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DIGEST OF DISCUSSION AT CONCURRENT SESSIONS

FEDERAL INCOME TAX

1. Review of recent rulings, court decisions, and audit programs.
2. Organization and responsibility for
   a) tax-planning and
   b) control of tax.
3. Role of actuary: Techniques that have proved useful.
4. Current situation in Canada.

Philadelphia Regional Meeting

MR. KENNETH P. HINSDALE: Since January 1, 1967, there has been one change in the tax law, and a substantial number of both revenue rulings and private rulings have been issued. The change in the tax law consisted of an amendment to Section 815 to permit a life insurance company to distribute the stock of its subsidiary life insurance company to a parent holding company without its incurring a Phase III tax.

Moving to some of the more important revenue rulings and their holdings, we have, first, 67-43. This was a holding that a company that has made a preliminary term election under Section 818(c)(2) and that has reinsured some of its risk on a Y.R.T. basis should first revalue these reserves under 818(c)(2) and then reduce the revalued reserves by the portion thereof attributable to the net value of the risk reinsured.

Ruling 67-129 held that the full amount of losses incurred but not reported must be deducted under 809(d)(1) and that the life insurance reserves must be reduced by the amount attributable to such unreported losses.

Ruling 67-180 held that retrospective rate credits under group life and group accident and health contracts were neither unearned premiums nor return premiums. Any credit that was allowed was allowed as a dividend. Furthermore, the reserve for dividends to policyholders cannot include any amount that could be reduced by the loss experience of the policyholder over the entire policy year. The effect of this is to defer the deduction to the year paid.

Ruling 67-243 held that land purchased as a future site for a branch office building, even if no improvements had been made on it, had to be included in assets. However, when construction had actually been started, that portion of the uncompleted building and the land that the company intended to use in carrying on its insurance business could be excluded from assets.

Ruling 67-244 held that interest paid on a mortgage assumed to purchase rental real estate was not deductible in computing investment yield under 804(c) but is instead interest paid for the purpose of determining the policy and other contract liability requirements.

Ruling 67-369 held that appraisal fees incurred in connection with the acquisition of mortgage loans are not deductible in the year incurred but should be capitalized and amortized over the lives of the loans.

Ruling 67-435 held that a reserve which is computed as a percentage of the life reserves, and required by state statutes in addition to the regularly recognized reserves, is not a life insurance reserve within the meaning of 801(b).

Ruling 68-103 held that life insurance companies were not required to reduce their investment expenses by the amount of such expenses attributable to tax-exempt interest and intercorporate dividends.

Ruling 68-85 held that any interest-equalization tax paid would qualify as amortizable bond premium.

I also wish to refer to four of the more important private rulings that have been issued since the beginning of 1967.

The first one held that the addition of a nonoccupational vehicle accident benefit to existing policies was not reserve strengthening but that the reserve established was similar to the reserve for any other new business coming on the books of the company.

The second ruling held that it is necessary and proper for a company that had, through error, overstated its life insurance reserves at the end of 1957 and prior years to adjust its reserves beginning with the taxable year 1958 so as to eliminate the overstatement from both the beginning and ending balances. This same ruling also held on another issue that reserves held under a company's nonqualified pension plan, which was subsequently discontinued, should be also eliminated from the beginning and ending 1958 reserves.

The third ruling held that a life insurance company's own qualified pension plan should be treated in the same manner as that required of qualified pension plans administered by the company for independent employers.

The fourth private ruling held that substandard extra reserves in a particular case did not qualify as life insurance reserves because they were not computed on the basis of recognized mortality tables and did not involve an interest element. The door, however, was left open for possible redetermination based on appropriate mortality tables and interest rates. The same ruling also held that an unearned premium reserve held with respect to certain group life policies did not qualify as a life reserve, again because it had not been based on a recognized mortality table and did not involve an interest element.

During 1967, in the litigation area, there were two United States district court decisions handed down. There were four industry issues common to these suits, and in the case of three of these four issues different decisions were reached by the district courts.

The first issue involved the treatment of deferred and uncollected premiums as assets. In one case the court held that they should be included on a net basis only, that is, exclusive of loading; in the second case it held that they were to be included in assets on a gross basis.

The second issue involved the treatment of increase in loading on deferred and uncollected premiums. In one case the court held that the company was not required to increase its gain from operation by the amount of the increase in loading, whereas in the second case it held that the company was not entitled to a deduction for increase in loading in deferred and uncollected premiums.

The third issue involved prepaid investment income. In the first case the court held that prepaid policy loan interest was not includable in income when received but only as ratably earned and that the unearned portion of unpaid capitalized policy loan interest was not an asset as defined in 805(b)(4)(B). In the second case the court held that not only policy loan interest but also rents paid in advance and mortgage loan interest paid in advance were includable in income when received.

A fourth issue involved mortgage loan escrow funds, which both courts held were not assets as defined in the law.

In other issues the courts held that bank accounts are assets and that the expenses of stock dividends are not deductible as ordinary and necessary business expenses. The additional 2 per cent tax incident to the filing of a consolidated return was applicable.

The court also held that the company's reserves under a nonqualified pension plan covering branch-office managers did not qualify as life insurance reserves. Charitable contributions are includable as general expenses that may be assigned to investment expenses. Agents' debit balances are assets within the meaning of 805(b)(4). The full amount of the increase in reserves in respect to nonparticipating contracts, including any increase that resulted from reserve strengthening, is deductible under 809(d)(5).

In an opinion handed down by the United States Tax Court, several issues relating to gross investment income items, retroactive reserves adjustments, and a nonpar deduction were covered.

The audit area questions regarding reserves are coming up more frequently, particularly where disallowance is based on a contention that the reserves are not computed on the basis of recognized mortality tables or do not involve an interest element. Questions are also arising in connection with the approximate reserve revaluation under 818(c)(2).

MR. QUINCY S. ABBOT: My assigned topic this morning is "Organization and Responsibility for Tax-planning and Control of Tax." I will interpret control of tax as being synonymous with "tax compliance."

