TRANSACTIONS OF SOCIETY OF ACTUARIES
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DIGEST OF DISCUSSION AT CONCURRENT SESSIONS

UNITED STATES FEDERAL INCOME TAX

I. Status of current audits and controversies, including issues being raised involving the definition and computation of the following:
   A. Life insurance reserves.
   B. Asset values.
   C. Allowable deductions for investment expenses and gain and loss items.
II. Taxation of separate accounts.
III. Problems in allocation of tax.

New York Regional Meeting

MR. WILLIAM B. HARMAN, JR.:* I have made an analysis of twenty-seven issues which have been decided or are in litigation in cases tried under the 1959 Company Tax Act. The companies involved and the status of their cases are as follows:

1. Franklin Life (years 1958–62, inclusive): U.S. Court of Appeals, 7th Circuit, No. 16580, decided July 11, 1968.
2. Jefferson Standard (years 1958–59, inclusive): U.S. Court of Appeals, 4th Circuit, No. 12326, decided March 13, 1969.
3. Pacific Mutual (years 1958–61, inclusive): U.S. Tax Court, 48 T.C., No. 13.
4. Western National (years 1958–61, inclusive): U.S. Tax Court, 51 T.C., No. 81; 50 T.C., No. 285.
5. Occidental Life of California (years 1958–61, inclusive): U.S. District Court, Central District, California; decision pending.

The twenty-seven issues involved and the decisions (and, in the case of Occidental, the arguments presented) appear below in outline form. The issues are arranged according to the sequence of applicable sections in the tax law.

SUBPART A—DEFINITION: TAX IMPOSED

Section 801(b): Life Insurance Reserves Defined

1. Branch office managers supplemental retirement plan: Decided (Jefferson Standard) reserves for such plan are not "life insurance reserves."

Section 802(a): Tax Imposed

2. Applicable rate of tax for consolidated tax return: Decided (Jefferson Standard) additional 2 per cent tax applies to life insurance companies filing consolidated returns.

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Section 802(b): Life Insurance Company Taxable Income Defined

3. Determination of consolidated "life insurance company taxable income": Decided (Jefferson Standard) methods and procedures used by company were not proper.

SUBPART B—INVESTMENT INCOME

Section 804(b): Gross Investment Income

4. Prepaid investment income–policy loans: Decided (Franklin Life, Jefferson Standard) includable in income when received and not as "ratably earned."
5. Prepaid investment income–rents: Decided (Jefferson Standard) includable in income when received.
6. Prepaid investment income–interest on bonds, mortgages, etc.: Decided (Jefferson Standard) includable in income when received.
7. Construction fees: Decided (Pacific Mutual) includable as gross investment income (§ 804[b] [i] [B]).
8. Option fee, standby fees, and bond-commitment fees: Decided (Pacific Mutual) includable as gross investment income (§ 804[b] [3]): "the gross income from any trade or business (other than an insurance business). . . ."

Section 804(c): Investment Yield Defined

9. Charitable contributions: Decided (Jefferson Standard) charitable contributions are not includable as general expenses that may be assigned to investment expenses.

Section 805(b) (4): Assets

10. Deferred and uncollected premiums: Decided (Franklin Life, Jefferson Standard) the gross amount of deferred and uncollected premiums (including loading) is includable in assets; decided (Western National) the net "deferred and uncollected premiums" (exclusive of loading) are includable in assets; argued (Occidental) these premiums are not assets or, in the alternative, these premiums should be included in assets net (gross less loading).
11. Due and unpaid accident and health premiums: Decided (Jefferson Standard) the gross amount of due and unpaid accident and health premium (including loading) is includable in assets; decided (Western National) the net "due and unpaid premium" (exclusive of loading) is includable in assets; argued (Occidental) these premiums are not assets.
12. Agents' debit balances: Decided (Jefferson Standard, Western National) agents' debit balances are includable in assets.

13. Bank accounts: Decided (Franklin Life) bank accounts are includable in assets (U.S. District Court; Franklin did not appeal).
14. Mortgage escrow funds: Decided (Franklin Life) mortgage escrow funds held by Franklin were not assets (U.S. District Court; government did not appeal); decided (Jefferson Standard) mortgage correspondent escrow funds were not assets (U.S. District Court; government did not appeal).
15. Amounts recoverable from reinsurers: Argued (Occidental) these amounts constitute personal property used in carrying on insurance trade or business and should not be included.
16. Amounts receivable from reinsurance assumed: Decided (Western National) includable in assets.
17. Whether home office property is includable in assets at gross value or at net (gross less mortgage): Decided (Western National) includable in assets at gross, with no offset for encumbrance.

Section 805(e): Interest Paid

18. Interest paid, credited, or accrued on group contingency reserves: Argued (Occidental) these amounts are includable as interest paid under either § 805(e) (1), (2), or (3).

SUBPART C—GAIN AND LOSS FROM OPERATIONS

Section 809(c) (1): Gross Amount—Premiums

19. Increase in loading on deferred and uncollected premiums: Decided (Franklin Life) increase in loading included in income and no deduction permitted (also affects item 21, below).

Section 809(c) (3): Gross Amount—Other Amounts

20. Gain from sale of U.S. Treasury Bills: Decided (Pacific Mutual) this gain is properly includable under § 809(c) (3) and not as an item of gross investment income under § 804(b).

Section 809(d): Deductions

21. Increase in loading on deferred and uncollected premiums: Decided (Jefferson Standard) there is no provision under § 809(d) for the deduction of the increase in loading (also affects item 19, above); argued (Occidental) § 809(d) (12) permits a deduction for increase in loading.

Section 809(d) (1): Death Benefits, etc.

22. Adjustment to accident and health claim reserves: Decided (Pacific Mutual) taxpayer was not entitled to retroactively adjust its beginning 1958 group accident and health claim reserves and individual hospital and medical claim reserves for alleged overstatements there-

in; court held that an insurance reserve could not be retroactively adjusted when, at the time it was established, it was based upon all available information and contained no mathematical error.

Section 809(d) (2): Increase in Reserves

23. Group contingency reserves: Argued (Occidental) these reserves fall under either § 810(c) (4) or (5) and, therefore, increases in these reserves are proper deductions.

Section 809(d) (5): Deduction—Certain Nonparticipating Contracts

24. Amounts left on deposit under settlement option provisions: Decided (Pacific Mutual) the 3 per cent alternative deduction does *not* apply to such amounts.
25. Premiums on guaranteed renewable accident and health policies: Decided (Pacific Mutual) the 3 per cent alternative deduction does apply to these premiums. Government appealed this issue and is presently awaiting decision in Court of Appeals.
26. Application of 10 per cent alternative deduction to strengthen reserves: Decided (Jefferson Standard) in the year of strengthening the 10 per cent alternative deduction applies to full amount of reserve strengthening (and not just one-tenth of the strengthening).

Section 809(d) (12): Deductions—Other

27. Expenses of stock dividends: Decided (Franklin Life) expenditures incurred in connection with a stock issuance are not deductible as ordinary and necessary business expenses. (U.S. District Court; Franklin did not appeal.)

