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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.

MR. THURSTON P. FARMER, JR.: There have been a number of important events occurring in the last year and a half which tended toward resolution of many income tax questions of life insurance companies. Five court cases were decided. Most of the issues presented to the IRS by the ALC and LIAA several years ago, which had not previously been resolved, were resolved or at least formally answered by the IRS. Also, there were several revenue rulings and private rulings dealing with important questions. I will discuss the court cases first and then some of the rulings.

Alinco case.—A case of importance to companies selling primarily credit insurance was the Alinco case, decided by the United States Court of Claims in 1967. Alinco was a company whose sole business was the reinsurance of credit insurance. The IRS contended (1) that it was formed for the purpose of tax avoidance; (2) that, since its sole business was reinsuring risks, it was not an insurance company; and (3) that it was not a life insurance company. The company was upheld on all points. The IRS decided not to appeal and has acquiesced on the general issue that a company whose only business is reinsurance is not per se prevented from being classified as an insurance company for tax purposes.

Pacific Mutual case.—This case was decided by the Tax Court in 1967. It involved several issues. Perhaps the one of most concern to actuaries is that dealing with the allowance of the special 3 per cent premium deduction for nonparticipating guaranteed renewable health insurance policies. In Revenue Ruling 65-237, the IRS states that policies on which the company retains the right to adjust premium do not qualify for the 3 per cent of premiums nonpar deduction because they do not meet the test of being issued or renewed for periods of five years or more. In upholding the company on this point, the court in effect said that the revenue ruling was an

improper interpretation of the code. The IRS is appealing this one point.

Another interesting issue, but one which is probably not of great financial importance to many companies, deals with the treatment of the gain from sale of Treasury bills before maturity. Such items are specifically excluded from the definition of capital assets in the code, and therefore the gain, that is, the excess of consideration over cost adjusted by accrued interest to date of sale, is not a capital gain. The IRS argued unsuccessfully that a sale was the same as the alteration or termination and that therefore the gain was defined by the code to be taxable investment income. However, the court held that, although such gain had to be included in net gain from operations, it was not taxable investment income.

On other points the company's position was not upheld. The court held the following:

1. The company was not allowed to adjust its January 1, 1958, group accident and health claim reserve in the light of subsequent experience that proved it to be too conservative.
2. Construction fees were held to be investment income.
3. Option fees, standby fees, and bond commitment fees were held to be investment income.
4. Amounts left on deposit under settlement options are not premiums and are not eligible for the special nonpar deduction of 3 per cent of premiums.

Franklin case.—This case was decided in a district court in Illinois. It involved many issues which apply to a number of companies. The court held the following:

1. The increase in loading on deferred and uncollected premiums is deductible.
2. The loading on deferred and uncollected premiums is not an asset to be included in the denominator of the current earnings rate.
3. Unearned interest income on policy loans is not included in income in the current year. It is also held that such unearned interest should be deducted in arriving at the amount of the policy loan asset to be included in the denominator of the current earnings rate.

The IRS is appealing these points and the ALC has filed an *amicus curiae* brief on behalf of the company.

4. Bank accounts are money and therefore are assets.
5. Escrow accounts may be deducted from cash in arriving at the amount of assets.
6. Employee withholdings, to the extent included in bank accounts, are assets on technical grounds.
7. Stock dividend expenditures are not deductible as expenses.

Although not decided by the court, the company and the IRS agreed for certain tax years that 35 per cent (a figure based on the company experience) of resisted claims could be recognized and that investment expense allocable to tax-exempt interest was not deductible. This latter point has since been resolved otherwise, as will be discussed later.

Jefferson Standard case.—This case was decided by a district court. Many of the points were the same as those decided in the Franklin case; however, they were decided in the opposite way. The increase in loading on deferred and uncollected premiums was not allowed as a deduction. The loading on deferred and uncollected premiums was deemed to be an asset for the purpose of determining the current earnings rate. Also, it was decided that unearned investment income is taxable to an accrual basis taxpayer when received and credited. Other points decided follow:

1. Jefferson Standard was subject to the additional 2 per cent tax for the privilege of filing consolidated returns in certain earlier years.
2. However, the method used to prepare consolidated returns was proper. They eliminated intercompany dividends and consolidated items at each step of preparation of the tax return.
3. Jefferson had a supplemental retirement plan for branch-office managers which was not a qualified plan. Although no policies were issued, a tabular annuity reserve was held. The court held that this liability was not a life reserve for the purpose of the tax law.
4. Jefferson and its subsidiary, Pilot, had allocated a portion of charitable contributions to investment expense. One company allocated it in proportion to number of employees and the other in proportion to salaries. The court held that such an allocation was proper.
5. Agents' debit balances were held to be assets for the purpose of determining the current earnings rate.
6. The court held that the mortgage escrow funds of Pilot (Jefferson's subsidiary) were not assets for the purpose of determining the current earnings rate. However, because of the facts relating to these escrow funds, the court may have been deciding on the basis of facts rather than on general issue.
7. The court held that, when reserves were strengthened, no spreading is required for the purpose of the special nonpar deduction of 10 per cent increase in reserves.