The tax-planner is responsible for shaping the internal activities of the company and the outside tax environment so as to minimize the economic impact of taxes on the company. His focus, though, must be on increasing aftertax earnings rather than on reducing taxes. For example, any one of us could reduce taxes substantially by shifting the investment portfolio to tax-exempt bonds. This would, however, be a poor tax-planning move for a life insurance company if net gains after tax would also be reduced.

Specific tax-planning tasks include (1) studying existing corporate structure, policies, operations, procedures, and business practices and recommending changes that would reduce tax costs; (2) reviewing specific major business transactions in their formative stages and proposing changes to achieve the best tax result (for example, a review of new products and new investments of a nonroutine nature, such as real estate); and (3) recommending changes in the outside tax environment and responding to changes in the outside tax environment instituted by others. This responsibility may involve reviewing proposed changes in the tax law, regulations, rulings, and so forth, as well as suggesting revisions to minimize the impact on the company.

It also may involve advising company personnel on the impact of new laws, decisions, regulations, and rulings so that existing practices or new proposals may be reshaped in the light of the revised tax environment. For example, Public Law 88-272, passed in 1964, made investment in market discount bonds more attractive for many life insurance companies.

In addition to tax-planning, a responsibility exists for complying with the tax laws at the least possible cost. Specific tax-compliance tasks include preparing and filing returns and negotiating with examiners; approving payment of taxes due; requesting rulings; preparing and prosecuting refund claims, protests against assessments, and administrative appeals; and recommending, authorizing, and conducting or controlling litigation.

Now that we have an idea of the responsibilities of tax management I will turn to the problem of organization. A study prepared for the Tax Executives Institute listed only two organizational essentials: (1) adequate information must be available for the tax managers on all aspects of top management planning and decision-making that have or can have tax implications and (2) there must be unquestioned technical tax competence on the part of those responsible for giving tax advice to corporate top management.

In addition, the study points out that personal effectiveness on the part of the tax manager is highly advantageous, and its absence may limit the effectiveness of corporate tax management.

The study gives two specific organizational moves that appear to offer significant advantages in many, but not all, situations: (1) integrating the legal and financial activities of the tax function into one department and (2) locating the integrated tax department within an integrated finance, tax and planning function.

On the negative side, the study points out two organizational limitations that must be guarded against. The first is burying the tax function so low in the organization that it cannot operate effectively. The second is breaking the tax function into too many organizational locations or groups for the various activities to be co-ordinated efficiently.

In my own company, there are two organizational groups with substantial involvement in tax-planning and tax compliance. In addition, legal and accounting tax consultants have been employed for specific problems where an outside viewpoint or outside knowledge may be helpful.

The inside groups containing tax specialists are (1) the tax unit of the Actuary's Department and (2) the Legal Department. Our corporate Actuary's Department is responsible for financial results and corporate planning as well as taxes. The tax unit is, therefore, strategically located for studying existing operations and monitoring future plans for tax-saving opportunities. The tax unit contains, in addition to me, one Associate of the Society, one accountant, and two clerks. We assemble data for and file all federal and state income and premium tax returns. The second group of inside tax specialists, found in the legal department, acts primarily in a consulting capacity on the legal aspects of tax problems. In addition, it joins in negotiations with the auditors and handles the various phases of requests for rulings, filing of protests, appellate proceedings, claims for refund, and tax litigation. Finally, it monitors new laws, regulations, and so forth, for tax developments.

Involvement in tax-planning and tax compliance does not stop with the tax specialists. Such questions, problems, or activities may arise anywhere within the company. No matter who originates the problem, the dollar effects are calculated and the legal aspects are investigated. In the current unsettled tax environment surrounding life insurance companies, any major evaluation must include a statement of the probable IRS and court views toward each alternative.

Once a decision has been reached on a tax-planning or tax-compliance problem, the tax unit of the Actuary's Department takes over to see that the decision is implemented in preparing returns and so on.

In conclusion, tax compliance is a necessity, while tax-planning represents an opportunity. Both responsibilities must be recognized and reflected in the organization of a company to produce effective tax management.

MR. JOHN C. FRASER: One of the things with which I am becoming increasingly impressed is the rate at which the complexities of the life insurance business are increasing. It has always been difficult to define to the uninitiated what an actuary is, but it is now becoming virtually impossible in this era of increasing specialization. The large companies are able to handle this because of the large number of actuaries that they have, but it is extremely difficult for the smaller companies.

One extremely important area that requires this kind of specialization is the area of federal income tax. The passage of the Life Insurance Company Income Tax Act of 1959 magnified the problems in the federal income tax area at least a hundred fold. As you are all well aware, this income tax act is exceedingly complex. Unfortunately, it is also extremely sensitive, that is, the tax impact of management decisions can be enormous. A lot of people are not aware of this. They are not even aware that there is a problem.

The actuary, therefore, must play a very important role in the federal income tax area because of the complex mathematical relationships that exist. No company should fail to have access to an actuarial tax expert. The larger companies, of course, must each have on their actuarial staffs at least one man who is conversant with the mathematical complexities of the federal income tax act. The smaller companies generally will find it is necessary to resort to outside consulting firms. Any company that does not have access to such an actuarial tax expert is playing with dynamite. It is like trying to test the adequacy of premium rates without using a mortality table.

The actuarial tax expert in the company or to which the company has access has to be thoroughly familiar with "marginal" tax rates since it is the only approach to the problem of federal income tax that is capable of cutting through the complexities and confusion of the law. This is admittedly a mathematical rather than a general reasoning technique. It would be nice, of course, if it were possible from general reasoning to determine the tax effects of making various decisions. Many people have tried it and have gotten themselves into considerable difficulty. I must warn you that the law is not logical, that the tax effects are not logical, and that, therefore, it is necessary to make use of the mathematical technique of marginal tax rates. It is not necessary to understand the underlying mathematical derivation of marginal tax rates, but it is essential to understand how they are used. In the infamous paper that I wrote several years ago, the third section was extremely complicated, and I think that it scared a good many people away. It is the notation that is so formidable. It is unfortunate if this has scared people away from the subject. To those of you who would like to give it another try, I would urge you to cut through most of the third section, particularly the notation, which is, I confess, abominable. There is, however, no other way to set up the formulas. You do not need to understand all the notation; you do not need to understand the derivations to make use of the marginal tax rates.

