RECORD OF SOCIETY OF ACTUARIES
1976 VOL. 2 NO. 1

TAXES UNDER CONDITIONS OF INFLATION

Moderator: QUINCY S. ABBOT.
Panelists: PETER W. PLUMLEY, B. KENNETH SANDEN.*

1. U. S. Tax Policy - effect on investments, jobs, inflation

2. Impact of inflation on tax burden under Life Insurance Company Income Tax Act of 1959

3. Discussion of paper by Peter W. Plumley, "Certain Inequities in the Life Insurance Company Income Tax Act of 1959"

MR. B. KENNETH SANDEN*: Congress in this election year has begun to recognize that when they talk about tax policy, they are talking about economic policy. They recognize that since tax policy is economic policy, changes in tax policy affect such things as jobs, rates of inflation and competition with the rest of the world. Congress also now recognizes that we cannot set tax policy in a vacuum with the rest of the world. All of the countries of the world, as Dr. Wallich and others mentioned, are affected in some degree with such problems as inflation, recession, energy crisis, pollution, capital shortages and unemployment. Dr. Kissinger said recently that economic interdependence is a reality. In all of the actions that the United States Government takes, including changes to tax policy, it must take that fact into account.

Not too long ago, American businessmen really did not care what tax policy was anyplace else in the world. With our abundant raw materials, a large amount of capital readily available, cheap electricity, high technology and high volume, we were able to compete with anybody, anyplace in the world, even if they had zero taxes. That is now painfully changed. There are raw material shortages in the United States as there are in other parts of the world. Some of the raw materials are now being controlled by others who want higher prices for them and controls on their own. There is a shortage of capital in the United States, just as there is in other parts of the world. Technology has spread around the world. The new economic order that is arising from the U. N. is causing the less-developed countries to demand a fair share of the world's production and a larger share of the ultimate revenues that are produced from whatever raw materials they have.

In the past, we have reacted to these world conditions in many ways in the United States, but we have never reacted to these world conditions at all in the tax area. Clearly the way in which business income is taxed has a significant influence on the manner in which the production capability of our economy is used, the growth of our economy, the expansion of our economy, and on our ability to compete effectively in the world economy. Business will not invest unless it is assured of recouping its full costs and realizing a fair return on its investment.

*Mr. Sanden, not a member of the Society, is Partner, Price Waterhouse & Company, New York, New York.

How does our tax system compare with the rest of the world? The United States capital recovery system including depreciation, even with such changes made in our law as Accelerated Depreciation Range (ADR) and the increase in the investment credit, is tied for last amongst the industrialized world. With relatively few exceptions, we tax capital gains more harshly than any other country in the world. We have a complete double tax on corporate income, because we tax both the corporation and the shareholders who receive the profits. All other industrialized countries provide some relief for double taxation but us. We constantly whittle away the economic neutrality of our tax law by limiting the amounts of foreign tax credit that may be claimed. All other industrialized countries either do not tax foreign income at all or give full credit for the taxes paid in the other country. We really do not have any incentives for investment as such in the United States. Other countries exempt certain types of income; they grant special write-offs and special allowances for investments. Most countries encourage capital formation through their tax laws. We do not have any inflation adjustments. There are no provisions in our tax law that were specifically inserted to take care of inflation. Other countries have special reserves, allowances, adjustments or write-offs to meet the problems of inflation. We are the only major industrialized country that relies almost exclusively on the income tax for our basic revenue. All of the other countries reduce the bias against savings and investments by obtaining a substantial portion of their federal government revenues through indirect taxation such as a value-added tax or a tax on consumption of some type. We rely strictly on an income tax that is biased against savings and investment. Thus our tax system compares most unfavorably with the rest of the world.

There are two problems in the foreign income area and they arise from the fact that all of the world tries to, in its taxation of foreign income, achieve economic neutrality. The first problem is that double taxation on foreign income must be eliminated. We operate through the tax credit system under which a credit is provided for any taxes that are paid on income earned abroad when that income is repatriated to the United States and is taxed again here. This is not a reduction of U. S. tax, per se. It is designed to offset additional U. S. tax computed on income not earned in the United States. The use of the tax credit has to be allowed to prevent taxing foreign income twice. If our taxes are twice the amount that would be paid any other country on the same amount of income, a company will manufacture abroad, not in the United States. The second problem involved is whether we should pay tax in advance, even before we receive the income in the United States that has been earned in a foreign subsidiary. Many people believe there is something wrong when tax is not paid currently on what has not been received just because one of our foreign operations has earned it. However, that is basic to the U. S. tax system; a shareholder pays tax only on income received.