This outline is very interesting, from my standpoint, because, out of, roughly, twenty-seven issues the insurance companies have won about four. It makes me wonder, since some of our best issues came up in these first cases, what we will do in later cases. The problem is, I believe, that you have lawyers arguing about many things that may be actuarial in nature, and you have a lawyer sitting as judge, trying to decide it. I am not sure that we lawyers understand enough about the life insurance business.

Note that twenty-one of the twenty-seven issues involve only a single company, while three involve two companies, two involve three companies, and one (item 10) involves four of the five companies. It is interesting that neither item 19 nor item 21, dealing with the increase in loading on deferred and uncollected premiums in Phase II, was involved in the Western National case. The judge asked "Why?" on the rehearing, and neither the taxpayer nor the government could quite explain it. I think that, if you were to look at the Western National case, you might understand why. For two years they had an increase in loading, and for two years they had a decrease in loading. I suspect neither the company nor the revenue agent quite knew what to do with it, so they left it alone.

I feel certain that the government will appeal the Phase I treatment of deferred and uncollected premiums in the Western National case; if so, it would go to the Fifth Circuit Court, in Texas. So we are still in the process of testing item 10. We have lost two in the court of appeals; Western National would go to a third court of appeals. Occidental has this issue in the United States district court, and there will probably be a decision in another few months. I am certain that whoever loses will appeal it to a court of appeals in California.

So, while we are behind two to nothing at this point on the deferred and uncollected premium issue, there is still some chance to win. If we could ever get into the Supreme Court, we would get a final answer. Jefferson Standard will probably ask the Supreme Court to consider its case.

The program lists three major areas for discussion—assets, life insurance reserves, and investment expenses. As for the first area, among the decided cases and the Occidental case, there has been only one issue involving life insurance reserves. That was an issue in the Jefferson Standard case (item 1) that had to do with reserves set up on a branch office managers' supplemental retirement plan. Jefferson Standard contended that this was a life insurance reserve and felt strongly that it was. It seems to me that it was clear that this was a life insurance reserve, and I thought that the regulations under the 1959 Act clearly set it up as a life reserve. Unfortunately, neither the district court nor the court of appeals permitted this—a very strange thing, since, if Jefferson Standard had placed its contract with another life company, I am positive that the other company could have treated this as a life insurance reserve. . . .

There have been a number of questions coming up on audit on what life insurance reserves are. On the first round of audits, involving years 1958–62, there were really very few issues raised about life insurance reserves. Primarily, those audits went to questions of what are assets, and they raised some questions about investment expense. On the second round—for some companies, the third round of audits—agents are getting into life insurance reserves on one of the three statutory requirements: (1) they must be required by law; (2) they must be set up to pay off future unaccrued claims; and (3) they must be set up on the basis of recognized mortality or morbidity tables and assumed rates of interest.

I would say that, with one exception, all the attacks of the revenue agents have been aimed at the third item—tables and rates of interest. Most of the questions arising are on the smaller reserves, in comparison with the ordinary life reserves. They do, however, involve quite a bit of money. For example, in the case of group life, instead of computing by tables and assumed rates of interest, many companies simply use a fraction of the gross premium. The Internal Revenue Service is ruling that this does not qualify as a life reserve, since it fails to meet one of the tests, namely, no mortality table, no assumed rate of interest. They are disallowing it.

We could mention a few other examples of types of issues revenue agents are raising. On group disability waiver some companies are setting up a reserve of $750 per thousand of face amount. Revenue agents are disallowing it on the basis that it is a flat amount; they do not see any table or assumed rate of interest. On group credit life, a company may set up on a disability claim a flat amount in the range of $300–$450, determined as the average claim. The revenue agent does not see the table or the assumed rate of interest, so he says, "The law requires it, and I don't see it; therefore, you have not met one of the requirements."

One runs into the same situation on some substandard policies, where, either from experience or rough estimates or rules of thumb within the actuarial profession, there is a certain amount that is set up. Again, unless there is a table or assumed rate of interest, the revenue agent will question it.

If you would check all the types of reserve that you may be setting up and find tables and set them up on a rate of interest, you may be able to keep many of these questions from arising. If they do come up, there are two alternatives. One is to go into court and argue that where, in the law, it says "reserves . . . which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest . . . ," the word "estimated" is broad enough to include these fairly rough rules of thumb that are being used. It is difficult to predict exactly what a court would do. Certainly, if you look at our record to date, it appears that the odds are loaded against us. The other alternative is to try to convince the agent that he should let you recompute the reserves that he is questioning and let you find a table and rate of interest; that is, permit you to recompute on a technically legal basis. As I say, I think that this is going to be the real question to be raised much more often by revenue agents, and in the very near future.

Concerning the second area to be discussed, assets have been fairly well worked out by revenue rulings, most of which the companies have lost, and by the cases. My items 10–13 and 15–17 indicate a number of issues that we have lost or appear to be losing. The only asset issue that we have really won has been mortgage escrow funds. Both Jefferson Standard and

Franklin Life won this in the district court, and the government did not appeal. I think that we have fairly well exhausted most of the asset issues, and I doubt whether those will be coming up much more in the next round of actions.

Investment expense issues have not really been raised. Only one item has been in litigation, and that involves Jefferson Standard with regard to charitable contributions: Can you allocate a part of charitable contributions to investment expense? The court of appeals said "No," but the district court had held "Yes," so it is a fairly close question. If we could win a few of these, I think that it would open the door to broaden the concept of investment expense. For example, some companies are trying to include some advertising expense. Other companies have claimed some of the administrative expense involved in filing the Form 1099 Information Return for interest accumulation accounts. However, while I think the tendency of companies is to look more and more at investment expenses, to see what can be included, certainly the Jefferson Standard court of appeals case seems to be taking a fairly narrow view of this area. There is a case in litigation involving the years prior to 1958, but it could be a current issue. This is whether the Connecticut tax on interest and dividends is a properly deductible investment expense. Not many companies have this issue, but, as the states begin looking more and more for taxes, they may try to add such a tax.

Let me turn to what I think is a very interesting issue involving many companies. This has to do with group-contingency or group-stabilization funds. Some companies set these up as life reserves; others treat them as interest-paid items. There is a proposed bill (H.R. 8442) introduced by the Honorable Wilbur D. Mills, chairman of the House Ways and Means Committee, which would attempt to clarify this by defining these group funds as interest-requiring items. This matter is in litigation by Occidental Life, where Occidental's position on the group-stabilization fund is that it represents an indebtedness. Therefore, the company is entitled, in Phase I, to an interest deduction and, in Phase II, to a deduction for the full increase in these reserves.

Basically, the Mills bill provides an amendment to section 805(e), the interest-paid deduction, to establish clearly that interest on special reserves of group term life and group accident and health contracts which are established and maintained for the provision of insurance on retired lives or for premium-stabilization purposes can be deducted in Phase I; also section 810(c) is amended in similar fashion to provide a deduction for the increase in these reserves in Phase II. This immediately raises the question as to a pure stabilization fund, and Mr. Mills attempts to cover this in his press release. He said: "This bill does not deal with reserves which are maintained solely for premium stabilization purposes since it does not now appear that there is any need for clarification with respect to such reserves."