All points are being appealed. On appeal, the company is now seeking to exclude only loading on deferred and uncollected premiums from assets but is no longer arguing for exclusion of the net premiums.

Western National Life Insurance Company of Texas case.—This was decided in the Tax Court in May, 1968. The court ruled on whether or not certain items are included in assets:

1. Any portion of the home office not used in the conduct of its business is an included asset, in an amount not reduced by mortgage indebtedness.
2. Both net deferred and uncollected premiums and loading thereon are excluded from assets.
3. Agents' debit balances are included in assets.
4. Accounts receivable from reinsurance assumed are included in assets.

In 1963, after several years of audits under the 1959 Life Insurance Company Income Tax Act had raised a number of unsettled issues, the ALC and LIAA met with officials of the IRS at the national level to put forth eight of these issues and to present the life insurance company viewpoints. It was hoped there would be a speedy resolution of these issues. However, only three were formally answered by the IRS before 1967. A discussion of these issues follows.

The first issue deals with disallowance of investment expense allocable to tax-exempt interest and dividends received. The IRS contended that investment expense should be allocated between tax-exempt interest and the proportionate part of partially tax-exempt interest and dividends received, on the one hand, and taxable investment income, on the other hand. The former would not be allowed as a deduction. Although there is no express provision in the code which supported the IRS position, the IRS contended that to do otherwise allowed a double deduction which is prohibited by the code. This same issue was litigated by a casualty company. The Tax Court held in favor of the company in the Allstate fire case late in 1966. Early in 1968, the IRS issued Revenue Ruling 68-103, in which it stated that it acquiesced on that point with respect to life insurance companies as well as to casualty companies.

The second issue dealt with uncompleted home and branch-office buildings. The tax code provides that assets used in carrying on an insurance trade or business are to be excluded from the denominator of the current earnings rate. The issue here is when the future home or branch-office real estate qualifies for the exclusion by being used in carrying on an insurance trade or business. In 1967, the IRS issued Revenue Ruling 67-243, stating that unimproved land which is to be a future home or branch-office site does not qualify for exclusion. However, once construction starts, the value of the land and partially finished building qualifies.

The third issue relates to loading on deferred and uncollected premiums. Actually, there are two issues. The IRS contends that no deduction is allowable on the increase in loading on deferred and uncollected premiums in Phase II and that the loading itself must be included as an asset in the denominator of the current earnings rate in Phase I. The first of

these issues involves a distinction between tax accounting and NAIC accounting and the question of when each should be used. The tax code states that the accrual method of accounting, or a combination of the accrual method with another method other than the cash receipts method, is to be used. However, to the extent it is not inconsistent with the foregoing, the method prescribed by the NAIC annual statement blank is to be used. The accrual method referred to is that prescribed by the tax code or, more specifically, that set forth in the regulations and court decisions pursuant to the code. Under accrual tax accounting rules, an item is included in income when all events have occurred that fix the right to receive it and the amount can be reasonably estimated. Similarly, a deduction for expense may be taken in the year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. Furthermore, a deduction is allowed only when some provision of the code so provides. The fact that a deduction is in accordance with generally accepted accounting or actuarial principles is not the criterion if the code does not provide for such a deduction.

The code requires inclusion of gross deferred and uncollected premiums in income. On this point it requires accounting which is consistent with the NAIC method but which is not in conformance with the tax accrual method, since not all events have occurred which fix the insurer's right to such income. The code does not expressly allow a deduction for the increase in loading, and there is no direct analogy to this in tax accrual accounting. Many companies contend that since NAIC accounting is required in determining income, it would be inconsistent not to use that method in determining deductions.

On the other point, the code required inclusion of all assets, including nonadmitted assets but excluding assets used in carrying on an insurance trade or business. Some companies contend that both net deferred and uncollected premiums as well as the loading thereon are an asset used in carrying on an insurance trade or business. However, even if that point is not upheld, the companies contend that the loading is excluded before arriving at the amount of assets, that it is not a nonadmitted asset, and that it is not an asset at all within the meaning of the tax code.

The IRS has not issued a regulation or revenue ruling on this; however, the IRS position is clear. These points have been litigated as discussed earlier.

The fourth issue relates to the discount on prepaid premiums. The IRS originally contended that, when a discounted premium deposit was made, the total amount of premiums eventually to be paid had to be included in

income even though the deduction for increase in reserve on this item in the year of receipt reflected only the actual amount deposited plus a part of a year's interest. Early in 1966 the IRS issued Revenue Ruling 66-36, which upheld the companies' position that only the net amount deposited need be taken into income.