In both of these areas there seems to be a feeling by many in Congress that really what we should do is keep all of the money in the United States. If we could put in a penalty tax by taxing corporations before they receive the income, they would not go abroad; or secondly, if we could deny them credit for the foreign taxes paid, somehow, automatically we would be better off in the United States. All of the studies to date that have been made on this disprove that. They show that in fact foreign investment is good for us and should be maintained. Clearly in this economic interdependence era, we must have neutrality in the foreign area.

What role should the tax system play in economic planning in the United States? Should it be completely neutral? If it should be made neutral, industry would have to work hard, because currently the tax system is biased against capital derived from savings and investment. If we wanted to have a neutral system, we would probably have to put more loopholes into tax laws. The question then is, should it go beyond neutrality and tilt toward investment? Should we use the tax laws, which are only one gun in our arsenal, as one of the weapons to stimulate investments and savings?

The basic question then is, do we really need more capital? All of the studies that have been made -- the Stock Exchange, the Roundtable, Chase Econometrics, Brookings, etc.-- basically conclude that there will be a large gap ultimately, and surely between now and 1985, between our demands for capital and the possibility of individuals and corporations saving enough to produce that much capital. The Brookings' study shows that we can just make it. If their assumptions are realized, there will not be a shortage. However, the Brookings' study is based on 3% inflation, 4% unemployment and a Federal surplus, which appear to be doubtful assumptions at the moment. If we just test it, there has to be a tremendous demand for capital. It has been indicated that there are a million and a half new people coming into the labor market every year. It presently costs from a minimum of $35,000 to a maximum of $200,000 to provide one job in the labor market. Thus, the annual new capital required for those million and one half people would be in excess of 50 billion dollars. That amount does not take into consideration replacement needs, modernization needs or environmental needs. It seems clear, then, that if there is not a shortage of capital in the United States, there certainly is not a surplus of capital.

What can we do in the way of a solution? At the corporate level, the largest source of earnings is the depreciation of capital recovered. In 1968 we attempted to solve the problem by developing the ADR system of depreciation. The Congress adopted our suggestion, to this extent, that we are allowed 20% more depreciation than we would have been allowed otherwise. Depreciation is the biggest single cost in the business stream; it is the one that produces the largest share of earnings. Since 1968, a high rate of inflation, new technology and environmental concerns have taken place. In 1968, no one saw the need for the billions of dollars of new investment that would be required to take care of the environmental problems.

Many are suggesting that we must move to a new plateau. Once again we should examine what has been done in other countries in this regard. In the United Kingdom, you can write off the entire cost of an asset immediately in the first year of purchase. In Canada, you are allowed in excess of 50% depreciation a year; you can recover all of your investment within two years. Many countries allow you to recover more than your investment. In Canada, you may recover 105%; in the Netherlands, you may recover 108%; and, in Sweden, you may recover 130%. There is encouragement to put this money in and to make it useful to create additional employment. They are more frightened with unemployment in Sweden. Thus, they do what they can to stimulate modernization, capital expenditures, etc., so that the people will be employed. Sweden is currently experiencing slightly more than 1% unemployment and they are adding additional incentives.

As a result, one of our current suggestions is to change our entire depreciation system again. We suggest something along the lines of the Kemp Bill which would allow business, if it desires, to write off all of its machinery equipment in five years, to write off its productive plant in ten, and to write off immediately anything it spends on pollution control facilities. The intent of the Bill is to create productivity gains, which is the only way we can have real wage gains. Dr. Thoré, a Washington economist, has reviewed the Kemp Bill and has estimated what it would accomplish, if this simple system of depreciation was adopted. By the third year, there would be four and a half million more people employed in the United States; the Federal revenue from taxes in that year would have been increased by 14 billion dollars. President Ford suggested that more depreciation be allowed only in those places where the unemployment is in excess of 7%. His suggestion would allow more depreciation if a new plant were built in a high unemployment area. He would also allow faster depreciation on the machinery equipment that went into a new plant, but not new machinery equipment that goes into an old plant. You could not modernize, you would have to build a new plant and put in new machinery, even if you left the one next door vacant. This concept is an example of attempting to tie together a political idea and an economic idea. It has some political appeal but it is clearly the wrong idea from an economic standpoint. Obviously a new plant anywhere in the United States will create jobs all over the United States; the demand for supplies will follow where it is. Economics should govern the location of a plant and not any tax incentive that creates this kind of discrimination.