Unfortunately, this can be interpreted as meaning either that the existing law is clear that this interest is not deductible or that the existing law is clear that it is deductible. I think Mr. Mills intended the latter interpretation—that stabilization funds are really pure indebtedness and that there should be no question of a company's getting a deduction for the interest.

He was apparently unaware that some revenue agents seem to be disallowing these deductions. If and when this bill begins to move, I think that Mr. Mills may be willing to clarify, either in the bill or in the committee report, that the interest on stabilization funds is deductible. The bill would be retroactive to the year 1958, so it would clear up the industry's problem on a retroactive basis. I do not believe that the Treasury Department will oppose this bill, in view of the apparent Congressional interest in 1959. It might take six months to a year before the bill can get through Congress because of all the other issues pending in the Ways and Means and Senate Finance committees, particularly tax reform proposals.

MR. JOHN C. FRASER: Before we discuss the problems in the taxation of separate accounts, it seems desirable to review in general the taxation of qualified pension plan reserves.

When the Life Insurance Company Income Tax Act of 1959 was originally passed, it was the clear intention of Congress not to tax under Phase I the interest earnings with respect to qualified pension plan reserves. It quickly became apparent that the law was not operating as it was intended to operate. The formula would have been appropriate for a company that had reserves only on qualified pension plans, where it was not necessary to revalue such reserves at the deduction rate according to the "10 for 1" rule. In the more typical case, however, where qualified pension plan reserves were only a portion, and often a rather small portion, of the total reserves of the company, the formula was not operating as it was intended to operate. Basically, what was happening was that, when qualified pension plan money was brought into the company and invested at the higher-than-average interest rates applicable to new money, the application of the "10 for 1" rule to nonqualified reserves was producing a situation in which the deduction with respect to nonqualified reserves was not going up appropriately. The result was that the company was in fact paying additional tax on funds received in connection with tax-qualified pension plan reserves invested at higher-than-average interest rates. This situation could have been avoided if the Phase I tax calculation for qualified pension plan reserves had been carried through independently of the calculation for the balance of the company's reserves, just as if qualified pension plan reserves comprised a separate company.

We can illustrate this by reference to Table 1. This is a simplified calculation of the federal income tax for a "Phase I" company, of whose assets 10 per cent represent qualified pension reserves and are returning 6 per cent interest and 90 per cent represent nonpension business and are earning 5 per cent interest. Columns 1 and 2 show the amounts of tax that would be calculated if the nonpension and pension accounts were treated as separate companies. The total tax of $118,080 so computed was, I believe, what the Congress intended in 1959, when it gave special treatment to tax-qualified pension reserves. Unfortunately, what resulted was column 3, which is a composite calculation, and it is easy to see that lines 7–10 of columns 1 and 2 do not add up to column 3; the tax is higher for the composite calculation than it is for the two separate calculations, and the problem is in line 6—the "reserve adjustment factor."

This is even more dramatically illustrated in columns 4–6, where we assume that an additional $1,000,000 is brought into the pension fund at 7 per cent interest, the nonpension funds being left undisturbed. If the tax on pension business were calculated as a separate company, it would increase only $160. The reason for this is that the tax base has gone up by $333, which is the additional interest on the $100,000 surplus of the pension business; in other words, the earnings rate has gone up from 6 to 6.33 per cent, and that additional 0.33 per cent on the $100,000 surplus (the excess of $3 million of assets over $2.9 million of reserves) is taxed. So, if separate calculations were made, the pension business would be taxed only on the interest on its surplus, and nothing would happen to the nonpension business. When the two calculations are combined (col. 6), however, the total tax of the company goes up by $5,936.

With the increasing attention that was being paid to reserves in separate accounts (both qualified and nonqualified), where the congressional intent was also not to tax such reserves, it was decided to modify the law in 1962 to permit a separate calculation of the tax base of reserves in separate accounts. The result now is that interest earned on reserves in separate accounts, whether qualified or nonqualified, is substantially tax-exempt except for any amounts withheld by the company from gross investment earnings. Unfortunately, as we saw in Table 1, this is not true of

TABLE 1

ILLUSTRATION OF WHY INTEREST ON PENSION RESERVES IN GENERAL ACCOUNT IS NOT TAX-FREE

	BEFORE			AFTER RECEIVING $1,000,000 OF PENSION FUNDS AND INVESTING THEM AT 7%		
	Nonpension Business (1)	Pension Business (2)	Total Company (3)	Nonpension Business (4)	Pension Business (5)	Total Company (6)
1. Assets	$18,000,000	$ 2,000,000	$20,000,000	$18,000,000	$ 3,000,000	$21,000,000
2. Interest	$ 900,000	$ 120,000	$ 1,020,000	$ 900,000	$ 190,000	$ 1,090,000
3. Rate of interest = (2) ÷ (1)	5.00%	6.00%	5.10%	5.00%	6.33%	5.19%
4. Nonpension reserves at 3%	$16,500,000	....	$16,500,000	$16,500,000	....	$16,500,000
5. Pension reserves	....	$ 1,900,000	$ 1,900,000	....	$ 2,900,000	$ 2,900,000
6. Reserve adjustment factor for (4)	80.0%	....	79.0%	80.0%	....	78.1%
7. Adjusted nonpension reserves = (4) × (6)	$13,200,000	....	$13,035,000	$13,200,000	....	$12,886,500
8. Reserve interest deduction = (3)[(5) + (7)]	$ 660,000	$ 114,000	$ 761,685	$ 660,000	$ 183,667	$ 819,319
9. Tax base = (2) − (8)	$ 240,000	$ 6,000	$ 258,315	$ 240,000	$ 6,333	$ 270,681
10. Tax at 48% on (9)	$ 115,200	$ 2,880	$ 123,991	$ 115,200	$ 3,040	$ 129,927
	$118,080			$118,240		

qualified pension plan reserves in a company's general account, since there is no separate calculation permitted with respect to such reserves. There is consequently a rather substantial additional tax paid by the company whenever qualified pension plan funds are brought into the general account and invested at new-money rates above the company's average portfolio rate.

With that background, I will now discuss more specifically the tax aspects of separate accounts. Under Phase I of the income tax act a separate calculation is made for each separate account. The company is permitted a deduction equal to the full current earnings rate on all reserves, whether they be qualified life insurance reserves, nonqualified life insurance reserves, or deposit reserves not involving life contingencies, except to the extent that amounts are withheld from gross investment earnings. As was previously indicated, the effect is to exempt from tax interest earnings on all reserves of separate accounts to the extent reflected in such reserves. Interest earnings on surplus of the separate account are fully taxable. The majority of separate account investments, however, are in common stocks, where the separate account receives an 85 per cent intercorporate dividend credit, leaving only 15 per cent of common stock dividends on surplus to be brought into taxable income. Applying the 48 per cent corporate rate (excluding the 10 per cent surtax) to this 15 per cent, we get an effective tax rate of only 7.2 per cent on the investment income on separate account surplus, to the extent such investment income represents dividends on stocks.

