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FEDERAL INCOME TAX ON LIFE INSURANCE COMPANIES

A. What impact has the new tax law had on
   (i) the investment policies of individual companies,
   (ii) company accounting systems and procedures,
   (iii) actuarial bases for new contracts?
B. What principles have been followed in allocating the federal income tax among the annual statement lines of business? How is the assessment to a line of business with a loss from operations established? Is the tax on the interest on surplus allocated on some general basis or with regard to the relative contributions of the different lines to the accumulated surplus?
C. How is the tax taken into account in asset share tests and dividend scale determinations?

Philadelphia Regional Meeting

MR. GILBERT W. HART: At the Mutual of New York we have found it advisable with the advent of the new tax law to establish a separate tax division. Previously the comptroller's department prepared our tax return under instructions from the law department with help from the actuarial department and other departments. Our tax work is now centralized in one division which has as a nucleus an accountant, an actuary and a lawyer. This division is charged not only with federal income tax but all Company taxes, although the federal income tax return is the only one which it has responsibility for preparing. The primary purpose for establishing the division was to have one central unit of people to whom tax questions could be directed and through whom a project could be carried to completion.

MR. ROBERT H. JORDAN: The Life Insurance Company of North America has developed substantial tax losses for four years and undoubtedly will for a few more years. To minimize tax losses we want to set up the smallest possible reserves for several years. In later years we will want to hold reserves on the net level premium basis to minimize tax gains. We are, therefore, adopting a special reserve basis producing CRVM reserves in about the first ten years grading to net level after the twentieth year.

We plan to write our policy forms so we can change our reserve method without changing the form. We will change to the net level premium reserve method when tax considerations indicate it to be appropriate.

MR. JOHN C. FRASER: It does not appear that the effect of the new tax law on our investment policy in the New York Life has been too great. While the tax aspects of investment decisions are probably more important than under previous laws, they are by no means the only consideration in investment policy. In general, the higher tax rates under the new law have affected most investments fairly uniformly.

We do not look unfavorably on investment real estate transactions as some others do. We have found where the initial lease is relatively long, as most of ours are, the tax advantages of accelerated depreciation generally outweigh the disadvantages of not being able to take full depreciation. Some illustrations I have seen have failed to consider the effect of interest discount and consequently may overlook this point.

In the accounting area, the new tax law has already had considerable impact on our operations. We have made a complete revision in our investment accounting procedures to establish the tax basis of capital gains and losses. We are also revising our deposit fund accounting in connection with the Phase 1 interest paid deduction and have set up new procedures for dealing with the Canadian dollar components of our various tax figures.

As far as the actuarial basis of new contracts is concerned, the decision as to the guaranteed interest basis for new issues should still be based on considerations of company policy regarding net payment and net cost position and not upon tax considerations. After all, the lower tax resulting from the use of a higher interest rate is achieved largely by having lower investment income on the lower funds accumulated. Of course, the new tax law may have altered the balance somewhat in favor of lower fund accumulations because of the very high tax rate applicable to excess earnings.

With respect to allocation of taxes, we are a Phase 1 company and make all our allocations of tax to the lines of business and to dividend classes by actually carrying out the Phase 1 tax calculation line by line and class by class on an exact basis. When over-all company interest rates are used, the sum of these items will equal the total company figures.

MR. JOHN S. FRY: At the Continental Assurance we write ordinary, group life, pension business, and both group and individual accident and sickness insurance. Except for group accident and sickness, these coverages are both participating and nonparticipating. Our federal income tax is first allocated between the participating and nonparticipating departments as for any income or expense item. Within each department we make a division next among major and then secondary lines.

Basically, in allocating federal income tax we calculate tax basis in departments and lines as if they are separate companies, ignoring the small company deduction and the lower tax rate on the first $25,000 of the taxable income. Two major problems must be solved in any allocation method. The first of these is the determination of the surplus applicable to each line. The second is to embody in the allocation method the limitation on the amount of special deductions.

For the determination of surplus in the participating department we developed funds by major line—ordinary, group, and individual accident and sickness. Today we are able to allocate investment income within the participating department by mean funds.

Tax on surplus earnings of the nonparticipating department was handled quite differently. There is a problem in that surplus exists which is really unallocable. There are capital and contributed surplus. Our solution was to bring into being the Corporate Account. By definition it is capital, contributed surplus, surplus of other nonparticipating lines, and the shareholders' portion of the Security Valuation Reserve. Nonparticipating investment income is allocated to lines by mean funds, but for the usual statement lines mean funds equal mean liabilities.

The method of recognizing the limit on special deductions is based on one principle when allocation is between departments and on another, somewhat conflicting one when between lines. The participating, nonparticipating split seeks to achieve equitable development of funds. The departmental split tries to recognize the direct source of a deduction.

Our tax base has always been Phase 1 for the company as a whole, but Phase 2 for the nonparticipating department. The effect is that fewer special participating deductions are allowed in the separate company calculations than for the total company, though for the total company some are wasted. This reduction in tax due to the ability to utilize more dividends is shared between the two departments in proportion to the tax they would have paid if separate companies.

In contrast, the allocation of the nonparticipating department tax by lines credits each line fully with its deductions. No deductions are wasted since the total tax base is Phase 2. The same spirit is applied in allocating participating tax by major line, although some modification is required since participating department's tax base is Phase 1 less $250,000, which means deductions are wasted.