The fifth issue relates to the treatment of incurred and unreported claims. In the annual statement, this item is included with death claims on the basis of an estimate of the gross amount of the claim less the reserve thereon. The IRS contends that the gross amount of claims should be included with death benefits but that the reserve thereon should be a decrement to reserve increase. This shifting does not affect the net gain from operations. However, it does affect the amount of reserves at year end, and hence it affects the amount of the policy and other contract liability requirement and the amount of taxable investment income. In 1967, the IRS issued Revenue Ruling 67-129, which confirmed the IRS position on this.

The sixth issue deals with reserves enumerated in Section 810(c)(3), (4), and (5). These are reserves on supplementary contracts without life contingencies, dividend accumulations, and premium deposit funds. The issue is whether interest on these items which is earned in the current year and paid out in such year may be deducted. If not paid out in cash, a similar amount of interest is included in the reserve increase item for which a deduction is allowed. A private ruling in 1966 upheld the companies' position on this. It appears that the IRS has consented on this point without a more formal revenue ruling or regulation.

The seventh issue deals with dividends to policyholders. More specifically, it deals with the portion of a group dividend which is earned at December 31, but which dividend is not payable until the following anniversary, the amount then payable depending on subsequent experience as well as on experience to year end. In order for a reserve for dividends to be deductible, the dividends must be either fixed or determined according to a formula which is fixed and not subject to change by the company. The IRS contends that this dividend liability does not meet that test, presumably because bad experience in the first part of the next calendar year could reduce the amount payable. In 1967, the IRS issued Revenue Ruling 67-180, in which it continued to maintain its position on this.

The eighth issue deals with the accrual of discount on prepaid mortgages. The IRS contended that when a mortgage is prepaid the unamortized portion of the discount should be included in income immediately, even though the discount had been accrued on a composite basis. The

companies maintained that their composite basis was proper because it took account of the average incidence of prepayment. In 1965, the IRS issued Revenue Ruling 65-214, in which it consented to the companies' position.

Some of the other more important rulings issued in the last year and a half are discussed below.

In 1966, the IRS issued a private ruling which stated that, when the net level election had been made on the approximate basis under Section 818(c)(2), a corresponding increase of $21 or $5 per $1,000 of amount at risk should be made in reinsurance reserves. No distinction was made between coinsurance and YRT reinsurance. Some revenue agents were applying an interpretation of this which resulted in such an increase in YRT reinsurance reserves, on which net level and modified reserves are the same. This situation was clarified in 1967 by Revenue Ruling 67-43.

A private ruling in 1967 stated that, when a new benefit is added to existing policies and a reserve is established for it, such does not constitute a change in the basis for determining reserves.

Revenue Ruling 67-244, issued in 1967, stated that interest paid on a mortgage which was assumed to purchase rental real estate qualifies as interest paid under Phase I.

MR. RALPH J. ECKERT: The organization and responsibility for federal income taxes at my company are quite typical of most other companies in that this responsibility rests with one individual. I have the overall responsibility for preparing and filing the tax return, estimating tax liabilities for year-end and quarterly reports, allocating tax by line of business, acting as the liaison with the revenue agent, requesting revenue ruling and procedures, filing claims for refund, and acting as a consultant and co-ordinator of tax planning to the actuarial, legal, investment, accounting, and administrative departments. A co-ordination-of-effort problem between these departments does not exist in our company because of the close working relationships between our officers and their general interest in maximizing after-tax earnings.

Our top legal officer was a trial attorney with the tax division of the United States government. His knowledge of tax law, tax-refund procedures, tax court processes, and obtaining revenue rulings has been invaluable. Other companies may have to obtain outside legal assistance for these services.

Our top financial and investment officer happens to be an actuary, and this, in turn, simplifies our problems, in that we can supply him with a computer run of marginal tax rates and from these he generates invest-

ment equivalence rates, sets investment policy, and handles real estate and special investment situations.

We prepare our own tax return, but we have an outside accounting firm review it prior to filing. This review has proved especially valuable to us on noninsurance and investment accounting matters.

With regard to revenue agents and audits, I would like to make a few comments.

During the audit of the years 1958–61, for which we have paid a deficiency and closed out the period although we have filed a claim for refund, and during the audit of the years 1962–65, for which we have received a pencil copy of their thirty-day letter, all contact with the revenue agents has been through my own office. I have, in fact, handled these contacts personally. All their requests have been in writing, and we have recorded all the answers given to them. Of course, this has been time-consuming over the last five years, but we believe it has been to the company's advantage, since we have been able to resolve many problems at the point of question rather than waiting until they are included in formal audit reports. This procedure proved especially valuable during the second audit when the IRS became quite interested in our reserve methods and so forth in relation to many of these reserve questions; we were able to convince them that our methods were proper.