Under Phase II of the income tax act there is also a separate computation made for each separate account, and any capital gains and losses reflected as an increase in reserves are deductible under Phase II.

It should be noted in a discussion of the tax under Phase I and Phase II that, although the Phase I tax base and Phase II tax base are developed independently for the general account and for each separate account, it is the total company situation that controls the tax situation. In other words, a Phase I company is not going to be involved with a Phase II situation in any of its separate accounts, even though for the separate account itself there would be a Phase II tax if it were in fact a separate company.

The special preferential treatment available for separate accounts under Phase I and Phase II is available whether or not the contract is a qualified plan. It is only necessary that the funds in the separate account relate to annuity contracts, where either the payments to the annuitant or the payments by the premium payer vary according to the investment experience of the account.

The Treasury has interpreted the foregoing to mean that an individual variable annuity will receive the preferential treatment during the accumulation period and, if payments are made in the form of a variable annuity, during the annuity period as well. In the case of group annuities the contract will receive preferential treatment, even though a certificate-holder under the group contract elects a fixed-dollar option. However, the annuity attributable to such certificate-holder shall not receive the preferential treatment. Conversely, a group annuity contract which does not reflect current market value shall not receive the preferential treatment, even though a certificate-holder elects an option providing for payment of a variable annuity. However, the variable annuity attributable to such certificate-holder shall receive the preferential treatment. As for group annuity contracts based on separate accounts, but not involving variable annuities, it appears that they will receive preferential treatment if it can be demonstrated that the amounts paid in by the employer reflect the investment rate and the market value of the separate asset account.

It appears from the foregoing Treasury rules that any "seed money" put into the separate account by a life insurance company to get the separate account started would not be deemed part of the separate account for tax purposes. On the other hand, any surplus that could be demonstrated to have arisen from variable premium or variable benefit contracts would probably be deemed part of the separate account for tax purposes. As previously indicated, the Phase I tax on the interest earnings on such surplus would be only about 7.2 per cent of interest earnings, if we assume that all interest earnings arose from dividends on stocks. On the other hand, if any such surplus were transferred to the general account, the interest earnings thereon would be taxed at the much higher marginal tax rates applicable to the general account. At New York Life, for example, this would mean a tax of about 63 per cent of any assets transferred plus about 21 per cent of the interest earnings on such assets, even if such assets continue to be invested in common stocks. This 21 per cent rate would be much higher if the assets were invested instead in the normal investments of the general account.

Let us now turn to the taxation of capital gains with respect to separate accounts. I will also discuss the implications of the capital gains tax with regard to nonqualified variable annuities issued to the general public. There is no capital gains tax payable by a company with respect to realized capital gains on tax-qualified variable annuities to the extent that such capital gains are reflected in reserves. This exemption does not apply to realized capital gains on nonqualified variable annuities issued to the general public. This is an extremely important difference between tax-qualified and nonqualified variable annuities and introduces considerable problems.

The general rules governing the taxation of realized capital gains separate capital gains and losses into "short term" (on assets held six months or less) and "long term" (on assets held over six months). All short-term capital gains and losses in a taxable year are netted against each other to determine whether on balance there is a net short-term gain or a net short-term loss; the same is done with long-term capital gains and losses. Net short-term gains are then netted against long-term losses; for a life insurance company, if the result is a gain it is reported as part of investment yield, and if the result is a loss it is carried over to following years as a short-term loss. Net long-term gains are netted against net short-term losses (including prior year carryovers); for a life insurance company, if the result is a gain it may be added directly to the tax base or taxed at a flat rate of 25 per cent (the latter being the better approach for established life insurance companies), and if the result is a loss it is carried over to following years as a short-term loss. Capital loss carryovers are lost if they are not used within five years.

Realized capital gains represent the excess of what is received on disposition of an investment over the cost of the investment (or amortized cost in the case of amortizable investments). In the case of life insurance company investments held December 31, 1958, however, realized gains are measured against market value as of December 31, 1958, and realized losses are measured against cost or amortized cost. The reason for this is that life insurance companies were not subject to capital gains taxes on capital gains accruing prior to 1959.

If a life insurance company maintains a separate account or accounts and if its net realized short-term gains exceed its net long-term losses, the net excess is brought into investment yield and separated between the general and separate account or accounts according to rules prescribed by the Treasury. The Treasury regulations have three examples indicating how any excess of net realized short-term gains over net long-term losses is to be separated between the general account and the separate account or accounts. The first two of these examples are obvious. The third example, however, appears to be illogical, and it is not possible from this third example to determine what general rules are intended. Fortunately, most companies are not going to get involved in this type of situation too often. Most companies do not as a general rule do short-term trading and usually do not have net realized short-term gains in excess of net realized long-term losses. It is interesting to note, however, that the tax treatment of net realized short-term gains in excess of net long-term losses is more favorable than the tax treatment of the net excess of realized long-term gains over realized short-term losses in the case of nonqualified variable annuities. This happens since, in the former case, the separate account receives an offsetting interest deduction, whereas in the latter case it does not. This is just another one of the idiosyncrasies of the Life Insurance Company Tax Act.

Normally, a life insurance company will have either (1) net long-term losses in excess of net short-term gains or (2) net long-term gains in excess of net short-term losses. In the first of these cases the amounts are carried forward to later years as short-term losses, and in the second of these cases the amounts are taxed as a capital gain, in the usual case as a flat 25 per cent rate. Where a life insurance company is maintaining a separate account for nonqualified variable annuities, an allocation of capital gains taxes is necessary. Table 2 illustrates the problems involved in the allocation of any net excess of realized long-term gains over realized short-term losses. It is important to keep in mind that I am no longer talking about problems that relate to the filing of a company's federal income tax but, rather, to the internal allocation of capital gains taxes. Section A of Table 2 shows capital gains (+) and losses (−) allocated to the general account (col. 2), nonqualified separate accounts A and B (cols. 3 and 4), and one or more qualified separate accounts (col. 6) for the six-year period 1970–75. For simplicity, we will assume no capital loss carryover from years prior to 1970; we further assume that all gains and losses in the qualified separate accounts are reflected in qualified reserves, thereby escaping taxation, so that the company determines its capital gains tax on the basis of the amounts in column 5. Note that the capital gains tax operates on the total company and that no tax is actually payable until the total loss carryover has been used up. Thus no tax is paid for the years 1970, 1971, and 1972, and a $50,000 loss is carried into 1973, resulting in $100,000 of net taxable gains, or a $25,000 tax for that year. The $450,000 of gains for 1974 and 1975 are fully taxable, the tax being $112,500 per year.

Sections B, C, and D of Table 2 involve amounts of tax rather than amounts of capital gains or losses and illustrate three of the possible methods of allocating taxes to the accounts. In Section B we make an immediate transfer of 25 per cent of any capital gains or losses, with the general account bearing any deficiencies that may result before a tax is actually paid.

