided at least annually.

A majority of the subcommittee of the NAIC has also suggested that the sale of the variable annuity be restricted to companies chartered for the sole purpose of issuing variable annuities.[28] It is contended by some that the use of separate corporate entities will serve to further reduce any possibility of public misunderstanding and protect the industry's reputation if the annuities give rise to unfavorable experiences. It seems improbable that the desired anonymity of the parent corporation can be attained in view of the fact that the sales force of the subsidiary would probably be quick to disclose the subsidiary's relation to the parent company. In addition, many other additional administrative and tax costs would be imposed if two separate entities are required. Since such expenses will eventually be passed on to the annuitant and no substantial benefits will apparently result, it would seem impractical and uneconomical to require two separate entities. The insurer guarantees only the mortality experience and administrative costs, as it does with its other lines. There are no guaranteed returns to endanger the investment of the other policy holders. Therefore, it would seem that a segregated variable annuity fund, within the company, with no preference to variable annuitants in a liquidation, would be as safe and a more practical and economical means of operation than the subsidiary theory. The NAIC has also proposed that regulatory statutes include a provision which would establish balance requirements that must be maintained throughout the life of the policy.[29] However, the state has fulfilled its obligation when it requires that the purchaser be fully and fairly advised of the nature and possible pitfalls of the plan. It is not the function of the state or of the law to prevent competent adult citizens

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[27] NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, REPORT OF SUBCOMMITTEE ON VARIABLE ANNUITIES (1955).
[28] *Ibid.*
[29] *Ibid.*

from spending their money in a foolish manner, if, indeed, the variable annuity could be considered a foolish investment. In addition, it is clear that it would be almost impossible to enforce or administer such a requirement. Aside from these considerations, it is almost certain that the insurers will voluntarily impose balance requirements as a matter of underwriting policy in order to ward off any possibility of mass cancellations during a depression period, as well as the consequent financial and good-will loss.[30]

The above recommended regulations, together with the existing general statutes and the common law, would seem to provide an adequate basis of protection for the variable annuity purchaser, the other policy holders of the issuing company and the public as a whole. If unforeseen problems arise, corrective legislation can be enacted as necessary.

Present Status of the Variable Annuity

There are presently three new corporations specifically chartered to issue variable annuities to the general public.[31] Two are organized and authorized to issue policies in the District of Columbia, one in Arkansas. In addition the insurance commissioners of West Virginia and Kentucky have approved the policies and authorized the sale of variable annuities in their states.[32]

Many other states, however, place restrictions on the total investment any insurer may make in common stocks.[33] In such states it will be necessary to enact new legislation permitting the purchase of large quantities of equity securities for the variable annuity program before such policies may be offered. Legislation may also be necessary if the variable annuity funds are to be segregated from an all-lines insurance company's general funds. Enabling legislation has been introduced in the states of Connecticut, Maryland, Massachusetts, New Hampshire, New Jersey, New York and Texas; however, none of these have been enacted as of this date.[34]

In New York, the home of the Metropolitan Life Insurance Company, one of the plan's strongest opponents, a bill permitting VALIC to sell individual variable annuity contracts was passed by both houses in 1954. However, it was vetoed by the governor after strong opposition from the State Commissioner of Insurance.[35] Simi-

30 See Note, *The Classification And Regulation Of Variable Annuities*, 42 MINN. L. REV. 1115, 1134-36 (1958).

31 Morrissey, *Dispute Over the Variable Annuity*, Harv. Bus. Rev., Jan.-Feb. 1957, pp. 75, 77 n.2.

32 See Brief for Appellee, p. 3, SEC v. Variable Annuity Life Ins. Co. of America, 257 F.2d 201 (D.C. Cir. 1958).

33 See, *e.g.*, N.Y. INS. LAW § 81(13); PA. STAT. ANN. tit. 40, § 506.1(g)(2) (Purdon 1954).

34 Schechter, *Variable Annuities—Boon or Bane?*, 1956 INS. L.J. 764, 767.

35 *Ibid.* Passage of enabling legislation in New York would appear to be a prerequisite to the issuance of the variable annuity by any of the major insur-

lar bills have been introduced over the past four years, but all have died in committee. It is interesting to note that the variable annuity had its birth in New York State. In 1952, the College Retirement Equities Fund[36] was established by a special act of the New York legislature[37] as an adjunct to the Teachers Insurance and Annuity Association.[38] Under this plan all members of TIAA are entitled to allocate up to fifty per cent of their total premium payments towards a type of policy which was the inspiration of today's variable annuity. Mr. George E. Johnson, Vice President and General Counsel of CREF, became convinced that such policies should be offered to the general public. He resigned from CREF and was elected president of VALIC upon its organization. Resigning from that position in 1956, he assumed his present position as President of Equity Annuity Life Insurance Company. Thus it is not surprising that the present day policies bear a resemblance to the early policies of CREF.