By means of marginal tax rates it is possible to break down any tax problem into subelements and to arrive at the tax effect of any decision. This is just as true in the investment and accounting areas as it is in the actuarial area. In all matters regarding investment and accounting the actuarial tax expert should be consulted.

In the investment area very large sums of money are being invested and the tax impact can be quite large. The investment people should be made aware of the marginal-tax-rate concept and should come to the actuarial tax expert whenever they have an "offbeat" investment problem. Unfortunately, this is not always done, so that investment decisions being made today in several companies are not always as well thought out as they should be.

Similarly, in the accounting area the controller should be aware of the marginal-tax-rate concept and should consult the actuarial tax expert with respect to any changes in accounting that affect assets, liabilities, income, and so on. This is particularly important in a company that is taxed in whole or in part under Phase II, but it also extremely important in a company such as ours that is taxed solely under Phase I.

The area over which the actuary has the greatest control, of course, is the actuarial area including the allocation of federal income tax to lines of business and within lines of business. Fortunately, the mathematical properties of the federal income tax law are such that marginal tax rates can be used not only to determine the tax effect of making decisions but can also be used in the allocation of federal income tax to various portions of the company's business. This avoids the conflict found in the expense area in general between (1) the financial effect of making decisions and (2) the problem of allocation.

In our company we use marginal tax rates in the allocation of federal income tax by line of business and within lines of business, that is, we use them in our asset shares. All our asset-share calculations recognize federal income tax as an explicit item that reflects properly the value of the fund, the investment income thereon, and the tax deduction arising from the reserves. Thus in our calculations we are capable of recognizing the negative tax that will arise on a policy in the early years after issue when it is in a deficit position and the heavy tax load that arises if and when a policy gets into a fat surplus position. Ever since the passage of the 1959 Tax Act you have been splitting your profits and losses with Uncle Sam, and, to the extent that you have failed to recognize this in your premium rate, cash value, and dividend structure, you are not properly performing your role as actuaries. I find it, for example, hard to understand why more companies have not gone to a higher interest-rate basis for their 1958 CSO series of policies. I wonder how many persons realize the heavy tax price they are paying in order to keep a good net-cost position.

In closing, I wish to re-emphasize the tremendous importance of having an actuarial tax expert on the staff or having access to such an expert through a consulting firm. When I say "expert," I do not mean a person able to understand all the mathematical subtleties involved in the derivation of marginal tax rates. I simply mean that he must know what marginal tax rates are and how to use them.

MR. H. EDWARD HARLAND: A year has passed since the release of the long-awaited Carter Royal Commission Report on Taxation. The main conclusions and recommendations of the report have already been discussed at meetings of this Society and of the Canadian Institute of Actuaries. I will, therefore, review the major recommendations only in very brief terms and only as they directly affect the life insurance industry.

The report recommends that life insurance companies, both stock and mutual, be taxed in a manner similar to that in effect for other types of business. However, actuarial reserves should be revalued, for tax purposes, at some rate of interest exceeding 4 per cent and the deduction for increase in reserves allowed only on the revalued basis. It is suggested that no special surplus or contingency reserves should be allowed to accumulate from pretax earnings, with the possible exception of very nominal investment reserves. Realized capital gains should be treated as income in the way recommended for other taxpayers. The report also suggests that the integration principle should apply between companies and policyholders if a satisfactory method can be worked out.

The report advocates a number of changes and extensions in the taxation of life insurance in the hands of policyholders and beneficiaries. The most important changes proposed are the following:

1. Interest credited on policyholders' reserves should be allocated to policyholders year by year and included in their taxable incomes.
2. Policyholders should be taxed year by year on dividends.
3. So-called mortality gains or losses should be included in the tax base of the policyholder.
4. Life insurance proceeds paid outside the tax unit should be taxed at the full rate.
5. Group insurance proceeds should be treated as taxable income whether in the same or some other tax unit. Employee contributions would be deductible and employer contributions nonincludable.
6. Retirement income plans would continue to receive tax-deferment advantages, with an over-all limit set at the equivalent of $12,000 annual income at male age 65, with ten years guaranteed.

Shortly after the release of the report, the Canadian Life Insurance Association, through its standing committee on taxation, established four subcommittees to study and comment on the report. Three of these committees addressed themselves to various aspects of the recommendations directly affecting the life insurance business. The fourth studied the probable financial and economic effects of the tax changes recommended. Two separate briefs representing the views of the life insurance industry were submitted late last summer. These have been followed by a meeting with the minister of finance and a series of meetings with representatives of the Department of Finance and the Department of Insurance.

The industry position can be briefly summarized as follows:

a) The report of the Commission underestimates the adverse financial and economic impact of the tax revolution it advocates.
b) Life insurance provides social benefits that are recognized in existing tax laws of Canada and many other countries and that should continue to be recognized.
c) If any change is to be made in the tax treatment of life insurance, a number of the specific recommendations for both policyholders and the company should be rejected as being improper or impracticable. Of particular concern are the proposed treatment of policyholder dividends, year-by-year allocation of interest earned on reserves, mortality gains and losses, and, at the company level, the proposed handling of actuarial and special surplus and contingency reserves held by the company.

The minister of finance has rejected the all-or-nothing approach to tax reform advocated by the Carter Commission. This does not mean that no changes will occur, nor does it mean that specific recommendations will not be implemented. However, partly because of the uncertainties that surround the choosing of a new party leader and prime minister, it is difficult to say when we shall see the White Paper that will indicate the government's thinking on new tax legislation.

Let us now look at some of the special problems that the United States tax law presents to Canadian companies. This law is an extremely complicated one that causes numerous difficulties for both domestic and foreign companies. There are, however, a few types of problems faced only by the latter.