At the corporate shareholder level, Dr. Wallich mentioned that all of the industrialized countries do something to avoid the double tax. Brookings Institute has estimated that the use of the corporate form of business in the United States costs an extra 19 billion dollars a year of tax over the partnership or the proprietorship forms. Equity demands that we eliminate the penalty. Equity and simplicity indicate that we should allow a deduction for dividends paid. This would mean that a corporation would only be taxed on the income it actually retains. The corporation would get its deduction for the cost of capital and it would not care whether it borrowed that capital or obtained it through the equity market; the shareholder would be taxed on his income regardless of the source, which gives him horizontal equity.

Turning to capital gains, one of the reasons we have a special tax rate for capital gains is the double tax on corporate income. If we reduce the double tax, we probably would have a lessened need for relief in the capital gains area. However, capital gains reflect largely the inflation element or rollovers. We must have a special rate for capital gains, if we are not going to allow the losses. If we find we are in a position where losses must be carried forward, they may never be used. Therefore, you must have some kind of a special rate when you have a gain. This is biased against savings; thus, we need some kind of special relief, which is why we have a special rate for capital gains. At the moment, Congress is keen on two things in the capital gains area. The first thing Congress wants is that capital gains relief be limited to securities held for at least a year. The second thing they are suggesting is that a sliding scale approach should be adopted. The Treasury has proposed to the Congress, and the Congress is very sympathetic at the moment, that with respect to capital gains on securities held between one and five years, you would only include half the amount. When the period securities are held is increased from five to twenty-five years, you could exclude as much as 70% of the gain. In effect, then, you would be adjusting for inflation and reinvestment. There is considerable interest in this in the Congress.

For investment incentives, the Administration has suggested the use of broad stock ownership plans (BSOP). The general requirement of these plans is that an individual could deduct in his tax return an amount of investment up to 15% of his compensation, limited to fifteen hundred dollars. The deduction starts phasing out at $20,000 and, at $40,000 of income, no deduction would be available. The income that would be earned on this investment, though, would be free from tax during the entire time it was held. The only restriction is that you must hold it for at least seven years. If it is redeemed in less than seven years, there is a penalty. If you hold it for seven years, then you only pay tax at capital gains rates. The backers of this idea argue that this arrangement would compensate for the inflation that would take place during that time. However, the biggest difficulty with these plans is they can only apply to common stock investments, although other securities forms could be held indirectly such as through a mutual fund. Obviously, it is a limited concept based on a variation of the Keogh and the IRA plans that are out at the moment; it clearly discriminates in favor of just one type of investment.

The Senate Finance Committee is interested in the employee stock ownership plans (ESOP). That is because Senator Long believes every employee in this country should be a part owner of the company for which he works. However, many of us do not work for companies where we can necessarily buy the stock. Some of us are schoolteachers, firemen, accountants, lawyers, etc., and there is no way we can buy stock in our company. Thus, this is a very limited type of an incentive, limited to common stock, and it really is of little benefit in many situations.

In Sweden pension funds are turned over to the federal government. The corporate pension funds are then added to one fund; however, the Swedish government takes pension funds from the large corporations and puts them into what they call pension fund number four. Pension fund number four is invested entirely in new equities. They use this to stimulate the economy of Sweden. If a company comes along and needs more money to build whatever it is, and needs to raise the money in the stock market, the pension fund purchases these new equities. Thus, the Swedes actually own all of the companies through their pension fund. Sweden has done this successfully for years. The pension fund was the largest single source of equity funding in Sweden in the last two years.

