

# NOLHGA JOURNAL

A PUBLICATION OF THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATIONS



NOLHGA's 13th Annual Meeting will be held Oct. 28-30 in Baltimore, just a few blocks from Oriole Park at Camden Yards, seen here from the third base line during the 1993 All Star Game. See pages 4 and 5 in this edition.

by Lisa Meyer

## IRC Sec. 72(s) Subject of Latest Battle in Tax War with IRS

By WILLIS B. HOWARD JR.  
Senior Vice President and Actuary  
NOLHGA

ny can prolong the period of uncertainty for policyholders.

The Spring NOLHGA Journal reported on the problems faced by Kentucky Central Life Insurance Company with respect to Internal Revenue Code Section 7702. In this edition, we review the implications to insolvent companies and guaranty associations of annuity contracts that fail IRC Section 72(s).

**Internal Revenue Code Section 72(s)** - Public law number 98-369 (also known as the Deficit Reduction Act of 1984) amended IRC § 72 for contracts issued after Jan. 18, 1985. Subsection (s) requires that if an annuity contract holder dies before the annuity starting date, the entire interest in the contract must be distributed within five years after his death. If death occurs on or after the annuity starting date, any remaining portion must be distributed at least as rapidly as under the method of distribution being used at the date of the contract holder's death. There are exceptions or special rules for amounts payable over the life of a designated beneficiary; a beneficiary who is a surviving spouse; annuity contracts that are part of qualified retirement plans, including IRAs; and tax sheltered annuities issued to school teachers. The law prevents indefinite deferral of tax; 72(s) limits deferral to one generation.

**Guaranty Association Coverage** - The tax status of a life insurance or annuity contract typically does not affect the guaranty associations' obligations to provide benefits, including cash surrender benefits under deferred annuities and payments under immediate annuities. However, if a contract loses its tax status, the complications for an insolvent compa-

Unless an annuity contract meets these requirements, it is not an annuity for federal tax purposes, including income, estate, or gift tax. Thus, the interest buildup within the contract is deemed to be taxable income received in the year the interest is credited to the contract.

## An Annuity by Any Other Name...

By JACK H. BLAINE  
President  
NOLHGA

The National Association of Insurance Commissioners has an Annuities Working Group, reporting to the Life Insurance (A) Committee, that is contem-



plating a uniform definition of "annuity." This has prompted much discussion as to how one would define the term to encompass its various uses and applications.

The Illinois Insurance Code, probably not dissimilar from codes of other states, provides that life insurance, as an authorized class of business, includes "insurance on the lives of persons and every insurance appertaining thereto or con-

nected therewith and granting, purchasing or disposing of annuities." Unlike Illinois, other state codes specifically define "annuity." The Virginia code says that it is an agreement "to make periodic payments in fixed dollar amounts pursuant to the terms of a contract for a stated period of time or for the life of the person or persons specified in the contract." Sounds pretty good. But the California Supreme Court held that "muni-GICs" issued by Executive Life Insurance Company and purchased by municipal bond trustees were "annuities" for purposes of inclusion in the same priority class with insurance policyholders, even though they had no connection with human life or lives.

The U.S. Supreme Court held in one of the major bank/insurance cases that annuities were not "insurance" and could,

See Blaine, Page 2

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President, ACLI  
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therefore, be sold by banks, notwithstanding the prohibition in the banking laws against the sale of insurance by banks. A letter to the editor in the May 14 edition of the Wall Street Journal takes up this argument (in a salvo against the life insurance industry for "trying to monopolize the annuity business"), by stating that the only risk that annuities protect against is the "exhaustion of assets." Actuaries might point out that there is something called a mortality risk associated with a guaranteed lifetime stream of payments.

The U.S. Supreme Court also held many years ago that annuities with values that vary to reflect performance of a pool of investments are "securities" and subject to the federal securities laws, as well as appropriate state insurance laws. Fixed annuities continue to be exempt from securities laws, but not without occasional challenges

For corporate tax purposes, life insurance companies are generally permitted to treat annuity reserves the same as life or health insurance reserves. Individual taxpayers are not taxed on the annual interest accrual on deferred annuities prior to surrender or annuitization, unless the contract fails the tests in Internal Revenue Code Section 72 (s), in which case they become something other than an "annuity" for tax treatment. (See article in this issue by Bill Howard.)