One of these problems arises from the minimum surplus provision of Section 819. Foreign companies are, of course, taxed in the United States on their United States business. The purpose of Section 819 is to ensure that foreign companies do not reduce their taxable incomes by transferring to other countries surplus amounts generated by and held in respect to United States business. This is accomplished by a special adjustment for any foreign company whose surplus, expressed as a ratio of "total insurance liabilities," is lower than that of "representative" domestic companies. The adjustment has the effect of imputing additional investment income to the company. A number of problems arise from this part of the law:

1. It adds a further element of difficulty in tax estimation, calculation, and allocation.

2. It can impose an extra tax burden on a foreign company even though it holds, in the United States, surplus equaling or exceeding all that ever earned by or held for United States business.
3. The adjustment works only one way. Companies with more than the minimum specified surplus level do not get the benefit of a negative adjustment.
4. The averaging principle involved can cause problems in special situations. For example, most lines of business at early durations, and some lines at all durations, develop surplus levels well below that determined and specified for the Section 819 adjustment on the basis of figures of domestic companies. Nevertheless, tax must be paid as though the full average surplus level of domestic companies is developed and maintained throughout the entire duration of the contracts or blocks of business involved.

Another problem has been created by the Foreign Investors Tax Act, effective from January 1, 1966. This act introduced a new concept for foreign companies, whose total income is now separated into that "effectively connected" with its United States business and income not effectively connected. The effectively connected portion is subject to tax under Part I of subchapter L, corresponding to the general treatment of domestic companies. Any United States–source investment income in the not effectively connected category is taxed under I.R.C. 881. This section imposes a tax at a 30 per cent rate, but the current Canada–United States tax treaty reduces the rate to 15 per cent.

The separate taxes on effectively connected and not effectively connected income created a new problem. Any imputed investment income in the regular tax base of effectively connected income, brought in through the Section 819 adjustment, should not be taxed again under Section 881. Therefore, a new provision was added to Section 819 to make an appropriate reduction in the income to be taxed under Section 881.

Another problem of United States tax calculation peculiar to foreign companies is the need to allocate all items affecting the tax calculation between the United States operation and business in other countries.

Head-office expenses present the greatest difficulty. The allocation of such expenses by region involves the usual problems of time analyses, functional cost studies, and so forth. It also involves the special problem of explaining the allocation to a tax auditor and convincing him of its soundness. Other allocation problems include the treatment of the United States portion of Canadian qualified pension plans on head-office employees, charitable donations in Canada, and so forth. The tax treaty overrides tax laws of both countries and should be studied by persons responsible for tax calculations and audits. It can be useful in some of the allocation-problem areas.

MR. ABBOT: In the audit area, it is important to recognize the difference between a reserve or interest requirement by actuarial theory, on the one hand, and a liability or interest requirement as defined by federal income tax law, on the other. The tax expert, who is also an actuary, has the responsibility of ensuring that this distinction is properly explained and recognized.

MR. GERALD A. LEVY: The prepared part of this tax program is directed mainly at the large insurance company. The small and even the new insurance companies have real dollars at stake and should also be planning to minimize their F.I.T.

Often company management and its consulting actuaries are abdicating a responsibility; they are closing their eyes either because other problems are more immediate or it is too complicated; besides, it may have no dollar significance now. For example, the actuary should be assisting through model-office projections to enable his company to utilize fully all past tax losses. If his company cannot absorb these from normal operations, he should be seeking alternatives, such as reinsurance. The actuary should also be advising when to elect Section 818(c) and other forms of reserve-strengthening. Through mathematical equivalence formulas he can also provide investment guidance as to which class of investments provides the greatest aftertax income.

Thus we see many opportunities, especially within the gain from operations, to minimize taxes, and this could lead to significant dollar savings.

Can management afford not to be concerned?

SPEAKER FROM THE FLOOR: I would like to ask Mr. Hinsdale whether we may now assume that the insurance company position with regard to the issue relating to escrow funds or mortgages has been sustained, in view of his statement that the government was not appealing this particular issue, although, in both the cases he outlined, the courts decided in favor of the insurance company?

MR. HINSDALE: I do not know. The particular facts in the two cases were somewhat different. There is some indication that the government will not appeal.

CHAIRMAN W. JAMES PREBLE: Are the escrow funds held by the mortgage correspondents rather than on the books of the insurance company?

MR. GILBERT W. HART: The case dealt with escrow funds commingled in the company's own bank accounts.

MR. WILLIAM SIMPSON: How is the gross loading on deferred premiums being handled in the closed accounts?

MR. ABBOT: In the audit I do not think you have much choice. The examiner has been told to make premiums gross in assets and to disallow the increase in loading as a Phase II deduction.

What you do have after the audit in pursuing a claim for refund is another matter. We have not yet decided what issues will be in our claim for refund, but the treatment of deferred premiums will probably be one of them.

MR. GEORGE H. DAVIS: I would be interested in hearing Mr. Fraser speak on the tax effect of the ten-for-one rule.

MR. FRASER: One of the significant facts about the Federal Income Tax Act of 1959 is how well the ten-for-one rule works (if you leave out of the picture reserves based on dual interest rates). This means that the level of reserves for tax purposes is virtually independent of the actual reserve interest rate.

It is generally agreed that it is necessary to build up larger funds on, say, $2\frac{1}{2}$ per cent policies than on 3 per cent policies.

Under Phase I of the Federal Income Tax Act of 1959 (and this discussion is limited to Phase I only), the tax is in essence a tax on the interest earned on surplus. Surplus for tax purposes is defined as the excess of funds over reserves, after adjustment according to the ten-for-one rule.

Since funds tend to be higher on $2\frac{1}{2}$ per cent policies than on 3 per cent policies and since reserves for tax purposes are virtually the same after adjustment according to the ten-for-one rule, it is clear that you are paying a heavy tax price to have the additional funds required to support the higher $2\frac{1}{2}$ per cent reserves. The additional tax is about half of the interest earned on the extra funds. This is a high price to pay in order to keep the good net-cost position associated with the lower reserve interest rate of $2\frac{1}{2}$ per cent.

CHAIRMAN PREBLE: Reverting to the question of reserves on substandard business raised by Mr. Blair, I would like to ask whether you feel that a reference in the annual statement to the use of the mortality table would reduce the likelihood of a question from the auditor, especially bearing in mind that so many questions are now being raised by the Internal Revenue Service with respect to reserves? In other words, are we not likely to have substantive things that will matter more than words?

MR. B. FRANKLIN BLAIR: I agree. However, it certainly does no harm to be sure that the wording in your annual statement clearly indicates the interest rate and mortality table, and it may well avoid one more hurdle in the audit procedure.