It is important that so much consideration is being given to an incentive for investment. Many of us have suggested to the Congress and to the President that we should have some type of a tax credit for incremental investment, a credit not a deduction. The reason for a credit is that a person in the lower brackets would net as much actual dollars as somebody in the higher brackets, and proportionately more incentive. You would not have to phase anything out if you receive a tax credit. Fifteen percent of an investment could be given as a credit, limited to perhaps a thousand dollars for a single individual and two thousand on a married return. But, any investment would qualify. What difference is there if it is a stock, a bond, a savings and loan account, a bank deposit, a government obligation? Let the marketplace decide what the person is going to invest in; what his personal needs and views are. We need capital in all of these areas. It does not make any difference where it goes; but, by putting it in all of these areas, we do not have disintermediation or discrimination. In this connection we have recommended that insurance would also qualify as one of the investments; but, what portion of the insurance should qualify as an investment? Congress raised questions as to whether the face amount should be qualified or merely the investment portion of it. Should the total cost come in or not? We pointed out that the total cost is a contribution to capital from the U. S. economy standpoint but perhaps there is also part consumption in the amount. Maybe members of the Society could be helpful in this regard as to how an individual's insurance cost could be integrated into an investment incentive credit. This is one of the questions that is open. Personal items like a house or a car would not qualify. We already favor consumption under our tax laws; we should not favor the purchase of an automobile in the tax law.

Turning to the inflation adjustments, we do not have any provisions for inflation adjustments in the United States. Dr. Wallich said that we have an overstatement of inventories in the United States because we are not matching current costs with current sales income. The only thing wrong with that statement is that you can. Under the LIFO method of inventory valuation that is exactly what you do. It was not put into the laws of inflation adjustment, but it does exactly what Dr. Wallich said should be done in the tax laws as an inflation adjustment. We have such a provision in our tax laws and most of the major corporations in the United States are using the LIFO inventory method. There is not this big overstatement of inventory profits in the United States because the major industries are using this method. With respect to depreciation on inflation adjustments, he pointed out that we have overstated our profits. We have paid tax on an amount that we should not be paying tax on. However, from the standpoint of what has actually happened in the last four years, U. S. corporations have borrowed more money in the market than they have spent on capital expenditures. At a time when inflation was taking place, they were incurring debts which they will pay off with lower-cost dollars. At the same time they were investing those dollars in depreciable assets. If the two exactly balanced, we would not need any inflation adjustments at all, because we would be having the credit on the one side and the charge on the other. From the standpoint of the business community in the United States over the last four years, we probably do not need an inflation adjustment. Individuals have experienced a very serious problem with inflation. We have not had any actual tax reductions in the last several years in the United States; we have overcome the tax increases that are attributable to inflation and they have almost exactly balanced out. The 1974 and 1975 tax reductions did nothing more than overcome the additional taxes individuals would have paid if there had not been any adjustment attributable to inflation. In the estate and gift tax area, the administration is recommending some inflation adjustments. They recommend that the sixty thousand exemption be increased to one hundred and fifty thousand dollars. The sixty thousand dollar exemption was established back in 1942; sixty thousand dollars in 1942 would have inflated to two hundred thousand dollars today. We should go to at least a hundred and fifty thousand dollars in that area. They have recommended stretch-out payments for small businesses and farms. Congress is completely sympathetic with this idea particularly for small business and for farms. They are not as enthused about applying it to everyone; however, they could hardly do something just for the farmers and small businesses.

All of which comes back to where I started; we should look at our tax structure in all of these areas and see what we should do. We might remove everything that we have in our tax law in the way of credit adjustments, exemptions, deductions, special provisions, etc., and just reduce the tax rate. However, that would not accomplish any of the things that I have described, namely, compensate for inflation or compensate for the bias against saving and investment. If we reduce the rate, it would still be there. As a matter of fact, if we made severe cuts in these special adjustments, it would be even worse. There could be a greater bias in our tax system against savings and investments than we have today. We would have to come along with special incentives to overcome them, and we would be right back where we were before. The Assistant Secretary of Treasury for Tax Policy came up with a very good suggestion to take a look at our present, consumption-biased, tax structure and tilt it in favor of savings and investment. He would change our tax structure by instituting an expenditure type tax, a value-added tax as in Europe or something similar. Seven years ago, our task force closed its report with that kind of a recommendation. We said that if at any time in the future we are going to need more revenue in this country, we must adjust our tax system. We must tilt it toward savings and away from consumption by adopting some kind of an indirect tax.