Finally, and closer to home, the NAIC Model Life and Health Insurance Guaranty Association Act distinguishes between allocated and unallocated annuities. A few state guaranty association laws do not have the current model act language making this distinction, and they continue to cover "annuities." The issue of what is an "annuity" continues to be a fertile field for litigation over guaranty association coverage. Last month, the Virginia Supreme Court held that pension GICs issued by insolvent Inter-American Insurance Company (Illinois) are not "annuities" under the above definition since they neither provide for periodic payments nor fix a dollar amount to be paid. There has been and continues to be litigation in other jurisdictions over the issue of GIC coverage, and whether they are "annuities" under state guaranty association law.

The model act does not define "annuity," but defines "unallocated annuity contract," and that too

has been the subject of litigation and controversy.

One might conclude, with good reason, that an "annuity" may or may not be a) a security; b) insurance; c) covered by a state guaranty association; or, d) given tax-deferred treatment. Therefore, the only certainty remaining is that annuities will continue to be the source of much litigation. Would that change with a uniform definition? My guess is that one can only answer that question with a question: For which purpose would the definition be applicable - taxes, regulation of how they are issued, securities laws or guaranty association coverage?

But then my neighbor swears that his daughter's dental problems constitute an annuity for the orthodontist. ▼

## Fifth Annual Legal Seminar Just Around the Corner

A distinguished group of guaranty association and industry leaders, attorneys and consultants, as well as Sam Zell, Chicago rehabilitation capitalist, will convene at NOLHGA's Fifth Annual Legal Seminar Aug. 19-20 in San Francisco. Chris Wilcox, Planning Committee chair, has designed a program of interest to all attendees.

On the agenda: legal issues affecting guaranty associations in the structuring of plans of operation; liquidation proceeding intervention; protecting communications; responsiveness to contract holders; advisory opinions regarding coverage; the aftermath of the *Fabe* case; emerging tax issues; implementation of the fledgling interstate compact system; bank loan documentation tips; issues raised by long rehabilitation periods; coverage when company players change; and protection from misappropriation or embezzlement. Updates on case law and NAIC activities relevant to state guaranty associations will also be presented.

The registration fee is \$275. For more information, please call Angela Franklin at 703/318-1186. ▼

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Life and Health Insurance  
Guaranty Associations

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Managing Editor Lisa M. Meyer



*ACLI President and Chief Executive Officer  
Gov. Carroll A. Campbell Jr.*

**Q** Do you see the industry’s attitude toward guaranty association disclosure evolving, perhaps to a point where the associations would advertise their coverage, much like banks trumpet their FDIC protection?

**A** Historically, ACLI has opposed companies advertising guaranty association coverage because of the potential for abuse in the solicitation and sales process. Agents and consumers alike would have less incentive to investigate the financial condition of an insurer if they believed no loss would result if a company became insolvent. Their decisions would be based primarily on the lowest premium offered or highest crediting rate, rather than on the greatest security provided.



Gov. Carroll A. Campbell Jr.

**Q** If insolvencies continue to decline, why have a NOLHGA?

**A** NOLHGA has provided an invaluable service over the past several years, particularly in managing the large, multistate insolvencies that have occurred. With each insolvency, the NOLHGA staff has dramatically enhanced its technical expertise and practical skills. NOLHGA resources should correspond to the needs of the marketplace. The difficulty arises in balancing the need to maintain staff expertise with the diminished incidence of insolvency.

**Q** Do you view banks’ expanded ability to sell insurance products as opening the door to underwriting those products? And will there be confusion among consumers that insurance products sold by banks have FDIC coverage?

**A** There is evidence of confusion on the part of the public over the safety of nonbanking products, such as annuities and mutual funds, sold by FDIC-insured institutions. While bank regulators have been taking steps to address this problem, clearly some degree of confusion persists. Unfortunately, this is as much a problem for our businesses as it is for bankers. If your name is on the product, and if purchasers’ expectations are not being met, the resulting ill will likely will be directed as much to the insurer as it is to the bank. The more sales that are channeled through banks, the more serious this problem becomes.

