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CURRENT INCOME-TAX PROBLEMS

I. LEGISLATION

Several new laws were passed by Congress this year which affect life insurance companies. I will attempt to review some of the provisions of these bills at this time.

A. The Revenue Act of 1962 (H.R. 10650)

This bill was proposed by the Administration and passed by the Congress after months of study in the Ways and Means Committee and the Senate Finance Committee.

There are several provisions which are of particular interest to the life insurance companies, as follows:

1. *The reporting provision.*—The bill as passed by the House would have required life insurance companies to withhold on certain payments made to taxpayers, irrespective of the amount. It would have been exceedingly expensive, particularly in connection with small items such as interest on dividends left on deposit. One of the pleas made to the House was that interest would be withheld for many persons who did not pay taxes. In order to solve this problem, the House provided that policyholders might file exemption certificates in which case the company would not be required to withhold. This would have made the work of the companies still more expensive, since it could not have been handled completely automatically, but exemption certificates would have had to be processed. A person might change his status from year to year, of course, filing an exemption certificate for one year but being required to pay a tax in the following year.

The final law was amended to eliminate this withholding tax provision, but in its place there is a reporting provision under which life insurance companies will be required to report all payments of interest and stockholder dividends made for amounts in excess of $10.00. This will, of course, be expensive, but it is probably better than the withholding tax, particularly as passed by the House.

2. *Foreign subsidiaries.*—Another part of the law taxes parent companies with foreign subsidiaries. There has been great abuse by some American corporations which organized foreign subsidiaries in tax-haven countries. By either buying or selling through these subsidiaries, the United States corporations have been able to transfer a considerable amount of normal taxable income in the United States to the foreign subsidiaries. The earnings of these foreign subsidiaries have then been loaned

to their United States parents at very low rates of interest or perhaps used to build factories for their parents which were leased at very low rentals. Thus the United States corporations had the use of their earnings but avoided paying taxes on them. It has been contended that a few life insurance companies, largely credit companies, have, through the vehicle of reinsurance, transferred profits from the United States corporations to tax-haven subsidiaries. In an effort to cure this abuse, the Treasury proposed a tax on the United States parents based on the income of their foreign subsidiaries. Because of the multiplicity of different types of corporations, it was necessary to write this provision in broad language. While the Treasury attempted to be fair, there are many references such as "appropriate deductions" which will be left to interpretation and probable regulation.

The most serious difficulty occurred, however, in connection with foreign subsidiaries which operate in the United States and pay a tax on their United States business. In order to catch the tax-avoiders, the original bill provided that a tax would be levied against the parent companies on all the income of foreign subsidiaries. Thus the United States income of these subsidiaries would be taxed twice. The final bill was amended to cure this unintended situation, but United States companies owning foreign subsidiaries will find they are not in as advantageous a situation as in the past.

3. *Expense accounts.*—Expense accounts will be handled much more rigorously than in the past. The original version of the law was very tight in this respect but was liberalized somewhat in the Senate Finance Committee. Irrespective of the actual provisions of the law, there is every indication that expense accounts will be scrutinized more carefully and disallowed unless there is sufficient evidence to show the expenses were incurred in the furtherance of business for the employer.

4. *Tax credits.*—The 7 per cent investment credit provision will make it more attractive for life insurance companies to invest in railroad equipment, store fixtures, and other similar items other than real property. This would appear to be quite advantageous, and the companies interested in this form of investment are urged to study this section of the law carefully.

B. Company-sponsored Bill (H.R. 8952)

The Life Insurance Association of America and the American Life Convention have worked with some of the life insurance companies in sponsoring a bill which attempts to correct several provisions in the 1959 tax act which were not given thorough consideration at the time the law was passed.

These may be summarized as follows:

1. *Variable annuities.*—The variable annuity companies succeeded in obtaining temporary relief in the 1959 act in a special provision which will expire in 1963. It is, therefore, necessary to extend this provision and this is included in the new law.

2. *Separate accounts.*—A number of states have recently enacted legislation providing that life insurance companies may operate separate accounts. These laws differ considerably, some of them being designed primarily to permit the issuance of variable annuities, while others—such as New York, Connecticut, and Massachusetts—are limited to the issuance of qualified pension plans. The object of the amendments to the tax law is to enable the companies better to reflect the experience of the separate accounts in the cost of qualified pension plans without unduly harsh tax consequences to the companies. The amendment would do four things: (*a*) It would exclude from tax the current earnings on assets held in segregated accounts, less any amounts retained by the company in excess of allowable expenses. (*b*) Capital gains and losses passed on to policyholders in such accounts would also be excluded from tax. (*c*) In Phase II, capital appreciation or depreciation reflected in policyholder reserves would not be considered an increase or decrease in reserves. (*d*) In Phase I, a completely separate computation of taxable investment income attributable to segregated account business—including a separate company's share—would be provided.

3. *Order of priorities of deduction in Section 809(f)(2).*—There is a defect in the 1959 act in the order in which the non-par deduction, the group deduction, and policyholders' dividend deduction must be taken. Under the law as enacted in 1959, a company must first take its group deduction, then take its nonpar deduction, and finally deduct its dividends to policyholders, including group experience rating refunds. Since there is a limit on the dividend item, but not on the other two deductions, and since the group and nonpar deductions affect Phase III, a company sometimes found itself worse off than if there had been no deduction. Changing the order of the deductions permits a company to avoid taking some or all the group and nonpar deductions in event such deductions would reduce Phase I income by more than $250,000.