However successful we have been in connection with some of these issues, we have apparently lost on some issues at the agent's level. For example, an entire reserve, which in our case amounts to about 8 per cent of our assets, has been dumped into one year—1962—even though 50 per cent of it was developed prior to 1958, without tax advantage to us. We are currently trying to decide what to do with this item—to contest it or to apply for revenue procedure 64-16, which will allow us to spread the item over a ten-year period and, hopefully, in that spreading eliminate the 1958 reserve. Under this procedure, however, we would lose any chance we would have of litigating the issue. However, if we litigate and lose, we would have the full reserve dumped into one year.

Apparently this is becoming common usage throughout the country, and other companies have run into this same sort of situation. If this holds up, it means that in a sense there is no such thing as a closed year with regard to insurance reserves and it may therefore be to our disadvantage to close out a year.

In closing, I think it would be very helpful if we could have a freer exchange of audit results and techniques without concern for our own companies' positions.

MR. JOHN W. PADDON: We all know that the subject of life insurance company federal income tax is an extremely complex one. Many of the technical aspects have been discussed in detail at previous Society meetings, especially in the landmark paper by Mr. John C. Fraser on the Life Insurance Company Income Tax Act of 1959.

This morning, I would like to concentrate on some of the communica-cation and management problems of over-all tax organization and planning in life insurance companies, as well as the role that the actuary can and should play in these areas.

Let me begin with two brief excerpts from Mr. Fraser's paper. The first is from his introduction:

> This analysis is not concerned with specialized subjects such as operations loss carry-overs and carry-backs, the tax on capital gains, the preliminary term or 818(c) election, Phase III, variable annuities, etc.

In contrast, our company has been very much involved with all of these items during the past two years.

The second excerpt is from his discussion of the four different company tax situations:

> It is quite evident that a company in a transition phase from one tax situation to another . . . is going to have considerable difficulty with its tax planning. In such a case, reliable projections of gains can be enormously important.

This second excerpt on tax-planning difficulties also applies to companies like ours, which are just emerging from a tax-loss position or which intend to make the 818(c) election but have not yet done so. I suspect there are tax planners in many companies who also are spending a tremendous amount of time on specialized problems like the ones which Mr. Fraser has mentioned. Many of these problems, of course, will have far-reaching implications within each company.

With the tremendous variety of tax situations and problems that all of us face in our own companies because of differences in size, in organization (stock vs. mutual), in procedures and practices, in the types of products sold, and in the relative importance of one product as opposed to another, which principles or techniques of tax management will prove to be most useful to us as actuaries?

There are many principles and techniques that we could talk about, but let me mention three that have been especially relevant for us.

The first is adequate and frequent communication between the actuarial, accounting, investment, and legal departments. This means that there should be over-all involvement of all these departments in as many

areas of tax management and planning as is feasible. In our own case, we have accomplished this through a formal tax committee, but in some other companies this might be on a more informal basis or perhaps through a formal tax department. Whatever the actual type or size of the tax organization may be in a particular company, I want to stress that each department—actuarial, accounting, legal, and so forth—has much in the way of tax insight and knowledge which it can and must contribute to other departments, in order to get the best results from tax planning. Furthermore, each department should do what it can to develop an overall consciousness and concern for basic tax problems within other departments; for example, it might be a good thing for actuaries and accountants, or perhaps both, to work with the legal department in developing strategies for audits or possible conferences and litigation.

The second factor is that there must be adequate, concise, and continual communication with top management. What this means is informing them and laying the groundwork in relation to all corporate policies and decisions which involve far-reaching or substantial tax implications. This point is especially vital for us, because we are owned by a company which is a nonlife insurance organization.

For example, although it will be several years before our company makes the 818(c) election, we already have begun to communicate in detail with the management of our parent company on the various aspects of this question. The biggest problem in this area is to satisfy them that we should take a substantial amount of our surplus and set it aside before making the election, in order to strengthen our preliminary term reserves to a net level basis. We know this will save us a substantial amount of tax in future years, but it is our responsibility to demonstrate this to management well ahead of time.

You may wonder why we are concerned about this specific problem. One reason is that we are aware of a large stock life insurance company that was in this same situation, getting ready to make the 818(c) election. However, the company could not persuade its nonlife management to put up the necessary surplus to strengthen preliminary term reserves on the old business ahead of time. Consequently, as this business goes off the books in future years, this company will pay a large amount of tax which could have been saved if it had strengthened reserves ahead of time.

Third, and finally, we agree with Mr. Fraser that reliable projections of operating gains and other basic data are enormously important for all life insurance companies, large and small. In our company we are currently developing a new projection system based on our actual master file of

ordinary business rather than on model-office assumptions. We hope this new system will produce more reliable figures for our tax planning and other purposes. The best communication by the actuary with management or other departments on tax matters is not worth a great deal, unless there is reliable forecast and projection data available to support his recommendations, as well as the decisions which management ultimately must make.