SPEAKER FROM THE FLOOR: I wish to direct a question to Mr. Harland. A previous speaker mentioned the possibility of substandard reserves' being disallowed if the mortality and interest rate is not mentioned. In the formation of the secretary's ratio adjustment of the reserves of a Canadian company, are we perhaps not better off to have those reserves disallowed than we would be if they were allowed?

MR. HARLAND: I would think not, because the "total insurance liabilities" that enter into the calculation of the secretary's ratio adjustment include total reserves.

SPEAKER FROM THE FLOOR: I would like to ask a question regarding the admissibility of unearned premium reserves in noncancelable accident and health business. The net portion is based on some recognized table involving mortality, morbidity, and interest. I know that in the past questions have been raised on audits with regard to the treatment of this item in line 1 of Exhibit 9.

MR. FRASER: Prior to 1967 the Annual Statement Blank required that a gross unearned premium be shown in line 1 of Exhibit 9, even though net level reserves were being held. Since the Internal Revenue Service is rejecting gross unearned premiums as tax-deductible reserves, they were taking the position that this portion of the reserve was not allowable. We feel that this is the result of a misunderstanding and hope that the Service will change its position. Fortunately, beginning with the 1967 annual statement, companies now have the option of not separating the gross unearned premium and showing it in line 1. We feel that this will resolve the problem.

MR. ANDREW DELANEY: I would like to ask Mr. Fraser whether the use of a higher interest rate results in paying out more dividends in the early years.

MR. FRASER: No. We have lower premiums.

MR. DELANEY: But do you avoid this high tax by increasing your dividends in the early years?

MR. FRASER: The premiums are lower to start with.

MR. DELANEY: I now wish to direct a question to Mr. Hinsdale. Is the amendment to Section 815 which you described very restrictive, that is, does it apply only to a limited number of companies?

MR. HINSDALE: Yes, it is quite restrictive. It applies only to a situation in which the parent owned its life subsidiary in its entirety prior to the 1959 Act. It does not apply to companies that have acquired a life company subsidiary since then.

Los Angeles Regional Meeting

MR. JOHN E. HEARST: Perhaps the logical time to start a review of recent revenue rulings is May, 1967, when the Internal Revenue Service lifted its suspension of audits, which had been imposed in June of 1964. [Mr. Hearst then reviewed the various rulings covered by Mr. Kenneth P. Hinsdale at the Philadelphia meeting. His additional comments follow.]

The Internal Revenue Service contends that deferred and uncollected premiums must be reported on a gross basis. The matter is in litigation.

When premiums are paid in advance, the company must treat the net amount received as premium income, according to Ruling 66-36. However, this may be offset by a reserve that reduces as the premiums are earned.

Ruling 68-85 holds that interest equalization taxes are to be capitalized when a life insurance company acquires the debts and obligations of another company.

Ruling 67-313 states that insurance companies are to use Form 1139 in computing a carryback of taxable losses. This is an interesting exercise if the company is in a Phase II or Phase III tax position.

Two other rulings provide that a fire insurance company that later becomes a life insurance company is not a new company at the time it becomes a life insurance company and that a life insurance company may not reduce cash by amounts that it holds as trustee.

In addition to the revenue rulings that I have listed, there have been some recent court decisions of interest. Most of these are now being appealed and, of course, have different effects on different companies.

Perhaps the most far reaching is the Franklin Life case, in which the United States District Court in Southern Illinois held that the increase in loading on deferred and uncollected premiums is recognized as an expense. The company does not have a legal right to the premiums. The premiums are an offset to the reserve; and, therefore, the amount for which credit should be taken is the net amount of the premiums. The loading on deferred and uncollected premiums is not an asset. The unearned investment income arising from loans to policyholders is not taxable. This is consistent with accrual accounting. Bank accounts not used in the conduct of the company business are assets of the company. Escrow funds received in trust are not assets, nor is it permissible to reduce assets by these. Stock dividend expenditures are capital expenditures.

The opposite decision with respect to deferred premiums was recently adjudged in the Jefferson Standard case. In this case, the company filed a consolidated return. The court ruled that it was correct in doing this and in paying the 2 per cent additional tax incident to this privilege. The supplemental retirement plan for managerial employees was disallowed, but the company was allowed to take credit for the amounts paid under this plan.

The computation in the annual statement can be used only if it does not conflict with the accrual method of accounting and is not inconsistent with the Internal Revenue Code. Unearned investment income is taxable. Charitable contributions can be allocated to investment expense. The increase in loading on deferred and uncollected premiums is disallowed. Congress, according to the court, made no provision for that. The loading on deferred and uncollected premiums is an asset. Agents' balances are assets.

Mortgage correspondent escrow funds are not assets but are segregated amounts held in trust. The nonparticipating contract deduction applies to reserve strengthening and to the full amount of the reserve strengthening.

In the Pacific Mutual case, the courts held that the company cannot retroactively adjust group claim reserves to 1958. Option fees, stand-by fees, and construction fees constitute investment income. Mortgage fees constitute gross investment income.

Gains from the sale of treasury bills are gains from operations rather than capital gains because this is not a capital asset, according to Section 1211. The company cannot take the nonparticipating contract deduction on amounts left under settlement options.

A case of importance to credit life insurance companies is the Alinco decision. In this decision, the court held that tax avoidance was not the principal reason for the formation of Alinco by its parent, Associated Investment Company, and that the company was a life insurance company engaged in the business of reinsuring credit life insurance risks.

A recurrent problem in insurance company audits is the examiner's lack of understanding of insurance company accounting. Despite this lack of understanding, or perhaps because of it, they frequently find substantial deficiencies. Another problem is the turnover of examiners. One person will start an examination and then leave for private practice. The company is then faced with the problem of dealing with a new examiner in the audit.

Mutual companies subject to Phase I tax have had a problem in the disallowance of miscellaneous reserves, such as the reserves for immediate payment of claims and for substandard extra mortality. Also, pension plan reserves have been disallowed if the plan had not been approved as of the date of the audit. I understand that the reserve for unmatured settlement options has been challenged.