There is a great amount of controversy among the nation's insurance companies as to whether they should write a policy of this nature. The proponents of the policy, led by the Prudential Life Insurance Company, envision the sale of the variable annuity as the fulfillment of the industry's responsibility to the public to provide it with an adequate means of preparing for a secure retirement.[39] On the other hand, the opponents of the plan within the industry fear a misunderstanding of the policy's non-guarantee features and, in case of a depression, a resultant loss of the great confidence the public places in the industry's reputation for safety and certainty.[40] A less oft-mentioned objection is the possibility that the federal government may impose comprehensive federal regulations upon all or part of the insurance industry.[41] If the SEC is successful in the current litigation, or special variable annuity legislation is passed on a federal level, all firms choosing to issue the variable annuity will, to some extent, be subject to federal regulation. Such regulation would be voluntary since only those firms choosing to issue the contracts would

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ance companies. Section 90 of the N.Y. Insurance Law permits the insurance commissioner to deny a foreign corporation the right to conduct business in New York if their investments do not substantially meet the investment standards imposed upon domestic insurers. Because of the large amount of insurance written in New York, it appears doubtful that any company would issue variable annuities if their right to do business in New York would be jeopardized thereby.

[36] Hereinafter referred to as CREF.

[37] Laws of N.Y. 1952, c. 124.

[38] Hereinafter referred to as TIAA.

[39] Shanks, *Do Variable Annuities Meet the Need?*, Dun's Review & Modern Industry, Sept. 1956, p. 43.

[40] Ecker, *The Case Against Variable Annuities*, Dun's Review & Modern Industry, Oct. 1956, p. 41.

[41] *Id.* at 132.

be required to submit to it, but many feel that it would be a prelude to general federal regulation of the insurance industry.[42]

Tax Aspects

The treasury department has ruled that variable annuities are to be treated, for tax purposes, in much the same manner as the conventional annuity.[43] As a result the annuitant is not permitted a deduction for premiums paid and he need not recognize any undistributed income. When the time for the payout to the annuitant arrives, an annual exclusion ratio is computed by dividing the annuitant's total investment in the contract by his life expectancy as determined by the appropriate tables in the regulations.[44] To the extent that the payments in any one year exceed the annual exclusion factor, such payments will be included in the gross income of the recipient.[45] If in any one year the total amount received is less than the annual exclusion factor, the annuitant may elect, in any succeeding taxable year in which a payment is received, to recompute the exclusion factor. Such recomputation consists of dividing the deficiency by the remaining life expectancy of the beneficiary and adding the result to the prior annual exclusion factor.[46] All amounts not treated as annuity payments are considered as ordinary income.[47] The insurance company is not considered as a mere conduit, and therefore dividend credit, exclusion of government interest payments, and capital gains treatment are not available;[48] but the income recognized is eligible for the retirement income credit.[49] If the annuitant surrenders his contract before maturity, any amount received in excess of his investment in the contract is treated as ordinary income.[50] The tax attributable to the inclusion of such income in gross income for the taxable year shall not be greater than the aggregate of the tax that would have been attributable to such income had it been ratably included in the income of the annuitant in the current and the two immediately preceding taxable years.[51] No loss can be recognized unless the taxpayer establishes that he had purchased the annuity contract for profit in the first instance.[52] If the annuitant transfers his interest in the contract to a third party for value, he will be allowed capital gain

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[42] See Chellberg, *Regulation of Insurance—The State-Federal Controversy*, 7 DEPAUL L. REV. 25 (1957).

[43] Treas. Reg. § 1.172-2(b)(3) (1956).

[44] Treas. Reg. §§ 1.172-6, -9 (1956).

[45] INT. REV. CODE OF 1954, § 72(c).

[46] Treas. Reg. § 1.172-4(d)(3) (1956).

[47] INT. REV. CODE OF 1954, § 72(c)(1).

[48] See, INT. REV. CODE OF 1954, § 72(a).

[49] INT. REV. CODE OF 1954, § 37(c)(1).

[50] INT. REV. CODE OF 1954, § 72(e)(2)(b).

[51] INT. REV. CODE OF 1954, § 72(e)(3).

[52] INT. REV. CODE OF 1954, § 165(c)(2).

treatment.[53] In addition to the tax imposed upon the annuitant, the insurance company also is taxed at an effective rate of 7.8 per cent on its investment income.[54]

Many leaders in the securities industry have attacked the tax treatment afforded to the variable annuity on the ground that this treatment discriminates against both the investor in a mutual fund and the individual private investor.[55] Therefore, a comparison of the treatment afforded each of these media would appear appropriate. This comparison should not be made in terms of figures alone. It must be remembered that there is a basic difference between the three plans. The variable annuity contract is basically a vehicle designed for long-term retirement planning. Personal investments and investments in mutual funds provide a readily marketable investment. Since Congress has repeatedly manifested its realization of the social and economic needs of our retired citizens and has as a result granted them certain tax concessions,[56] it should not come as a surprise to find some slight benefits afforded to the variable annuitant.