The allocation method in Section C delays transfer of tax amounts until the loss carryover has been used up and a tax is actually payable by the company. No amounts are transferred in "no-tax years," but, in any year

TABLE 2

ALLOCATION OF CAPITAL GAINS TAX

YEAR	GENERAL ACCOUNT	NONQUALIFIED SEPARATE ACCOUNTS		TOTAL (2)+(3)+(4)	QUALIFIED SEPARATE ACCOUNT(S)	TOTAL COMPANY (5)+(6)
		A	B			
(1)	(2)	(3)	(4)	(5)	(6)	(7)
	A. Capital Gains (+) and Losses (—)*					
1970...........	—$1,000,000	+$500,000	+$250,000	—$ 250,000	+$100,000	—$ 150,000
1971...........	— 500,000	— 100,000	+ 50,000	— 550,000	+ 300,000	— 250,000
1972...........	+ 700,000	+ 200,000	— 150,000	+ 750,000	— 400,000	+ 350,000
1973...........	— 100,000	+ 200,000	+ 50,000	+ 150,000	+ 250,000	+ 400,000
1974...........	+ 800,000	— 100,000	— 250,000	+ 450,000	— 150,000	+ 300,000
1975...........	+ 200,000	+ 150,000	+ 100,000	+ 450,000	+ 100,000	+ 550,000
Total........	+$ 100,000	+$850,000	+$ 50,000	+$1,000,000	+$200,000	+$1,200,000
	B. Immediate Transfer of Tax Changes and Credits†					
1970...........	+$ 250,000	—$125,000	—$ 62,500	+$ 62,500	$ 0	+$ 62,500
1971...........	+ 125,000	+ 25,000	— 12,500	+ 137,500	0	+ 137,500
1972...........	— 175,000	— 50,000	+ 37,500	— 187,500	0	— 187,500
1973...........	+ 25,000	— 50,000	— 12,500	— 37,500	0	— 37,500
1974...........	— 200,000	+ 25,000	+ 62,500	— 112,500	0	— 112,500
1975...........	— 50,000	— 37,500	— 25,000	— 112,500	0	— 112,500
Total........	—$ 25,000	—$212,500	—$ 12,500	—$ 250,000	$ 0	—$ 250,000

* Results in $25,000 tax in 1973, $112,500 tax in 1974, and $112,500 tax in 1975.

† Positive figures for total company must be carried over and applied against negative figures. "General" account will bear deficiency until tax paid.

TABLE 2—*Continued*

Year	General Account	Nonqualified Separate Accounts		Total (2)+(3)+(4)	Qualified Separate Account(s)	Total Company (5)+(6)
		A	B			
(1)	(2)	(3)	(4)	(5)	(6)	(7)
		C. Transfer Delayed until Total Loss Carryover Used Up				
1970	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
1971	0	0	0	0	0	0
1972	0	0	0	0	0	0
1973	+ 225,000	− 200,000	− 50,000	− 25,000	0	− 25,000
1974	− 200,000	+ 25,000	+ 62,500	− 112,500	0	− 112,500
1975	− 50,000	− 37,500	− 25,000	− 112,500	0	− 112,500
Total	−$ 25,000	−$212,500	−$ 12,500	−$ 250,000	$ 0	−$ 250,000
		D. Partial Transfer until All Accounts Have No Loss Carryovers				
1970	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
1971	0	0	0	0	0	0
1972	0	0	0	0	0	0
1973	0	− 20,000	− 5,000	− 25,000	0	− 25,000
1974	0	− 112,500	0	− 112,500	0	− 112,500
1975	− 25,000	− 80,000	− 7,500	− 112,500	0	− 112,500
Total	−$ 25,000	−$212,500	−$ 12,500	−$ 250,000	$ 0	−$ 250,000

TABLE 2—*Continued*

YEAR (1)	GENERAL ACCOUNT (2)	NONQUALIFIED SEPARATE ACCOUNTS A (3)	NONQUALIFIED SEPARATE ACCOUNTS B (4)	TOTAL (2)+(3)+(4) (5)	QUALIFIED SEPARATE ACCOUNT(S) (6)	TOTAL COMPANY (5)+(6) (7)
	E. Tax Accounts in Connection with (D)					
1970	−$ 250,000	+$125,000	+$ 62,500	...	$ 0	...
1971	− 375,000	+ 100,000	+ 75,000	...	0	...
1972	− 200,000	+ 150,000	+ 37,500	...	0	...
1973	−$ 225,000	+$200,000	+$ 50,000	...	0	...
Tax	0	− 20,000	− 5,000	−$ 25,000	0	−$ 25,000
Net	−$ 225,000	+$180,000	+$ 45,000	...	0	...
1974	−$ 25,000	+$155,000	−$ 17,500	...	0	...
Tax	0	− 112,500	0	−$ 112,500	0	−$ 112,500
Net	−$ 25,000	+$ 42,500	−$ 17,500	...	0	...
1975	+$ 25,000	+$ 80,000	+$ 7,500	...	0	...
Tax	− 25,000	− 80,000	− 7,500	−$ 112,500	0	−$ 112,500
Net	$ 0	$ 0	$ 0	...	$ 0	...

when a tax is payable, the prior amounts that would have been transferred under the Section B "immediate transfer" approach are charged or credited to the appropriate accounts.

Under the third approach, illustrated in Sections D and E, partial transfers are made until all accounts have no loss carryovers. For each of the accounts, a cumulative record is maintained of the total amount (which may be negative) of tax incurred less amounts actually transferred. In years when a capital gains tax is payable, the tax is prorated against only those accounts which have positive cumulative amounts, and, of course, these amounts are then decreased by the amounts of tax so transferred. Thus, for example, Section E shows that at the end of 1973, before transfer, the general account has accumulated a negative \$225,000 of capital gains tax, while nonqualified accounts A and B have positive accumulations of \$200,000 and \$50,000, respectively. The \$25,000 of tax actually payable is therefore transferred from accounts A and B proportionate to the accumulations in these accounts—\$20,000 from account A and \$5,000 from account B. Similarly, all of the \$112,500 tax paid in 1974 is transferred from account A, since it is the only account with a positive accumulation amount. By the end of 1975, when each account's loss carryovers have been used up, we find that the net of the transfers is identical under all of the three allocation methods, being equal in each case to 25 per cent of the algebraic sum of gains and losses over the six-year period for each account.

It seems better that no transfers of funds take place at least until a capital gains tax is actually payable. In this way, the accounts that on balance have realized capital gains can earn interest on the portion of those gains that will ultimately be paid as capital gains taxes, until such time as a tax is actually payable. Of course, a reserve (which can be negative) for unpaid capital gains taxes on realized capital gains (or losses) should be set up at the time the gain (or loss) is realized and charged against the variable annuity unit value.

It is easily seen that this is a very complex question tied in with the question of the higher tax on surplus funds transferred to the general account as compared to surplus account funds arising from variable annuities and retained in the separate account. I cannot attempt to cover all the aspects of this problem.

This brings us to the question of whether or not a reserve for future capital gains taxes should be maintained with respect to unrealized capital gains (or losses). Some companies set up such a reserve, but others do not. In any event, any reserve set up should be charged against the unit value.