**Q** Will competition with banks and mutual funds force the industry to look for federal regulation, rather than state, to achieve a level regulatory playing field? And would this

lead to industry support of a federal, rather than state, guaranty system?

**A** I don’t believe that bank competition will intensify pressure for federal regulation of our business. How the structural framework of the financial services industry evolves may pose serious challenges to the viability of state regulation. Will national banks that sell insurance argue successfully that state insurance licensing laws, even those applied uniformly and in a nondiscriminatory manner, must be preempted? Will bank operating subsidiaries be empowered to underwrite insurance without state regulatory oversight? If restructuring of the financial services industry leads to the creation of a new regulatory body to oversee “financial services holding companies,” will the states have a place at the table?

**T**he institution of state insurance regulation is at a critical juncture. The states can strongly assert their role as the primary regulator of the insurance activities of all comers and be co-equal regulators with the Comptroller of the Currency, the SEC, and other federal regulators. Or will they find themselves relegated to second-class status? If the trend is toward the latter, I am certain that interest in federal regulation of our business will grow and will carry with it a desire to have a federal rather than a state guaranty system.

**Q** Are the assessment costs and expenses incurred in running the guaranty system a concern?

**A** Absolutely. Particularly since 1990, company balance sheets have taken a pounding from the costs associated with liquidations and rehabilitations. Most importantly, the life insurance industry is firmly committed to honoring the promises it makes to millions of policyholders, as it has done throughout its 232-year history. ▼

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*Carroll A. Campbell Jr. became president and chief executive officer of the American Council of Life Insurance in January, 1995. Prior to joining the organization, he completed eight years as governor of South Carolina. Gov. Campbell began his political career in 1970 when he was elected to the South Carolina House. A Republican, he served in the state Senate until he was elected in 1978 to his first of four terms as a U.S. Congressman. While in Congress, he was the only sitting member to serve on both the Appropriations and Ways and Means Committees. In 1986, he was elected governor and four years later was re-elected with 71 percent of the vote. Gov. Campbell was elected chairman of the National Governors Association in 1993. He received his degree in political science from American University.*

# NOLHGA Members Sail Smooth

Two insurance commissioners, the governor of Nebraska and a prominent political commentator are scheduled to speak at NOLHGA's 13th Annual Meeting, to be held Oct. 28-30 at the Renaissance Harborplace Hotel near Baltimore's Inner Harbor.

Robert G. Lange, director of insurance for the state of Nebraska, has been invited to participate in a panel discussion on interstate compacts during the Second General

Howard News Service. He is the writer/narrator of several PBS documentaries, including the award-winning "Summer of Judgment," a retrospective on Watergate.

Josephine W. Musser, commissioner of insurance for the state of Wisconsin, will address members and guests during the Second General Session. Ms. Musser is next in line to be president of the NAIC.

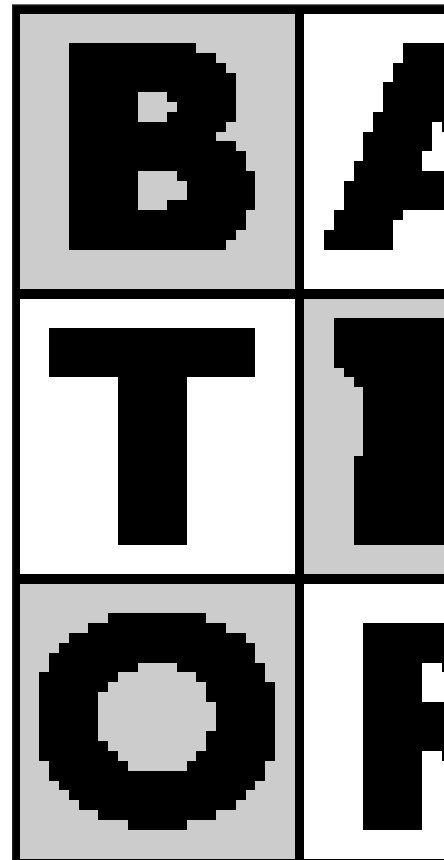
Gov. Ben Nelson will deliver "virtual" remarks during the

compacts, which may feature NOLHGA Vice Chairman James M. Jackson and Director Lange.