4. *Alternate method of taxing—capital gains.*—The tax on long-term capital gains, which is sometimes called Phase IV, requires that companies must pay a tax on capital gains even though they have operating losses. Thus a new company which is still suffering losses from operations might be required to pay a tax on its capital gains. It has been suggested that long-term capital gains may be offset against ordinary losses in such cases.

5. *Eight-year carry-forward provision.*—The 1959 tax law provides for a five-year carry-forward of losses except that new life insurance companies not controlled by corporations are granted an eight-year carry-forward. All new companies need carry-forward provisions of eight years or longer, and there is no logical reason for exceptions. The new law provides that new life insurance companies owned by fire and casualty companies will be granted the eight-year carry-forward provision. This partially corrects an injustice, but I believe there is no good reason not to allow also the eight-year carry-forward provision to life insurance companies owned by other life insurance companies or by holding companies.

6. *Spin-off of stock of subsidiary companies.*—Senator Russell Long added an amendment to H.R. 8952 on the Senate floor which was designed to permit Connecticut General Life Insurance Company to spin off its Aetna Insurance Company stock. In December, 1961, Connecticut General proposed to acquire controlling stock interest in Aetna Insurance Company through an exchange of its stock for outstanding stock of Aetna Insurance Company. At that time it advised its stockholders of "a peculiarity in the Life Insurance Company Income Tax Act of 1959, which burdens any life insurance company owning a subsidiary by imposing a tax beyond normal standards," and it also told its stockholders at the time that legislation would be proposed to correct this inequity but that there could be no assurance that Congress would pass remedial legislation. Connecticut General acquired substantially all the stock of Aetna Insurance Company, resulting in an increase in its assets of about $120 million, with about $3 million in annual income from dividends. The effect was an increase of about $1,800,000 in Connecticut General's tax, or 60 per cent of dividend income. Even without any dividend income, the tax would have been about $1,500,000.

Connecticut General claimed that the tax was unreasonable and relief should be afforded. It suggested a tax at the regular corporate rate on 15 per cent of dividend income or, in the alternative, it suggested the elimination of "assets" represented by the Aetna Insurance Company stock in the computation of the tax. The Treasury refused the type of relief it sought but offered an alternate solution which permits the spin-off of the stock without tax consequences to either the company or the stockholders.

C. 2 Per Cent of Health Premiums (H.R. 12180)

Senator Kerr introduced an amendment which will provide for a 2 per cent deduction of premium for individual health insurance. This is similar to the deduction provided for group life and health insurance.

II. LITIGATION

There are at least two major points which seem destined for early litigation. These are as follows:

A. Tax-exempt Interest

This item received scant attention in the House, which was concerned with the general outline of the tax bill. However, it became one of the substantial issues on the Senate side. The Treasury contended that, since the companies received a deduction for interest earned on reserves, there would be a double deduction if all interest on tax-exempt bonds was permitted as a deduction. Therefore, the Treasury said the deduction for interest on reserves should be reduced in proportion to the amount of interest received from state and municipal bonds. The Senate followed the House bill in substance though not in form on this prorationing concept but inserted an amendment to the general effect that, if any part of the interest from state or municipal bonds was taxed under the formula, the formula should be adjusted to avoid such a tax. It is the proper interpretation of the intent of Congress in inserting this so-called exception sentence that forms the foundation of the tax-exempt litigation. About seventy companies have banded together to test the matter in court. It is their contention that the presence of tax-exempt interest in an insurance company's tax return should have no effect on the tax which a company pays.

The chairman of their action group has stated that he feels tax-exempt interest should not, on one hand, give a company a double deduction and should not, on the other, cause a company's tax to increase because of the presence of such interest in its gross investment income. The matter is being tested by the Atlas Life Insurance Company in Tulsa, Oklahoma. If the suit is successful, the total amount of refunds, with accumulative effect of the passage of years, will be substantial. Some companies fear a win in this action will bring on retaliation by the Treasury Department, causing it to suggest an entirely different basis of taxation.

If this lawsuit is won, there presumably will be a scramble for the limited amount of bonds available, and, other market factors being equal, there should be a net decrease in the yield rates obtainable.

B. Definition of Assets

As soon as the new bill was passed, questions began to be raised as to what constituted "assets used in the course of business." A number of companies have contended that items such as deferred and uncollected premiums, agents' debit balances, and similar assets should not be included in the company's assets in determining the current earnings rate.

The Internal Revenue Service has apparently taken the attitude that only the home-office building, furniture, and fixtures used by the company are included in the definition of assets used in the course of business. This question may be litigated by some of the companies that are interested in it.

Again, there is a difference of opinion. Some of the companies are afraid that, if deferred and uncollected premiums are excluded from assets, the Treasury may take the position that such items should then be deducted from reserves. The elimination of deferred and uncollected premiums from both assets and reserves would result in an increase in taxes for most companies. Consequently, several large companies have taken the position that they would support the Treasury in this matter, fearing that, if the Treasury's present position was upset, it might try to deduct deferred and uncollected premiums from reserves.

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