One interesting related question here is the over-all effect on the unit value of holding a reserve for capital gains and losses. If, for example, a company adopts the most conservative assumption that the full 25 per cent reserve is to be held, so that only 75 per cent of all realized and unrealized capital gains and losses will be reflected in the investment performance of the separate account used to determine unit values, it would appear appropriate to distribute to the unit values some or all aftertax dividend earnings and 75 per cent of capital gains and losses earned on the funds backing the capital gains tax reserve. As time goes by and the capital gains tax reserve begins to build up to a significant degree, the earnings on the reserve can have a significant effect on unit values.

MR. ALBERT GUBAR: I will discuss interline allocations only in the general account. I will further assume that an investment-year method is in use, because this makes things a little more complicated, and I will refer at present only to Phase I taxable investment income, because this is the more difficult part.

As you can see from the example in Mr. Fraser's Table 1, there are certain basic parameters that affect the Phase I tax assets, investment yield, reserves, interest paid, and, for the current year, the subdivision of investment yield between taxable and tax-exempt investment income.

In doing a line allocation, it is fairly simple to determine, by line of business, the interest paid and the reserve items. I mention the investment-year method in this connection only because, in allocating assets and investment yield by line of business, you must exercise some caution when using such a method. You may find, for example, that tax-exempt interest is not distributed by lines of business the way everything else is, and this can produce significantly different tax effects. Similarly, because of peculiarities in the tax law's definitions, assets may not be distributable by line of business as they are for annual statement purposes.

After a determination of all these parameters by line of business, there are two basic approaches to determining taxes by line. The first is the separate-company approach, which is in effect the method used in the first example under Table 1. The second is a marginal rate approach, which takes first derivatives of the tax formula for Phase I and applies them to the parameters to arrive at a tax by line of business.

Each of these methods has certain characteristics. From the example, it is obvious that one of the characteristics of the separate-company approach is that taxable investment income for each of the various lines of business, determined by using current earnings rates, average earnings rates, and the like, separately for each line, will not equal the taxable investment income for the company as a whole. The marginal rate approach, on the other hand, has the characteristic, when applied to the parameters for each line of business, that the sum of allocated amounts of taxable investment income will equal that for the whole company.

The marginal rate approach has a second characteristic that I consider desirable. If a line of business makes a particular kind of decision, the marginal rate approach will automatically throw the tax effect of that decision into that line of business. I have based my calculations on the Equitable's data, but I believe that the conclusions would be valid for any company. For example, consider a $1,000,000 increase in assets. We will be concerned with the effect on taxable investment income, rather than the effect on the tax, and we will define the "true change" as the change in taxable investment income which would result if the entire tax return were to be reworked. The total marginal rate effect is identical to this "true change," for all practical purposes. For a $1,000,000 increase in assets, the "true change" in taxable investment income would be an increase of $18,000. The effect on group health, as a separate line of business, is zero—a very reasonable result, because the group health line has no life insurance or pension plan reserves and therefore is not affected by changes in current earnings rates, where assets enter the tax formula. The change in the group annuity line, which has substantial pension plan reserves and is therefore very much affected by a change in the current earnings rate, is an increase of more than $42,000, or 230 per cent of the "true change."

Let me give you another example. Let us assume a $100,000 increase in fully taxable investment yield. The "true change" is $57,000. The effect on the group annuity line, as a separate company, would be only $8,000, while the effect on the group health line, as a separate company, would be almost $100,000.

These examples might not seem realistic, so let me give you one more which combines various parameters. Assume a $1,000,000 increase in both mean assets and life insurance reserves other than pension plan reserves and a $65,000 increase in fully taxable investment yield. The "true change" is an increase of about $19,000. However, as separate companies, the effect on the group life line would be over $27,000, or 140 per cent of the "true," and the effect on the group annuity line would be less than $10,000, or about 50 per cent of the "true."

I might observe that changes in life insurance reserves or pension plan reserves and in interest paid, taken by themselves, produce almost the same effect on taxable investment income, whether the separate company approach or the marginal rate approach is used.

There are many interesting allocation problems within lines of business, and I will mention just a few. In the group annuity line you must allocate the tax by contract. You may treat it as a per cent of investment income otherwise attributed to the group annuity line, so that it affects all contracts in the same way. Should it? Some contracts may have a significant surplus, while others may have very little. Should you, instead, allocate the tax on the basis of assets?

In individual insurance, there is an interesting effect on the calculation of the asset share for a particular policy. In the year in which the policy is sold, there are reserves but probably almost nothing in assets and investment income; the company really receives a tax deduction rather than incurring a tax. Similarly, the incidence of the tax at subsequent durations will be not flat but based on the relationship of assets to reserves and investment yield. Should this be recognized? You may need a fancy program to do it.

These are the kinds of questions that arise in allocating Phase I taxes. As for Phase II, it has always struck me as relatively straightforward, if anything ever is, and I will not discuss it. I should mention one thing, though, that you may not have thought about. If you treat each line of business as a separate company for capital gains tax purposes, using an investment-year method, how do you allocate capital gains taxes, if such taxes emerge? They may emerge from different generations and have entirely different impacts on the various lines because of the differences in their distribution. What do you do in a year when the company pays no tax, but one generation has substantial losses and another generation has substantial gains? These are the same kinds of questions, as you see, that arise for the separate-account tax-allocation problems discussed earlier.

Atlanta Regional Meeting

MR. GILBERT W. HART: The problems arising from the audit of life insurance reserves claimed on companies' federal income tax returns can be summarized as the search for a middle ground between the contention of the companies that all amounts claimed as reserves in Exhibit 8 of the Annual Statement should be allowed and the position of many Internal Revenue Service agents that any amounts in excess of, or different from, a "textbook definition" of a reserve are not to be accepted.

The definition of life insurance reserves in the Internal Revenue Code, with the emphasis that I have supplied, will indicate some of the issues that have come up.

> [T]he term "life insurance reserves" means amounts which are computed or *estimated* on the basis of *recognized* mortality or morbidity tables and *assumed rates of interest* and which are set aside to mature . . . future *unaccrued* claims arising from life insurance, annuity, and non-cancellable health and accident

insurance *contracts* . . . involving, at the time with respect to which the reserve is computed, *life, health or accident contingencies.*

In addition to this, life insurance reserves must also be "recognized by law."

The issues raised by IRS agents hinge on the exact meaning of the terms in this definition. None of the current litigation has dealt with these problems, and there have been only a few IRS rulings in this area. This summary indicates, in the briefest fashion, some of these issues.

These issues can be roughly classified in two areas. One area involves the "quality" of the reserve—Is the "estimate" good enough? Was a "recognized" table used? The other area is concerned with whether the benefit or contingency for which the reserve is set up is one covered under the IRS definition.

One revenue ruling, 68-185, probably is a good indication of the current IRS feeling toward "estimates." This ruling accepted average ages and durations, provided that the averages are determined from the risks for which the reserve was being set up and that reserve factors from the stated table were then applied to these averages. It is substitutes for these reserve factors that create questions about the meaning of "estimates." Even when it can be demonstrated that the substitutes are close approximations to the reserve that would otherwise result, estimates based on percentages of premium, face amount, or some other index are frequently questioned. It might be said that it is not the "estimate" that is being attacked but rather the company's assertion that a recognized mortality table was the "basis" of the estimate.