Dwight K. Bartlett III, commissioner of insurance for the state of Maryland, is scheduled to address members and guests on Oct. 29.

Case studies of several insolvencies are scheduled to be presented Oct. 29.

The Renaissance Harborplace Hotel, formerly the Stouffer, is



Smooth S



by Middleton Evans for the Baltimore Area Convention and Visitors Association

Baltimore's World Trade Center (tall building on right) is a charter member of the World Trade Center Association, a non-political network of 167 such centers. Past the harbor and the building is the Port of Baltimore, founded in 1706.

Session Oct. 30. Mr. Lange was appointed director in March, 1995, by Nebraska Gov. Ben Nelson.

Charlie McDowell, a political commentator, will speak at a noon luncheon on Oct. 29. Mr. McDowell, who has covered all national political conventions since 1952, also writes a column syndicated by Scripps-

First General Session on Oct. 29. Plans are underway to videotape the governor at his office in Nebraska for presentation at the meeting.

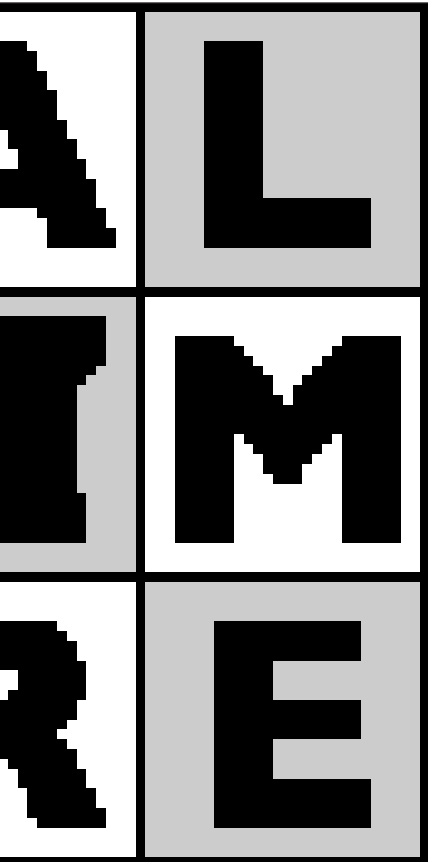
Under consideration are a panel presentation on guaranteed investment contracts, which may be moderated by a NOLHGA Board member, and a presentation on interstate

located at 202 East Pratt Street, Baltimore, MD 21202. The phone number is 410/547-1200. Downtown Baltimore is about 25 minutes by cab from Baltimore/Washington International Airport. ▼



Members and guests at NOLHGA's 13th Annual Meeting were docked at the Inner Harbor, on Oct. 29 beginning

# ly into Baltimore October 28-30



## Sailing...



by Holly L. Wilding

Meeting may board and visit the Bay Lady, sailing at 5:30 pm.



by Roger Miller for the Baltimore Area Convention and Visitors Association

The National Aquarium, located at Baltimore's Inner Harbor, is just a short walk from the Renaissance Harborplace Hotel. Harborplace was completed in 1980, a project of the late developer James W. Rouse, who also built New York City's South Street Seaport and Boston's Faneuil Hall.

### PRELIMINARY AGENDA

#### Sunday, Oct. 27

GRC Compensation Committee  
GRC Investment Committee

#### Monday, Oct. 28

8 - 11:30 am  
GRC Board of Directors

8 - 11:30 am  
NOLHGA Legal Committee

11:30 am - 5 pm  
Registration

11:45 am  
Luncheon  
NOLHGA and GRC Boards

1 - 4 pm  
NOLHGA Board of Directors

4:15 - 5:15 pm (pending)  
State Board Chairs Conference

6 - 7 pm  
Reception  
Members and Guests

#### Tuesday, Oct. 29

#### FIRST GENERAL SESSION

8:30 am  
Greeting - Lawrence F. Harr  
NOLHGA Chairman

Welcome - Gary C. Harriger  
Chairman, Maryland Life and Health  
Insurance Guaranty Corporation

Address - Jack H. Blaine  
NOLHGA President

Address - Dwight K. Bartlett III,  
Commissioner of Insurance, Maryland

Scheduled - Gov. Ben Nelson (R-Neb.)