For stock life insurance companies and mutual companies subject to the Phase II tax the problems are somewhat different. Some have had their pension reserves challenged, particularly when their plans had not been approved and when amendments were necessary in order to have them approved. The examiners have at times capitalized expenses that had been charged off in the annual statement, such as minor home-office improvements. One examiner has challenged the treatment of business assumed when the 818(c) election was taken. The reserves assumed were about twice the consideration for the contract. His position was that this was tax avoidance.

Another problem concerns bad debts attributable to investments made before 1958 when the company had charged off the debt in years after 1958.

For closely held companies, examiners have at times disallowed parts of the compensation of officers as being excessive. Their contention is that compensation was paid in lieu of dividends. Expenses such as automobiles, when used by officers for personal purposes, have also been disallowed.

Initially, credit companies had problems qualifying as life companies. The examiners argued that companies should be carrying unearned premium reserves not involving life contingencies and, therefore, would not be life companies. They also challenged the incurred but not reported loss reserves. In one case they have backed down; another is awaiting conference.

For companies in affiliated groups, the expenses and the allocation of income among affiliates have been challenged.

MR. HENRY B. RAMSEY, JR.: My discussion concerns the organization and responsibility for tax matters within companies. Since I have had the good fortune of having contact with a number of companies in connection with federal tax audits, I circulated a questionnaire to obtain a number of opinions on this subject. Twelve companies responded, including my own. All are eastern companies. Most are large mutuals, the smallest having about a billion dollars in force.

One of the questions was, "Who carries the primary responsibility for tax matters in your company?" The answer in seven of the twelve companies was that an accounting officer had this responsibility, but two of the seven were also members of the Society. In three companies the actuarial officer had direct responsibility, and in one of the other two the director of taxes was an actuary. Thus exactly half of these companies' top tax men are actuaries.

Almost all the companies have prepared a manual or series of memorandums for use by the investment department in determining the tax impact on investment decisions. Most also provide specific guidance on individual investment questions on request. About a third indicated that they had a formal tax committee, and several had tax divisions, with representation from the actuarial, legal, and accounting areas.

My impression is that companies which have good tax-guidance programs can attribute their success to active co-operation among these four areas. The exact organization does not seem to be the key. Some might envy those companies having a centralized tax division, but there may be some loss of concern about tax matters in the other areas of these companies.

I sense that most companies are worried that their investment people do not have sufficient tools to judge properly the tax impact of investment decisions. Almost all companies seem to use tax-equivalent tables to compare yields for tax-exempt and taxable securities. However, most tax men feel that investment people should compare all investment alternatives on an after-tax yield basis.

My own preference is to use what might be called an equivalent fully taxable yield obtained by converting back from the after-tax rate on a tax-exempt security to the fully taxable rate. It is the rate required on a fully taxable investment to produce the same after-tax income on a present value basis. This rate has two advantages—the base is not altered by a change in the income tax rates and it produces a rate comparable to the going yield rate for new investments.

It may be of interest to note, in closing, the two essentials of effective tax management, as developed in a study performed for the Tax Executives Institute. These are, first, adequate information for the tax managers on all aspects of top-management planning and decision-making that might have tax implications and, second, unquestioned technical competence on the part of those responsible for giving tax advice to top management.

The same study also emphasized the importance of the personal effectiveness of the tax manager, which, if absent, seriously limits the effectiveness of corporate tax management. The complexity of our present tax law and the very important role that policy reserves and surplus considerations play in determining the amount of tax make it almost mandatory that actuaries play a key role in tax planning and control. To slight this responsibility is an open invitation to very substantial tax losses.

MR. WILLIAM D. BISHOP: My remarks concern the role of the actuary with respect to federal income taxes and include some specific techniques that have proved useful.

My personal role includes responsibility for preparing the tax return, seeing that timely payments are made, estimating the tax liability used for interim and annual statements, allocating the tax to the lines of business, working with Internal Revenue agents on audits of prior returns, and advising management on the tax consequences of various situations and decisions. If I have inadvertently omitted any tax function, let me assure you that I do it too. So much for the role of at least one actuary in the federal income tax area.

Webster defines "technique" as "a method of accomplishing a desired aim." With respect to taxes it seems to me that there are several aims. Perhaps the most important and obvious one is to minimize legitimately the tax burden. This is primarily achieved through the decisions made in preparing the tax return, by advising management on tax consequences, and by convincing Internal Revenue agents and the courts of the correctness of one's position. At the same time, as many of us know only too well, there has to be the aim of calculating the tax liability as simply and as accurately as possible, not only for the tax return but also for statement purposes, including the allocation to lines of business. In connection with the allocation by line, an important aim must also be equity.

We do have two powerful tools to help us accomplish all these aims—the computer and the concept of marginal tax rates. In our case, we have not made as much use yet of the computer as we should, primarily because little, if any, of our basic accounting input data are now on the computer. On the other hand, we have used the concept of marginal rates extensively, particularly to advise management on investment decisions. While it has been expressed before, I would like to add my gratitude to Mr. Fraser for his work in developing this concept. It has made my work in this area much easier to do and to explain to management.

I do want to mention a few specific techniques that I have found useful, keeping in mind that their aim may not always be to minimize taxes; sometimes the aim may be to simplify the calculations required or to produce an equitable distribution of the tax.

We prepare our tax return from worksheets set up to follow the format of the tax return. We do this not only for the total company but also individually for each major line of business—ordinary life, group life, group pensions, individual accident and health, and group accident and health. As those of you who have worked with tax calculation know, a pure separate-company approach for each line of business will not add to the correct tax for the total company. To compensate for this, we force each item of income and deduction to add to the correct total company amount. In the case of the interest on life insurance reserves deduction, for example, we use the average earnings rate of the total company but then incorporate the assumed rate for each separate line of business in determining the adjusted reserves. The resulting interest deduction for each line of business will then add to the proper company total. In other areas, such as the small-business deduction, we use ratios to split the total-company figure. Our company has for the past several years paid tax only on investment income—a so-called Phase I tax. However, in our modified separate-company approach to the allocation of the tax by line of business, a positive gain from operations or Phase II tax does develop for some lines of business. In such cases we charge the Phase II tax to the line but offset it, by ratios, for those lines producing a negative Phase II tax. The total will, thus, add to zero. The choice of a philosophy for the allocation of tax by line involves a considerable amount of judgment, and I recognize that there are strong arguments that can be made for other types of allocation procedures.