A frequent problem concerning "recognized" tables is the use of a company's own experience for valuing certain benefits, for example, health and accident reserves. Another problem can be those instances in which there is no "recognized" table for the risk, since no experience on insured risks has been developed. The absence of "assumed rates of interest" has been cited by IRS agents when they do not permit unearned premium reserves.

Probably most of these problems can be avoided by more involved reserve computations. (This may not, however, be feasible for the smaller company.) The other type of challenge—whether certain reserves fit into the definition in the tax law—cannot be met by recalculation.

The meaning of the term "unaccrued" has come up in some areas of the country where reserves for disabled lives are being questioned because of the IRS agents' failure to distinguish between the accrued and the unaccrued portions of such reserves. This is at least partly due, I think, to the concept of an "incurred loss" which we use in measuring financial results in the accident and health business. Reserves set up to provide for the mortality or morbidity risk present in various options in our insurance contracts are being questioned by IRS agents, because they assert that the need for the reserve is being established for the additional contingency of "option election." Some companies have had reserves for benefits extended to existing contracts, when a benefit was added to a new series, questioned because of the absence of a contractual obligation.

In summary, I think it can be said that, while there is a trend toward these types of questions among IRS agents, there is no firm national policy in these areas as yet and that the question of what is an allowable life insurance reserve for federal income tax purposes may not be answered for some time to come.

MR. PAUL T. HARKNESS, JR.: The principal asset adjustments that we had to make were in the valuation of investment real estate. We did not choose to hire independent appraisers to get values for all our properties, as the IRS probably intended. We used a "book value" approach, which consisted of taking the original cost of these properties less the depreciation. These were not, however, the values that we put in the annual statement. In most cases they were above the annual statement values. The agents did not accept these values, and, to assist them, they brought in two so-called engineers from Boston, who went over all these properties individually and looked over all our papers. We finally came to a solution that they accepted. For most properties it consisted of capitalizing income at the current mortgage rates plus a factor which took into account the depreciation rate.

Also, the current rate of return on investment properties was considered. In some cases we moved these rates up or down, depending upon the condition of the buildings and of the locations. Also, of course, when we had just purchased the property or had received an offer for it, whether we sold it or not, they would accept that value.

Re-evaluations of these items are contemplated as we get closer to the end of the write-off period, because, as the leases approach termination, the discounted value of the reversion becomes very important. We own all our properties outright, so we had no problem with repurchase agreement values.

As part of the whole approach, we had to change our depreciation rates in some cases. Rates of depreciation varied all the way from 2 per cent to $3\frac{1}{2}$ per cent, depending upon the condition of the property. The result was that in the years from 1953 to 1960 our total assets were lowered over what we had first used, and, in total, the depreciation was increased. The IRS agents were not too pleased. We found that the engineers were much easier to work with. They had a knowledge of the real estate business and knew what we were talking about.

Our other asset adjustments were the usual ones. We excluded amounts withheld for payment of taxes and where we acted as agent or trustee, and, of course, we met with no success there. In connection with some of our mortgages we pay origination as well as participation fees. They considered these originating fees to be finders' fees, and we had to capitalize them. They suggested the same treatment for participation fees, but as yet this has not been done.

For obvious reasons, our company did not carry agents' loans as an asset. We handled them by including in expenses the increase of these debts, less, of course, any repayments. At the time that the first revenue agents were looking over 1958–60 returns, unfortunately, the state examiners were with us. The IRS agents assisted them in writing the report, and so, after fifteen or twenty years, the state examiners suddenly decided that agents' loans were a bona fide asset and should be carried as such. In addition, they went further in their search of cash items and made us include agents' petty cash in the assets. That did not amount to much, but it showed the extent to which they went in increasing our assets.

Their treatment of investment expenses from 1958 to 1960 was clouded a bit by the fact that we still had a claim for refund on our 1955, 1956, and 1957 taxes. The main item in that claim came about from the fact that the agent had disallowed our use of an expense allocation based on the ratio of investment income to total income. It ran in the neighborhood of 25–30 per cent. We had been using that for a considerable period of years with not too much argument. This agent came in and suggested that, inasmuch as our annual statement used an allocation based upon salary ratios for the most part, this ought to be the one to be used for tax purposes. Rather inconsistently, instead of changing all the investment expenses where we apportioned them by ratio, he picked only the largest items and left the others with the larger ratio.

In view of this, for 1958–60 they decided that we should use the salary ratio for all our items, except in cases which they arbitrarily reduced to a flat 10 per cent. Among the items so reduced were printing and postage. We ran into difficulty since our company does not have cost accounting, and we had problems in trying to justify a salary ratio in some cases. They wanted us to try a space allocation approach for certain items. When we arrived at higher figures than the salary ratio gave, they immediately discarded that method and agreed to the salary ratio.

The next agents came in for the years 1961–65 and cut some more. We were told unofficially that, by the time they got through with all the adjustments and disallowances, with which we are all familiar, investment expenses were about the only things left and that they would eventually get those whittled down some more.

Participation fees on due and accrued mortgage payments have been disallowed as an investment expense, even though the due and accrued mortgage payments themselves have to be included in income.

They insisted that certain expenses for the home office and real estate, which we had usually expensed in the year they occurred, on the assumption that over a long period of years it makes little difference, be capitalized. We have transportation equipment for which we used a fast write-off. They disallowed this, on the assumption that it was no more than a mortgage and therefore should be treated that way.

I have one more subject—which does not fit into any of these topics—that I want to mention. That is the redemption of bonds at values over par. For 1961–65, on all our promissory notes, any gains have been treated as income rather than capital gain. They were considering the same thing for all our mortgage bonds, on the assumption that, after all, there is not much difference whether it is called a mortgage or a bond; it is the same thing. They finally decided that they would not pursue that until they see what happens with the promissory notes. Eventually they will go after the rest and will probably try to move most of capital gains on bonds into income.

MR. HART: The pertinent element of a variable annuity contract or a separate investment account contract is that the contracts are credited with investment earnings based on the investment results of the particular assets attributable to these contracts and that this investment result is insulated from the rest of the company's investment operation. The purpose of the variable annuity and segregated asset account section of the Life Insurance Company Income Tax Act is to insulate the treatment of investment earnings of these contracts in the tax return from the investment earnings of the company's other assets.

We sometimes speak of a separate account or a variable annuity operation as if it were a separate company, but the tax law treats it only as a separate line of business requiring special treatment of its investment results. The over-all profit or loss on this line of business is combined with the results of the company's other insurance operations in the tax return.

Generally speaking, the tax law imposes no tax on the investment income credited to separate account contractholders and imposes no capital gains tax on the capital gains passed on to qualified pension plan separate account contractholders.

The "exemption" from tax on investment income—interest and dividends—holds, provided that no amounts in excess of allowable investment expenses are withheld from investment income to be credited to contractholders and that no surplus is held in the account. The tax that can arise from withholding amounts in excess of investment expenses from investment income should be considered in deciding how to provide for charges for mortality and expense guarantees and other contingencies.