MR. HARRY D. GARBER: The method used by the Equitable Society in allocating the federal income tax charge among lines of business consists of the following steps:

1. The taxable investment income and the gains from operations are determined for each line of business, these calculations reflecting, to the extent practicable, the adjustments to investment earnings, assets, expenses, etc., required in the federal income tax return. Current and average earnings rates are determined separately for each line and are used in obtaining taxable investment income. In the gains from operations, full credit is allowed for dividends to policyholders and for the special deductions on nonparticipating and group insurance policies.
2. An initial tax base is determined for each line of business. If the gain from operations for the line is greater than the taxable investment income, the initial tax base is the mean of these two quantities. If the gain from operations is smaller than the taxable investment income, and the line has deductions which are limited under the tax law (*i.e.*, dividends to policyholders, etc.), the initial tax base is the taxable investment income. If the gain from operations before the deductions for dividends, etc., is smaller than the taxable investment income, the initial tax base is the gain from operations determined without these deductions, but not less than zero.
3. The sum of the initial tax bases for the several lines is compared with the total taxable income. If this sum is greater than the company's taxable income, the difference is credited to those lines in which the initial tax base reflected less than full credit for dividends, etc., or for a loss from operations before dividends.
4. If the sum of the initial tax bases for the individual lines is less than the company's total taxable income, the results for the individual lines are prorated upward to equal this amount.
5. The tax is computed by applying the tax rate to the tax base for each line, as adjusted, and subtracting the line's share of the foreign tax credits.

The basic principle that underlies our method of assessing the tax charge among lines of business is to charge each line with the tax it would have incurred as a separate company, adjusted to make the total allocated amounts equal to the actual tax paid. Under our allocation method the tax with respect to interest earnings on surplus is charged, in effect, to the lines in proportion to their relative contributions over the years to the accumulated surplus. We do not plan to employ refinements such as an "operations loss carry-over" for lines which have not received full credit under our allocation technique for losses from operations, but we may make adjustments if the earnings from such a line improve to such an extent that it is subsequently placed in a Phase 2 position.

In our accumulation fund or asset share tests of ordinary insurance premium, dividend and nonforfeiture value scales we take into account in the interest factor that portion of the federal income tax charge associated with the investment income. We do not take into account the difference between this charge and the actual tax amount allocated to the line, because it is difficult to associate this portion of the tax with a particular plan, issue age, etc. Further, this element of the tax charge is affected by the dividend action and we do not believe it should be considered as a source of earnings to be taken into account in setting the dividend scale.

For the group annuity line of business, the federal income tax is taken into account by crediting to the "experience funds" for the individual contracts the rate of interest earned after deduction of the entire federal income tax charge to the line. For this line, the charge or credit associated with gains from operations is much less significant, and therefore, in order to have an allocation by contract of this entire expense item, the full tax charge is reflected in the rate of interest credited.

MR. B. FRANKLIN BLAIR: In considering allocation of tax on the interest on surplus it seems clear that this tax should be allocated in the same manner as the interest itself. Thus no new problem is presented by the 1959 tax act in regard to allocating this portion of the tax.

The following remarks on the way tax is taken into account in asset share tests and dividend scale determinations are made with respect to a company having, and expecting to continue to have, a tax basis equal to taxable investment income less $250,000. Assuming that any differences in tax base among different lines considered individually are to be ignored and that we are dealing with the ordinary life lines alone, there is a question whether differences in reserve interest rates should be taken into consideration in determining the after-tax rate to use in accumulating asset shares. I feel it is reasonable to assume that there is no correlation between surplus ratios and reserve interest rates. Under this assumption, if the current average earning rate exceeds the reserve interest rate the net effect is that the interest rate earned after tax is increased in a typical company by about 0.1% for each 0.5% increase in the reserve interest rate. It would seem appropriate to take a differential of this magnitude into consideration in determining the interest rate to be used in asset shares and in choosing the actuarial bases for new contracts.

MR. PETER W. PLUMLEY: The Travelers uses an asset share method in calculating individual life premiums. Under previous tax laws we were able to allow for federal income taxes by a simple reduction in the earned interest rate. With the new tax law, however, we assess against each policy the tax which would result if that policy were the only one in force.

We make two modifications, however. First, we charge the interest earned on the surplus held for the protection of policyholders. We assume that each policy requires a certain amount of surplus which is a percentage of the reserve held. The tax on the interest on this amount is assessed in the asset share calculation. No credit is given in the interest itself, however, since it belongs to the stockholders. We could have charged tax on surplus interest in proportion to the contribution each line has made to surplus, but we believe this approach would, in effect, subsidize the lines of business which have not contributed much to surplus at the expense of the more profitable lines.

We also make an allowance for Phase 3 taxes. Although at our present rate of growth it would be many years before such taxes are paid, we have allowed for the possible erosion of our markets because of expansion of the federal Social Security System by assuming the amounts paid into the policyholders' surplus account will be taxed under Phase 3 an arbitrary number of years from now.

These allowances for the tax on surplus funds and the Phase 3 taxes increase the minimum ordinary life premium at age 30 by about $.50. For a 25 year endowment policy the increase is about $1.00.

Kansas City Regional Meeting

MR. JOHN C. FRASER repeated the discussion on this subject which he had given at the Philadelphia regional meeting.

MR. JOHN S. FRY repeated the discussion which he had given at that meeting.

MR. WILLIAM J. NOVEMBER: We are in the early stages of our 1958 CSO planning but have spent a little time studying the tax effect of the interest assumption within certain ranges. The impact appears to be rather modest, and our conclusion is that there are other considerations of more importance. These other considerations are often immediate in their effect, whereas the tax on a new line of policies is going to be gradual and spread over a long period of years.

Tied in with this question is the amount of surplus that will be accumulated in association with different reserve interest rates. Since no one can be sure what that will be, a tax impact estimate made today is not likely to be too firm.

In the annuities line there are other problems. Companies which have been using lower interest rates to allow for mortality improvement will probably find it to their advantage tax-wise to raise the interest rate to a realistic level and to take care of mortality improvement by other means.