During our first audit by the Internal Revenue under the new law, the agent required us to prepare various reconciliations between tax amounts and annual statement amounts of investment yield, assets, reserves, and gain from operations. While I will not go into detail about the difficulties encountered in producing such a reconciliation for the first time, it has now become routine along with the calculation of the tax return. Actually I am indebted to the agent for requiring such a reconciliation, because it has formed the basis for our calculation of the year-end tax liability for statement purposes. From such a reconciliation it is fairly easy to pick out the critical items of difference for an approximation to the tax calculation using annual statement figures. In our statement schedule, the tax calculation is now the final item; and, with a certain amount of advance planning, it is a relatively easy task to plug in the investment income and gain from operations with a handful of adjustments to derive the tax liability for the total company and for each line of business. I might also say that it has proved to be quite accurate over the past several years.

In the area of advising management on the tax consequences of investment decisions, the first big hurdle was to convince them of the complexity of the new law and that not every item of net income was effectively taxed at a rate of 48 per cent. With the help of marginal rates, I think that we have made some headway in this area. We have been fortunate in not yet having been required to pay any capital gains tax. This has not just happened; it is the result of a considerable amount of continual communication between me and the investment people regarding our capital gain position for tax purposes throughout each year. My experience with our people has been that they always seem to be able to discover something to sell at a loss late in the year as long as they are convinced that we would otherwise incur a capital gains tax. Each year, after the tax return is completed, we furnish factors of equivalence for the purpose of evaluating the before- and after-tax yields of fully taxable, tax-exempt, and stock investments. For some time, we have been fairly close to the foreign tax credit limit, so that periodic analyses are made of our position in foreign securities and the effect on net yields of exceeding this limit. Other subjects that have produced rather lengthy, but I hope intelligible, memorandums are the tax consequences of bank loans, particularly those carried over a year end, and real estate investments with and without encumbrances.

All these studies have been greatly simplified by utilizing marginal rates. In the realm of actuarial considerations are the studies showing the tax consequences of increasing the interest rate allowed on supplementary contracts, with and without life contingencies, dividend accumulations, and the effects of various reserve strengthening programs.

I have deliberately not gone into great detail on some of these techniques—partly because you may already be familiar with most of them and partly because I wanted to illustrate my original point with examples showing that there are techniques aimed at distributing taxes equitably, simplifying calculations, and minimizing the amount paid.

MR. WELBURN J. ADAMS: Some fifteen months ago the Report of the Royal Commission on Taxation—the so-called Carter Report—was released. This report recommended revolutionary changes in the taxation of incomes, capital gains, and other increases in economic power of individuals and corporations. The taxation of life insurance was an important part of these recommendations, probably affecting more individuals than all the other recommendations put together, since it, alone, could increase the number of personal income taxpayers from 5,900,000 to 11,000,000.

The far-reaching changes recommended by the report have been fully discussed at every meeting of the Society since then, and there is no point to be served in reviewing them again at this meeting. The Canadian Life Insurance Association presented two briefs to the Minister of Finance last fall, one of which examined in detail the far-reaching tax implications for life insurance policyholders and beneficiaries and made critical appraisals and recommendations. The second submission examined the report's assumptions of the economic effects of the over-all tax proposals and challenged its conclusions with regard to the changes in capital formation and investment flow from domestic and foreign sources.

At the end of November, the Minister of Finance told Parliament that the government did not plan to implement all the recommendations of the Carter Report and referred to the unpredictable effect such sweeping and sudden changes of great magnitude could have on the economy and the position of taxpayers. He said that tax reforms presented in the form of a white paper "will be more in the nature of reforms of existing tax structures rather than the adoption of a radically different approach." While this statement appeared to rule out some of the more radical recommendations for the taxation of policyholders and beneficiaries, it did not preclude some changes in policyholder and company taxation. Political developments in Canada have delayed the promised white paper, so we are still in the dark with respect to what the government may propose.

The position taken by the life insurance companies in their brief is to justify the present basis of life insurance taxation in Canada, that is, the 2 per cent premium tax paid to the provinces and the regular federal corporation tax on the shareholders' interest in Canadian stock companies. This tax basis has been confirmed by successive governments since the income tax was adopted in 1917 on grounds of national economic and social policy—considerations as valid today as they have been in the past.

The companies, however, indicated their willingness to discuss the principles and alternative methods of taxing life insurance. The last two sentences of the taxation brief to the Minister read:

There is no reluctance on the part of the life insurance companies to discuss in depth with you and your officials all facets of life insurance taxation. Indeed, the companies would welcome such discussions and would hope their representation could make a useful contribution to your consideration of the Report.

The Department of Finance has asked for such discussions, and these have now been under way for some months. The companies, however, have the clear understanding that these discussions are without prejudice and that the industry will still be in a position to oppose, at the government and parliamentary level, any proposals which are in conflict with the principles stated in the briefs.

To answer questions arising out of these discussions, a series of detailed studies has been undertaken by several task forces working under the auspices of the Canadian Life Insurance Association. Some of these are largely statistical in nature, but three of them, involving general principles, will be of interest to actuaries. In each of these three areas there has been very little actuarial research, and these studies may give some impetus to further exploration in the future. The task forces are still working on their assignments, and it is, therefore, not possible to report their conclusions at this time; we can only present to you the general scope of the studies.

One study is concerned with the levels of actuarial reserves, insurance and investment contingency reserves, and free surplus that might be justified on a pretax basis as an essential part of the cost of providing fixed-dollar guarantees for two generations or more into the future. A paper by Charles L. Trowbridge entitled "Theory of Surplus in a Mutual Insurance Organization," presented to this Society at its meeting last October, was of timely assistance. The recent "Report of the Special Committee on Insurance Holding Companies" released by the New York Insurance Department develops the concept of "required surplus" and is also very pertinent to the development of a logical bais for the portion of surplus that might be accumulated pretax.