Two points should be considered in connection with surplus in a separate account or variable account. Initial funds put in these accounts by the company as seed money probably cannot be used as part of the separate account for tax purposes, but any surplus or contingency reserves generated from the separate account operations and held within the account can be treated as part of the separate account. While the investment income allocable to such surplus is subject to tax, the separate accounting enables that surplus income to have the full benefit of any dividend received credit and to be subject to only a slight tax.

In considering the taxation of capital gains in a separate account, one important aspect to be remembered is that the capital gains and losses, if any, arising from the separate account assets are combined with the gains and losses from the balance of the company's accounts for tax purposes. A company does not fill out a separate capital gains schedule for its separate account operations and does not pay any capital gains tax if there is a net capital loss from the combined operations. If the combined result shows net short-term capital gains in excess of net long-term capital losses, then an allocation of the excess between the separate accounts and the general account is required. It should be noted that the short-term gain allocated to the separate accounts is exempt from tax because it is treated as part of the ordinary investment income of the account.

The capital gain or loss on separate account assets held for contractholders who are not qualified pension plans is no different from the calculation of the gain or loss on any asset. For a contractholder who is a qualified pension plan, the exemption from capital gains tax comes from adjusting the cost basis of the asset upward as unrealized appreciation is credited to the contractholder and down as depreciation is charged. Where all such appreciation or depreciation is passed on to the contractholder, the asset has an adjusted cost basis equal to its fair market value at any time and a sale results in no gain or loss.

MR. CHARLES M. BEARDSLEY: My assigned topic this morning is "Problems in Allocation of Federal Income Tax." It is never easy simply to talk about the subject of allocation—whether it be the allocation of expenses, investment income, federal income taxes, or any other item. This is a subject that is much more easily comprehended by working out examples. One has only to witness the lengthy discussions of allocations by lines of business which are given in the Instructions to the Annual Statement blank. This is a very well-organized set of definitions and principles, and it certainly makes it clear that there are problems involved. It does not, however, offer much in the way of solutions to one's own individual problems. In all these situations there are too many details involved when related to one particular company.

I am starting my discussion in a negative sort of way because, as soon as one faces the need of allocating federal income taxes by lines of business, he has no difficulty in finding that there are problems. But in nearly every case he has to come up with his own unique solution. One would like to be able to go to a textbook, to see how the experts had it all worked out. If there is any such textbook, I certainly would like to know about it! The closest thing I have been able to find is the set of study notes prepared for students working on Part 10 of the examinations. They give an excellent five-page discussion on the specific subject of allocation of federal income taxes by lines of business which everyone should read. The basic problems are certainly brought to the reader's attention.

The solutions to the problems, other than in very broad terms, are nowhere to be found. There appear to me to be four good reasons why a careful allocation of federal income taxes by lines of business should be undertaken:

1. The analysis of operations by lines of business in the Annual Statement (p. 5) specifically requires such an allocation for federal income taxes incurred during the year (excluding the tax on capital gains).

2. Internal company management reports should also show gains or losses from operations, both before and after incurred income taxes. Here it is assumed that there are departmental divisions within the company or lines of business engaged in which do not necessarily exactly agree with those major lines and secondary lines of business as shown on the Annual Statement. For example, the company may have a credit insurance department whose operations are intermingled with those of other departments when it comes to completing the Annual Statement blank. Again, the company may for internal reasons separate its investment department gains. Another company might use a separate shareholders' fund, as distinguished from the funds related to operating insurance divisions. There is also the possibility of separation between participating and nonparticipating funds.

3. A careful allocation of federal income taxes can be of value in establishing participating and nonparticipating premium rates and dividend scales, particularly in such highly competitive areas as pension plans and annuities.

4. The impact of federal income taxes on various lines of business may lead to management decisions to pursue some lines more vigorously than others.

Before trying to be at all specific about methods of allocation of federal income taxes, I believe that it is important to point out that any attempt to allocate only the final incurred tax figure itself involves at least one serious problem which can and should be avoided. The incurred amount is made up of three separate items: (1) the amount of taxes paid during the year, (2) the liability at the end of the current year, and (3) the liability at the end of the previous year. Each of these three items should be separately allocated by lines of business and the incurred amount prepared from these separate elements. There is good reason to believe that the allocation for items 1 and 3 could be prepared in the same way. There is a strong likelihood, however, that allocation of the liability at each year end will differ in detail.

Another factor might be mentioned with regard to the allocation of additional assessments for prior years or refunds received. The problem involved is whether these should be incorporated with the taxes incurred for the current year, as shown in the summary of operations, or be excluded from the summary of operations and handled only through the surplus account adjustments. If the latter position is taken, allocation of these additional assessments or refunds by lines of business does not have a direct bearing on the current annual statement. However, it would still remain an important element for internal management reports.

There are many ways in which a company might make its allocation of federal income taxes for annual statement purposes in a fairly elementary way. However, it would not be worth the time to catalogue these. Each of the superficial methods can be misleading. An informative allocation is hardly less intricate than the calculation of the tax return itself.

The two general methods of detailed allocation that have been mentioned publicly so far are called the "separate company" approach and the "combined company" approach.

In very simple terms the separate company approach assumes that the tax allocable to a given line of business should be that which would result from applying the federal income tax calculation to the taxable investment income and operating gain or loss generated by that line of business as though it were a separate company standing apart from all the other lines of business. The primary disadvantage mentioned for the separate company approach is that the sum of the separate tax amounts calculated for each of the given lines of business for a company will not equal the tax for the company as a whole.

The distinguishing characteristic of the combined company approach is that each line of business is to take its share of the total company tax according to the tax situation (Phase I, Phase II, or Phase III), regardless of the tax situation which might apply if the given line of business were to be treated as a separate company. Each of these two methods seems to have advantages and disadvantages that will bear different weights with different companies.

Granted that there is no perfect method, I have been able to live quite comfortably with an approach which uses some of the techniques of each of the two philosophies. The basic idea is to take each item of the federal income tax return and to allocate it among the various lines of business. This is really no different from the approach used on page 5 of the Annual Statement. For many items, such as premiums and increase in reserves, the working papers for the tax return already provide a breakdown by line of business. There are other items, such as the small-business deduction, which require careful individual analysis. It is at this point that explanation by example can be given so much better than an explanation in words.

This is, in essence, the separate company approach, down to the point where the taxable investment income and the gain or loss from operations are developed for each line of business. By developing it in this way, the items just mentioned for each line of business add up to the corresponding items for the entire company. If the taxable investment income for the entire company is less than the gain from operations, the total company tax is prorated according to the taxable investment income allocated to each line of business. If the gain from operations for the entire company exceeds the taxable investment income, then the taxing formula is applied to each line of business, using negative amounts where required, to keep the total for all lines of business the same as that for the whole company. Thus it is possible to generate negative incurred taxes for a given line of business. It seems logical to give this credit to a line of business if it, in fact, reduces the total taxes of the company because of its operations.

This still leaves unresolved many problems, such as the allocation of Phase III taxes among lines of business, but items such as this must necessarily be considered in relation to the circumstances of a particular company.