The mutual fund investor is taxed at ordinary income rates in the taxable year of receipt on all dividend income,[57] subject to the 50-dollar dividend exclusion [58] and the four per cent dividend credit.[59] He is also taxed, but at capital gain rates, on all capital gain dividends.[60] If the mutual fund member is using his investment as a retirement program, the sale of a number of shares each year would parallel the variable annuitant's annual payments. Such sales are taxed at capital gain rates.[61] Upon a redemption of the shares by the fund, which is equivalent to a surrender by a variable annuitant, the fund member will receive capital gain or loss treatment.[62] The mutual fund itself is taxable only on undistributed investment or capital income and as a result pays little or no tax.[63]

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[53] INT. REV. CODE OF 1954, §§ 1201(b), 1221.

[54] INT. REV. CODE OF 1954, § 811. See Schechter, *Variable Annuities—Boon or Bane?*, 1956 INS. L.J. 764, 772.

[55] See, *e.g.*, Funston, The Case Against Variable Annuities, Dun's Review & Modern Industry, Oct. 1956, pp. 41, 135.

[56] See INT. REV. CODE OF 1954, §§ 37, 151(c), 213(a)(2). Persons sixty-five and over are permitted a double personal exemption [§ 151(c)], a retirement income credit [§ 37], and are not subject to the limitation on medical expenses [§ 213(a)(2)]. The social security system is the greatest recognition of the problem.

[57] INT. REV. CODE OF 1954, § 61(a)(7).

[58] INT. REV. CODE OF 1954, § 116(a). Section 116(c)(2) subjects the exclusion to the limitations imposed in § 854 when the distribution by the company does not substantially represent dividend income.

[59] INT. REV. CODE OF 1954, § 34(a). Section 34(d)(2) subjects the dividend credit to the limitations of § 854.

[60] INT. REV. CODE OF 1954, § 852(b)(3).

[61] INT. REV. CODE OF 1954, §§ 1201(b), 1221.

[62] INT. REV. CODE OF 1954, §§ 302(b), 1201(b), 1221.

[63] INT. REV. CODE OF 1954, § 852.

The individual investor would receive much the same tax treatment as the mutual fund member. He would be currently taxed on all distributed or distributable dividends and entitled to the dividend credit and exclusion.[64] He would receive capital gain treatment in the taxable year of transfer on all sales or exchanges of such investments.[65]

Thus, the only apparent advantage that is afforded to the variable annuitant is the non-recognition of his pro rata share of the insurer's current income. This gives the variable annuitant an advantage, since his taxable income during the payout period, when the gains realized over the years will be ultimately recognized, will conceivably be much less than during his working years. Therefore, as a result of the graduated tax rates, he should obtain the benefit of a low effective rate. However, this advantage may be offset by several factors. While the mutual fund member and individual investor may be taxed at a higher rate on currently distributed dividend income during their earning years, the tax rate on long-term capital gains never exceeds twenty-five per cent. If the mutual fund member intends to use his investments for retirement planning, he can achieve a low effective rate on any appreciation in value by annually cashing in or selling only the number of shares required to satisfy his current needs. In this way he may take advantage of the twenty-five per cent capital gain rate or his current ordinary income rate on any appreciations in value not previously recognized. In addition, if he has suffered a loss he will be permitted to offset it against any other capital income that he might have in these years.

Thus it would appear that, although the variable annuitant may fare somewhat better taxwise during the years in which he need not recognize any income, there appears that there may be little or no over-all advantage over individual investors or mutual fund members.

Conclusion

The variable annuity has been proposed as an answer to the retired individual's problem of consistently maintaining a desired standard of living after retirement. While it is almost certain that an adequate investment in variable annuities alone could achieve this result during an inflationary period, it seems that it will be necessary for the annuitant to balance his investment in variable annuities with a reasonably proportionate investment in stable or guaranteed investments in order to achieve protection throughout the entire economic cycle.

Currently, attempts are being made to bring the variable annuity under the Securities Act of 1933, and the issuing companies under

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[64] INT. REV. CODE OF 1954, §§ 34(a), 61(a), 116(a).
[65] INT. REV. CODE OF 1954, §§ 1201(b), 1221.

the Investment Company Act of 1940. The variable annuity was not in existence or even contemplated at the time that these statutes were enacted. Therefore, since the contract does not come within the exact definitions of the Securities Act, new legislation specifically adopted to the unique problems involved appears to be the proper solution, either on the state or federal level. It would seem beneficial if currently operative insurance companies are permitted to issue the variable annuity instead of requiring the formation of new and independent corporate entities. Finally, continuation of the present, somewhat favorable, tax treatment of the variable annuity seems proper and consistent with the legislature's sympathetic attitude towards the problems of our retired population.