To summarize, there is no question that the actuary is in a position to, and in fact must, play a key role in tax planning and management. As much as possible, he should see that top management and other departments become involved and concerned with not only the technical aspects of tax problems and decisions but also their over-all, basic implications.

In order to accomplish this goal, the ability of the actuary to communicate effectively is just as essential to good tax planning as is his technical know-how or competence. If the actuary fails to develop these abilities, both managerial and technical, if he fails to be a good co-ordinator in the matter of taxes, or if he fails to take the leadership in the tax area (if and when this becomes necessary), this can result in a haphazard corporate approach to the over-all problem of federal income tax and, at worst, can result in a substantial tax loss for his company.

MR. LLOYD J. BROWN: In Canada today we find ourselves very much in the same tax position as the United States life companies were in 1958. For those of you who are not familiar with developments in Canada, I will take a minute to run over how this developed.

You may know that in February of 1967 the Report of the Royal Commission on Taxation was made public. This report ran to about 2,600 pages, and it contained proposals for an entirely new system of taxation for Canada. In particular, it contained recommendations which would impose a considerable tax burden on the insurance industry and which would involve many administrative complexities as well.

Following publication of this report, the Canadian Life Insurance Association appointed a number of committees and subcommittees to study various phases of the report. This took a number of months, but it did culminate in October of 1967, when the Association filed two briefs with the Minister of Finance.

The first brief dealt entirely with the tax that would be imposed upon the insurance companies and their policyholders as a result of the recommendations contained in the report. In general, the tone of the brief was to try to maintain that the present system of taxation was satisfactory and should not be enlarged, although it was agreed that perhaps the

policyholders should pay income tax at their own tax rate on any gains arising to them on termination of their contracts by surrender or maturity, as is the situation here in the United States.

The other brief was a general economic and financial appraisal of the effects of this proposed system of taxation—the effect it would have on the country, with particular reference to the insurance industry as a supplier of capital.

In addition to these briefs, of course, many other individuals and industries also submitted briefs.

As yet, we do not know just what action the government is going to take. Presently the only indication we have is a statement made by the minister of finance when he presented a supplementary budget on November 30, 1967. In presenting the budget he made the following statement:

> However, the work we have done within government as well as the analyses we have received from others, leads us to the conclusion that while the reforms we will place before Parliament and the public in the form of a White Paper and ultimately in draft legislation will undoubtedly be influenced by the monumental report of the Royal Commission, it will be more in the nature of reforms of the existing tax structure rather than the adoption of a radically different approach. They will not necessarily be limited to items which the Commission has recommended.

Shortly after this budget was placed before Parliament, the Canadian Life Insurance Association was advised that the white paper would contain some proposals regarding the taxation of life insurance companies and their policyholders. As a result, representatives of the Canadian Life Insurance Association met with the government staff that was appointed to draft the white paper in order to discuss various aspects of the life insurance business.

The government people, of course, would give no indication of their thoughts on the subject. They merely sought information. The company representatives could only draw conclusions about what they had in mind from the questions they asked.

It was made quite clear, however, that they were concerned with the fact that the large amounts of investment income coming into the life insurance companies which escaped taxation needed to be accounted for. Of course, we had been well aware of this and had done considerable groundwork along these lines. Finally, after three or four meetings with the staff, the representatives of the companies were asked to submit a proposal for an income tax basis for the life insurance companies.

As is the case in the United States, there was quite a difference of opinion on what the tax formula should look like. The result was that we ended up by submitting two bases, designated as "Basis A and Basis B," without any commitment that either basis would be acceptable to the companies.

Basis A was a modification of the British system, which is based on interest less expenses, that is, all expenses of management. We thought that, perhaps, for those types of business, such as group insurance, where there was very little investment element, investment income and the expenses allocable or applicable to the business should be excluded. We also thought, in the case of registered insurance and annuity plans and qualified pension plans, where the payments on vesting were subject to tax in full, that the investment income applicable to these plans, as well as expenses, should be excluded.

After eliminating these classes of business, our recommendation was that the net taxable income produced by the formula should be taxed at the average rate that would be payable by the policyholders as a group rather than at the corporate rate, except to the extent that profits were credited to the shareholders, where the corporate rate would apply. The policyholder rate would be about 15 or 20 per cent in comparison with a corporate rate of around 50 per cent. The company in effect would then be paying tax on the gains currently accruing to policyholders. It was also proposed that on a termination the company would determine the net gain to the policyholder and would withhold tax from the policyholder at the rate it had paid on that gain and credit him with the tax that had been paid on his account. In his tax return the policyholder would report the gain and take the tax credit and, as a result, might have to pay more tax or receive a refund.

Basis B was a modification of the United States system. In effect, it proposed that the tax basis should be the gain from operations, that is, Phase II, but with full deduction for dividends to policyholders and with some allowance for tax-free surplus to provide for investment and contingency reserves.

Taxes would be paid on this gain at the corporate rate. In addition, as under the United States system, the policyholder would pay income tax on the net gain upon termination of his policy by surrender or maturity.