Another study is concerned with the true nature of policy dividends and the relationship of the participating ordinary policyholder with the life insurance corporation, whether it be a mutual or a stock company. The Carter Report attempted to equate the interest of a participating policyholder in a mutual company with the position of a shareholder in an industrial or commercial corporation. It regarded a policy dividend as similar to a stock dividend paid to a shareholder. It further assumed that participating policyholders had a beneficial interest in the retained earnings of a life insurance company comparable, although not exactly equivalent, to shareholders' interest in the retained earnings of a stock corporation. These misconceptions are by no means confined to the Carter Commission. We have found that they are widely held by the public and even by actuaries who have not really analyzed the true corporate nature of a mutual insurance company or the real extent of the policyholders' stake in a stock insurance company.

These misconceptions are aided and abetted by our advertising and sales arguments employed in the sale of participating life insurance. The fallacy is not so obvious when the simple type of company situation is considered, such as is common in the United States and Britain, where the mutual company usually sells only participating insurance and the stock company only nonparticipating. However, there is no purely participating Canadian mutual company and no purely nonparticipating Canadian stock company, and the Carter Commission's attempt to treat participating policyholders as sole propriety owners of a mutual company leads to inequitable and absurd results.

I shall not attempt to describe the line of logic and reasoning that the studies and discussions have followed. The end result, however, is to regard the policy dividends not as a distribution of earnings—and, hence, taxable, as suggested by Carter—but rather as merely a technical device to determine the cost of insurance from year to year over the lifetime of the policy. It is an alternative to the nonparticipating method of determining the cost of insurance and to the technical methods used for group insurance, pension accounts, segregated funds, and so on. All these groups are partners in a mutual company and are required to make greater or lesser contributions to "required surplus" according to the nature of the risk involved, which, in turn, is a function of the method of determining the premium required from year to year and the long-term safety factors inherent to each method.

A document released in November, 1967, by the state of Wisconsin questions the familiar concept of the policyholder–mutual company relationship, using many of the arguments developed independently by the task force. It was written by the Wisconsin Insurance Commissioner with respect to the chapter covering domestic mutual corporations in the draft of the Insurance Corporation Code.

The third study is for the purpose of developing principles and methods of confining any tax to the Canadian business only of both Canadian companies and foreign companies operating in Canada. Since one-third of the business written by Canadian companies is in jurisdictions outside Canada, this is a matter of considerable concern to Canadian companies, whose competitive position could be seriously affected in some countries by a Canadian tax on foreign business. The task force studying this problem is wrestling with many knotty problems involving a closed-account approach versus a pro rata approach to a division by country. The treatment of surplus, particularly the "surplus surplus" which may flow as required from country to country, is particularly complex.

In Canada, a new Prime Minister has taken office within the last week· His ideas on taxation reform, and particularly on life insurance taxation, are unknown at the moment. The studies that I have described and others undertaken during the past year should put us in a position to discuss insurance taxation from a base of far greater knowledge than would have been possible a year ago.

MR. MARVIN L. WEISBROD, JR.: We have a line of business, called "corporate accounts," which most companies do not have and which has all the surplus income. We allocate interest on pension reserves according to the income of the pension line and have determined that there are certain assets that are allocable only to the corporate line of business. By this allocation we end up with the total interest on reserves, Phase I, being greater that what would be allowable in the total tax return. We then allocate a negative interest on reserves to the corporate line of business to try to achieve the equity that we feel was intended in the law in the first place. This is our solution to the problem of qualified pension reserves.

CHAIRMAN WILLIS J. LUTZ: I believe that the matter of the taxation of qualified pension plans was not fully understood at the time the law was passed. There was a great deal of sentiment then that pension plans were exempt, and yet, if you dig through the testimony, you will find that individuals at different times put in, almost as side comments, the fact that they wished that pension plans were truly exempt. They are not. If you add the pieces together, you do, in effect, pay a substantial tax on pension plans.

Can we have an expression of opinion in the area of audits and closing out returns? Undoubtedly many of you have had new issues raised on the second and third go-around which were not raised initially. The question is whether you should attempt to close out your early contests with the Treasury Department in the hope that it will not apply new issues retroactively. Or is there much retroactive application of new issues?

MR. PAUL T. HARKNESS, JR.: I can offer some information on this point. The Connecticut Mutual received its thirty-day letter for our 1958–60 returns and is in the process of applying for appellate review. Two or three weeks later, the audits for 1961–65 were given to me, unofficially and before an Internal Revenue Department review. In return we gave them photocopies from our equipment.

In the later audits are several issues that were not raised for 1958–60. For example, on certain bonds and corporate notes which were called, the premiums were treated as income rather than capital gains. I would suggest that, if this is being done universally, the carry-over of capital gains and losses may be changed. I do not know what can be done about it when the audit comes four or five years later. I was informed that they did not intend to take similar action on bonds for the 1958–60 returns.

MR. WEISBROD: We have actually had all our audits up to the current date closed. We had some changes in subsequent audits in which new issues were raised, and they did not go back.

The only retroactive application that we have experienced concerns group contingency funds on which the IRS not only wants to deny the interest paid in Phase I but also is going to take the position that they are not a reserve under 810(c). We were a little surprised at this position, and the issue is now in the district court with respect to our returns for 1958–61.

MR. JOHN E. SMITH: During the audit of Western's returns, the expenses on tax-exempts were disallowed. However, the auditor did suggest that they would accept allocated expenses rather than the higher average-expense rate on all investments, including mortgage loans. I would like to ask if any companies have changed any portion of their in force to continuous function reserves to incorporate for income tax purposes immediate payment of claim, the nondeduction of premium, and the return of unearned premium reserves in the policy reserves?

MR. RAMSEY: If this is done, I think they are prepared to take the position that the increase is not a reserve required by law. They are taking that position in our case for all elements of reserves not contained in the original basis.

MR. ABE OLSHEN: I think you can get this required by law in certain states if you want to follow that through. For example, if one treats check-a-matic premiums as, say, one-twelfth of the annual with no deduction at death, I think you will find that many insurance departments will require an additional reserve to avoid discrimination and that this will be qualified for tax purposes.

CHAIRMAN LUTZ: I believe Michigan did issue a letter stating that, in their opinion, immediate-payment reserves are a requirement. I am not sure whether they gave this broad distribution or not, but I have a copy of the letter signed by the commissioner.