Pending  
Panel on GICs

Noon - 1:30 pm  
Luncheon, Address by Charlie McDowell  
Members and Guests

1:30 - 2:30 pm  
Business Meeting

2:45 - 4:45 pm  
Case Studies

6 pm  
Reception - Baltimore Harbor

#### Wednesday, Oct. 30

7 am  
NOLHGA Board of Directors  
Organizational Meeting

#### SECOND GENERAL SESSION

9 am  
Address - Lawrence F. Harr  
Immediate Past Chairman,  
NOLHGA

Address - Josephine W. Musser  
Vice President, National  
Association of Insurance  
Commissioners and Superintendent  
of Insurance, State of Wisconsin

Pending  
Panel on Interstate Compacts

11 am  
Adjourn

Materials and invitations to NOLHGA's 13th Annual Meeting will be sent in August. For more information, please call NOLHGA at 703/481-5206.



*“The adverse reaction of contract holders and potential buyers of the block of business to 1099s makes a ‘closing agreement’ the preferred choice.”*

Sec. 72(s), from Page 1

Most companies quickly modified their policy forms and implemented administrative procedures to comply with § 72 (s), or so they thought. Yet National American Life Insurance Company, Corporate Life Insurance Company and other insolvent companies face potential IRS penalties related to their deferred annuity contracts. The receivers and guaranty associations discovered that the insolvent company’s adoption of business practices to distribute benefits upon the death of the contract holder as prescribed by § 72 (s) is not sufficient.

**Form Over Substance?** The IRS maintains that the contract language, not company practices, must mandate the distribution. Paragraph one of the section begins, “In General - A contract shall not be treated as an annuity contract for purposes of this title unless *it provides that...*” (emphasis added) and goes on to specify the distribution requirements.

**Consequences To The Estate** - If the contracts are not considered annuities for tax purposes, the receiver must report to the owner and the IRS the income each year on forms 1099. A company that does not furnish these forms for annuity contracts not in compliance with § 72 (s) may be subject to penalties of up to \$350,000 per year. A solvent company may have additional tax concerns: if the contracts are not annuities for tax purposes, would the company’s annuity reserves be treated as reserves for tax purposes?

**Consequences To The Guaranty Associations** - An assuming reinsurer may be understandably reluctant to assume policies out of compliance with § 72 (s) that were issued by an insolvent insurance company. Had their contracts been in compliance, the annuity contract holders of National American would have been moved in near record time by the guaranty associations to a solid company.

**What Is The Cure?** The receiver may bring the contracts into compliance by filing with the insurance departments in each state where the contract holders live, and distributing to each contract holder an endorsement that contains the § 72 (s) rules for distribution of proceeds upon death of the contract holder. To avoid the large IRS penalties, the receiver may send 1099s to policyholders for out of compliance years or negotiate a “closing agreement” with the IRS. The adverse reaction of contract holders and potential buyers of the block of business to 1099s makes a closing agreement the preferred choice. The agreement may include a payment by the receiver of some fraction of a “toll charge,” the tax that would have been due from the contract holder during the time the contracts were out of compliance. For a solvent company, the “fraction” might be 100 percent. In exchange for the toll charge, the IRS agrees that the endorsed contracts were in compliance from the issue.

**In Conclusion** - The issues fac-

ing the guaranty associations and receivers for annuity contracts that fail § 72 (s) are the same as those arising from life insurance policies that fail § 7702:

- Would IRS tax claims against annuity contract holders reduce estate assets available for distribution to policyholders and guaranty associations?
- Would IRS penalties assessed against the insolvent company’s estate be entitled to a priority equal to or greater than policyholder priority, thereby diluting policyholder and guaranty association claims?
- Would a toll charge payment by a liquidator be challenged under the state priority statute?