In effect the proposed Basis B of taxation as compared to Basis A seeks to tax the same income in a somewhat different way and with a different tax incidence.

Under Basis A there is no deferment of tax from the point of view of

government—that is, the company would currently pay the tax on the net gains accruing to policyholders from investment income (whether paid out eventually or retained by the company) at their own tax rate, while on profits to the shareholders tax would be paid at the corporate rate.

Under the other basis, all retained taxable earnings would be taxed at the corporate rate, and the tax on the gains received by the policyholders would be deferred until the policies were terminated by surrender or maturity.

I might mention that we did not like the idea of any gain at death being taxed and have objected to any proposal to tax any gain arising at the death of a policyholder.

As yet, we do not know what reaction the government staff has had to these recommendations, since they were submitted on March 12. I think the government staff was supposed to prepare a draft white paper by April 15, and it is quite possible that this draft was completed. However, in April a new minister of finance was appointed, and now there is to be an election on June 25, at which time we may have another minister of finance. We are, therefore, almost completely in the dark as to what is likely to develop.

The government staff, as you may know, has full knowledge of both the British system of taxation and the United States system, and I might say that their knowledge of the United States system is causing us some concern, particularly the limitation on dividends to policyholders and the Phase I limitation in general.

We think that the United States tax basis is onerous and that it places the insurance companies at somewhat of a disadvantage with other savings institutions. This is something we are trying to prove, but there are so many factors entering into the situation that we find it very difficult to demonstrate the fact in a convincing way to the government staff. Therefore, if anyone has any ideas on the subject, we will be glad to have them.

I would also like to mention that we have insisted very strongly that any additional tax imposed upon the business in Canada should be confined only to the Canadian business operations of both Canadian and foreign companies operating there and further that there should be no discrimination between the Canadian and the foreign companies.

We have also stressed that the social benefits resulting from life insurance and its vital importance in the Canadian economy are a sound reason for not placing additional burdens on the business.

There was recently some indication that instead of a white paper being issued, legislation might be drafted and put forward which would

be submitted for hearings before a parliamentary committee, in which case the industry would have an opportunity to present its views on the proposals put forward. However, as I say, we do not know just what is going to develop until after the election and the selection of a new finance minister.

I might just mention in closing that there are a number of Canadian companies doing business in the United States which face the same problems here as the United States companies do with regard to the points that these other gentlemen have mentioned.

We likewise have one or two particular problems of our own in the United States, mainly because of Section 819 of the Internal Revenue Code, but these are gradually being worked out at the present time. While a number of the Canadian companies have had internal revenue agents in, generally speaking the assessments are still open back to 1958.

CHAIRMAN DALE R. GUSTAFSON: What has been the effect of the 1959 tax act on the life insurance industry? Has it been an inhibitory influence in the sale of individual policies as opposed to other savings mechanisms? We are paying more taxes under the law than we used to pay. Has it hurt you competitively?

MR. FARMER: It seems to me that one of the immediate occurrences after the passage of this act was a tremendous bull market in life insurance company stocks, which was somewhat contrary to what one might expect. I also think the business has continued to grow. I do not feel that there has been an adverse effect on the sale of life insurance or on the attractiveness initially of the stock of life insurance companies.

MR. ECKERT: As a mutual company heavily oriented toward group and individual accident and health, we are finding that we incur 30 or 40 per cent of the tax we incurred under the previous law.

MR. BROWN: Our problem is to try to convince the staff in Ottawa that the United States tax is relatively high in comparison with the tax paid by other savings institutions. This is difficult to prove, but there was a big case made for it in 1958, when the United States tax law was being developed. Our concern is that we will be at a disadvantage with regard to other savings institutions.

We have been trying to demonstrate that there has been some effect on the insurance business in the United States, but I must say that we have not been very successful and therefore are trying to obtain some information along this line.

MR. CHARLES F. B. RICHARDSON: I would like to ask Mr. Brown whether the United States federal tax burden assumed by a reasonably mature company is comparable to the situation in Britain. In saying that, of course, I realize that in Canada you have a special situation because of the rebate of income tax allowed to the policyholder.

When I was in London a long time ago the policy of the British treasury was to try to tax the industry the same amount as the total tax rebates to the policyholder.

MR. BROWN: That situation still exists. There is very little difference between the credit the policyholders get for premiums on their individual tax returns and what the government collects from the insurance companies. There is no burden on the United Kingdom insurance industry, because the policyholder deducts the premiums he pays from his taxable income and gets a tax credit that way. This offsets the tax paid by the companies to the government. Therefore, for the industry and policyholders as a whole, there is practically no tax burden.

MR. REA B. HAYES: I understood that, when the Income Tax Act was first adopted in 1958 or 1959, the government's revenue from taxation of life insurance companies had practically disappeared or, at any rate, was at an unsatisfactorily low level. Therefore, I was surprised to find somebody from a mutual company saying that the burden today is so much lower. Is this the general experience of the large mutual companies?

MR. ECKERT: I think it is a peculiarity of our company. We are a life insurance company, even though 90 per cent of our premium is accident and health. Under the previous law, we incurred a 1 per cent tax on accident and health premiums, which was a heavy tax, and this tax was incurred whether or not a profit was made.

CHAIRMAN GUSTAFSON: For the industry as a whole, this was not the case at the outset, because the revenue being realized prior to this act was virtually nil. One of the goals in connection with this new law, it was said, was to produce $500 million of income revenue for the year 1958, although I do not recall the precise details. However, it came close to doing this, and the total revenue has been increasing to the point that it is now well over $800 million, I believe. However, I do not know that I have seen any comparison as to what we would have been paying had we continued under the old law.

MR. BROWN: In 1958, if the new law had not been adopted, we would have gone back to the 1942 law, which would have imposed a greater tax on the mutual companies than the new law did. However, they wanted to discontinue this stop-gap law, which resulted in the greater tax.

MR. PADDON: Many people feel that the 1959 act has resulted in a significant shift of the federal tax burden to the stock life companies. I recall reading in the congressional hearings about a company that paid $2 million in dividends to stockholders in a given year and only $50,000 in federal income tax. One underlying purpose that Congress apparently had in mind was to alleviate this type of situation.

MR. GEORGE H. DAVIS: I do not think there is any question but that the mutual policyholders are paying more now for their insurance than they would have paid under the various stop-gap laws. As Mr. Brown indicated, it reached the stage where even the 1942 law would have cost them more. However, during the same period interest earnings have gone up so much that both the par and nonpar policyholders have benefited from this increase by much more than the cost of the higher tax rate.

If you were to try to find out what effect the 1958–59 law had on the life insurance business as an attractive savings vehicle, you would find the effect of the tax law combined with the impact of these increased earnings and with changes in price levels.

While we have had considerable difficulty on some issues with the IRS, and some of them have not been satisfactorily resolved in broad general terms, this tax bill has been a relatively successful law in that, while nobody is really completely happy with it, the level of unhappiness is reasonably equitable. Now, among the various interests in relation to the industry—mutual versus stock, large versus small, individual versus group—how do you feel about this?

MR. BROWN: I would say that there must be some discrimination against the participating business here because of the disallowance of the full deduction for dividends to policyholders under the Phase II operation, thus bringing in Phase I. I cannot see any particular reason for it. I think that at the time the limitation was put in it was done to make sure that the mutual companies did not pay a lot less tax and the stock companies a lot more. They did not want to make the effect of the change too great between nonpar business and par business. However, I cannot see any reason for this limitation of the dividends to participating policyholders. I think it is a discrimination against them.

MR. PADDON: From reading some of the comments and testimony in the Congressional hearings, I find that the consensus was that this was one of the most complex pieces of tax legislation ever to come before Congress. If that is the case, I think it will also be a long time before there is any basic change in the tax formula.

Even though there are definite spheres of interest within the life insurance industry (such as the large or small mutuals, the stock companies, and so on), I think that ultimately it boils down to the fact that, since each individual company must pay its own tax, it also must fight its own battles with the Internal Revenue Service, regardless of the consequences to the industry as a whole.

MR. FARMER: The stock companies felt that the tax had been increased more proportionately. Of course, this is aside from the question of equity. More important is the practical matter of how many dollars they had to get in. If the mutual companies were allowed to get a full deduction for dividends, whether it is equitable or not, I think they would not have achieved the objective of getting the tax dollars they wanted. I think that they felt also they had to maintain a parity between the cost of nonpar and par life insurance. This is one way of attempting to do it.

MR. DAVIS: I would like to have a little better understanding of Mr. Eckert's problem with a disallowed reserve.

MR. ECKERT: We have settled and closed out the 1958–61 period. The reserve I have referred to is a group accrued rating credit reserve which was allowed in the 1958–61 period. It is now being disallowed for the 1962–65 period. Since we had the reserve at the end of 1961, the effect of setting the reserve to zero at the end of 1962 is to dump the entire reserve into 1962 income, even though one-half of the reserve was generated before 1958 at no tax advantage to us.

CHAIRMAN GUSTAFSON: To put this in other terms, it is not just a reserve increase for 1962 that is being disallowed, is it?

MR. HAYES: Could the same thing happen to the rest of us, say, on substandard premiums, where we hold half the premiums?

MR. BROWN: Definitely.

CHAIRMAN GUSTAFSON: You do not have closed years insofar as reserves are concerned. I would say that the general principle we will

have to fight for in the event we do lose the issue is that we will have to go back to the basis of the end of the final year that it had been closed on. There must be a constitutional right involved here somewhere.