NOLHGA’s tax committee, composed of representatives of each task force with known 7702 or 72 (s) problems, and each of the individual task forces are making every effort to assist the liquidators in resolving these issues so that the holders of failed annuity or life insurance contracts in insolvent companies can be taken care of expeditiously. ▼

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*Joseph F. McKeever of Davis & Harman in Washington, D.C., and Richard T. Freije and Kevin P. Griffith of Baker & Daniels in Indianapolis contributed to this article.*



BETTY J. OLSSON, EXECUTIVE DIRECTOR  
*Idaho Life and Health Insurance Guaranty Association*

Mrs. Olsson has been administrator of the Idaho guaranty association since 1984. Prior to joining the association, she was associated with Continental Life & Accident, an Idaho company. She had previously worked for six years for a Phoenix company which merged with Continental. Mrs. Olsson is a graduate of the Salvation Army College. She also attended Phoenix College and Boise State College and is a Fellow of the Life Management Institute.

PHILLIP A. HAMMOND, ADMINISTRATOR  
*Indiana Life and Health Insurance Guaranty Association*

Mr. Hammond has been executive director for both the property/casualty and life/health insurance guaranty associations since June, 1990. Beginning in 1963, he spent 25 years with American United Life Insurance Company in Indianapolis, the last 15 of which as regional vice president, reinsurance sales. Mr. Hammond, a graduate of Indiana University, holds the designation of chartered life underwriter and is licensed by the National Association of Securities Dealers. He volunteers for the United Way, the Salvation Army, and other community organizations.



LUTHER L. HILL JR., ESQ., ADMINISTRATOR  
*Iowa Life and Health Insurance Guaranty Association*

Mr. Hill has been counsel and administrator for the Iowa guaranty association since its creation in 1987. He is also of counsel to the law firm of Nyemaster, Goode, McLaughlin, Voights, West, Hansell & O'Brien. Mr. Hill was previously employed by Equitable Life from 1969-1987, becoming executive vice president of Equitable of Iowa Companies in 1977. As a U.S. Army captain from 1942-1946, he received a Bronze Star for service in the European Theater. A graduate of Harvard law school, Mr. Hill was a law clerk from 1950-1951 for U.S. Supreme Court Justice Hugo Black.

LINDA BECKER, ADMINISTRATOR  
*Kansas Life and Health Insurance Guaranty Association*

Ms. Becker has been the administrator of the Kansas guaranty association since January, 1995. For five years prior to joining the association, she was a financial analyst and insurance company examiner in the Financial Surveillance Division of the Kansas Insurance Department. Ms. Becker worked in the banking industry before becoming an insurance regulator. She is a certified financial examiner and a graduate of Emporia State University in Emporia, Kan.



THOMAS E. PETERSON, EXECUTIVE DIRECTOR  
*Kentucky Life and Health Insurance Guaranty Association*

Mr. Peterson has been executive director of the Kentucky guaranty association since August, 1992. He previously served as special deputy commissioner and special deputy liquidator on two Kentucky insurance company insolvencies. Mr. Peterson spent 18 years in the insurance industry as an officer of a small mutual life insurance company. He has served on many civic and charitable boards and advisory groups and was once the mayor of Stathmoor Village, a small city in Jefferson County, Ken.

# CALENDAR



## MEMBERS' PARTICIPATION COUNCIL

June 24-26	Peabody Hotel, Memphis
Sept. 9-11	Westin Hotel, Indianapolis
Dec. 3-5	Hyatt Regency, Denver

## BOARD OF DIRECTORS

Aug. 7	Marriott Lincolnshire, Chicago
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## FOURTH ANNUAL LEGAL SEMINAR

Aug. 19-20	Stouffer Renaissance Stanford Court Hotel, San Francisco
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## ANNUAL MEETING

Oct. 28-30	Renaissance Harborplace Hotel, Baltimore
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*Visit the NOLHGANet home page at <http://www.nolhga.com>. Call Beth Watson at 703/318-1162 for more information.*



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