MR. ECKERT: I believe Mr. Paddon mentioned another company to which this happened in relation to the regular reserve basis. You then have the dilemma of whether or not to close a series of years. There are so many questionable issues today. There are advantages in closing some of the issues. However, in relation to reserves, it does cause a real problem.

MR. PADDON: I would like to reiterate what Mr. Eckert said about talking to as many people as possible, especially from other companies, and getting as much information and as much of their tax experience as they are willing to share with you.

We also have had a couple of informal meetings in the Twin Cities area within the last year or two, with tax people in some of the other life insurance companies. This includes a variety of organizations of different sizes but all with a great deal of information from which to draw.

MR. CHARLES W. SOUTHERN: In 1958 we were the first company in Des Moines to be audited. The revenue agent did not know too much about the law then, and we got that corrected before he left. When we were audited in 1959, we had a reserve of the type you are speaking of here—in fact, we were over-reserved on our unreported claim reserves to the tune of about half a million dollars. Therefore, he disallowed that at the end of 1959. I said, "Well, if you are going to take that out at the end of 1959, take it out at the beginning of 1959, because it was a lower reserve at the end of the year." He said he could not change that since we had reported it, and we therefore had to accept those figures as they were. Fortunately, however, we did not get into a two-phase deal. Then we certainly could have gotten into trouble.

We have just been in the Appellate Division and have completed 1959–1962. We received several compromises, one of them having to do with contributions to charity. We have taken about 25 per cent of these as being investment expenses. We allocate, among the corporate rate ratio, the interest on this, and, of course, the internal revenue agent disallowed everything. Ultimately, this was lowered to a salary ratio, equivalent to approximately 70 per cent of the corporate ratio figures.

I wonder if contributions are being disallowed in other parts of the country, or if other companies represented here are getting anything for them.

MR. E. BRIAN STAUB: We had agreed with the internal revenue agent that we were going to split the donations fifty-fifty between investment expense and insurance expense and that we were all very happy with that. However, he came back a little later and said he had received word from Internal Revenue Service headquarters that he could not do it. Donations had to be allocated to insurance expense. Therefore, if investment income less a quarter of a million dollars is the tax base, this allocation gives no federal income tax reduction to those companies making charitable contributions.

We have had some questions in relation to our agents' debit balances (financing of agents and general agents which we consider to be salary). The amount going to the individual agent's or general agent's account is reported as income on his W-2 form. These are not loans, but the internal revenue agent has disallowed a substantial part of them because there is a "string" attached to them—there is a potential recovery in the event the agent or general agent leaves the Wisconsin Life and we have sufficient renewal commissions coming in to cover them.

We have really not worked out a satisfactory basis for this. We have taken as expense all increases in the debit balances where those amounts have gone through the individual agent's W-2 forms, saying that he had paid tax on them, they were not loans, and they were a legitimate expense to us. Naturally, we feel too much weight is being attached to the "string" by the Internal Revenue Service action in disallowing much of this expense.

I wonder if anybody would care to comment on that particular issue.

CHAIRMAN GUSTAFSON: The education process that is necessary to make a proper 818(c) election has been described by Mr. Paddon. Corporate planning and long-range projections have been mentioned. I was very proud some years ago when the company which I was with, a stock company, made a lot of money and was probably in a landmark position because we were one of the first companies to go through this 818(c) election. I was proud of the job I had done in convincing management that they really ought to take all that money out of surplus and put it into reserve and strengthen past reserves so we could make the 818(c) election. My projection indicated how much we were going to save in taxes. Two years later my projections turned out not to be worth very much because something had happened in the marketplace. Instead of the nice happy 15–20 per cent growth rate, new business went up 50 per cent for two years running, and this shifted around the operating gains so that the virtue of the 818(c) election was, and still is, largely lost.

You need to be very confident that you are going to need those deductions before you make the election, because it is rather irrevocable and, if you lose them in the meantime, they are lost forever.

There are a number of companies, principally small or medium-sized companies, that may not know from year to year whether they are going to be classified as a casualty company or life company. What account of this can the tax planner build into his operations? Is this a hopeless situation? Is there anyone that has any answer to this?

MR. FARMER: I know of a few small companies in that situation. I think you can attempt to emphasize the life business more, maybe sell single-premium policies—do not make loans against them. If you slip for one year, then you do not lose your status as an insurance company. You have to be out for two consecutive years to really get hurt badly. The main thing is to try to build up the life business and point out to management that there are dangers of treading along the line in fluctuating between being a life company and casualty company. Among other things, if you have losses, you do not get to carry over the losses from one status to another.

MR. ECKERT: You can also switch to selling guaranteed renewable or noncancellable policies. I would like to elaborate on my earlier comment that our tax is lower under the current tax law. It is about one-third of what it was under the previous law. However, the present law forces us to invest in tax-exempt bonds in order to produce the maximum after tax return. The investment in lower-yielding exempt bonds offsets some of our tax advantage under the current law.