MR. QUINCY S. ABBOT: Several of Ken's points relate directly to life insurance company taxes. If the Congress should eliminate double taxation of corporate profits by a deduction for dividends paid to shareholders, there would be a question of how this deduction would fit into the Phase I, Phase II or Phase III computation. In considering the alternatives of expanded tax credits versus expanded tax deductions, life insurance companies will generally favor tax credits since they have a higher relative value than tax deductions. An extension of the holding period for capital gains to one year rather than six months will affect tax planning of life insurance companies. Those companies which realize capital gains every six months in their non-qualified Separate Accounts will have a full year before it becomes necessary to realize gains. The concept of an investment credit for the savings element in insurance premiums is an intriguing one.

MR. RALPH H. GOEBEL: Dr. Wallich discussed the law of diminishing returns with respect to investment capital. He said that if we increase capital relative to land and labor, then the return on that declines. It appears that there is a conflict between that statement and your statement that we need more investment.

MR. SANDEN: I do not think Henry and I are in disagreement. We receive from the corporate area approximately one hundred and fifty billion dollars a year of savings; that is our largest single source of investment in the United States for such things as plants and equipment. The corporations obtain their savings from their depreciation and their retained earnings. Clearly what we have to do is to make sure that they get the depreciation as fast as possible or else they do not really get any savings out of it at all. To use a ridiculous example, if we had to put in a million dollars today, but we could only depreciate it over twenty-five years, we would not receive back our million dollars at a tax rate within inflation. Therefore, we would never have the money to reinvest, because the cash flow does not go that way. We need far more than the one hundred and fifty billion we obtain from corporations. The corporations in computing their rate of return, which is what Henry Wallich was talking about, have to calculate how much they get back on this property as against their tax bill to determine how much the plant is costing them, because they borrowed the money. We start with the fact that the largest single source of savings in the United States is the capital recovery allowance we have for corporations. That is the one thing that the rest of the world has recognized and done something about, but not the United States.

We keep using that as a loop-hole concept, a big business concept. We need inflation adjustments; inventory and plant are not being recognized enough. These are consistent, but the rate of return is related to how fast you get your money back through the depreciation schedules. Also, if we had no inflation, no improvement, and no environmental concerns, maybe the hundred and fifty billion would be there. When we start adding four hundred billion all over a 10 year period for pollution controls, none of which is in that original hundred and fifty billion that we started with, we just are not going to have the money at all, unless we can obtain additional savings. Therefore, we have to move the rate of savings up some way; the biggest single source is the corporate depreciation. If we can move that up 10%, we would have another ten billion a year to invest in pollution controls. It is a very, very simple concept and one that is easy to work on.

Quincy made a comment a moment ago with which I am in complete agreement. The dividend deduction scheme makes the life tax computation very difficult; it makes it difficult for every other industry in the country that has some special tax incentive percentage depletion, investment credits, foreign income, etc. For example, let us assume the oil industry pays a 15% tax, not the 48% paid by many other industries in the United States. If they receive a deduction for dividends paid, they are only saving the 15%, not the 48%. But from the standpoint of the individual who receives the dividend, the concept is that the individual is supposed to pay his taxes if he earns that money. Hence, there must be a dividend deduction in order to have the thing work out appropriately. If he has the dividend, he should pay a tax on it; you do not have the money and you should get a deduction for it. But, you are not taxed at 48% in your industry; nor in the steel industry; nor in the oil industry. Then, why should you get a bigger saving than applies to someone else.It is the same with interest; I agree that it does not do what you want it to do.

MR. CLAYTON A. CARDINAL: I read recently in the Wall Street Journal where Peter Drucker was describing the proliferation of the institutional investor. He pointed out that these investors represent for the most part the population. Is this the populace to whom you have referred? He estimates that by the year 2000 most of the ownership of American industry will be in the hands of the institutions so thereby the double taxation is all the more depressing if the taxation is supposed to benefit the people.

One of the observations that I have made is that the economist is always strongly analytical, but he is always telling us in retrospect why he was wrong. It seems that he has a scenario that touches on maybe seven to a dozen primary forces. There are a multitude of forces that affect the economy and it is almost impossible for the economist to adequately, simply because he is human, anticipate the impact of the interaction of all of these forces. Thus, we are always listening to his explanation as to why his forecast was wrong. We heard some comments this morning that there is a tremendous danger in this. Professor Forrester, Sloane Professor of Management at MIT, reported to the Conference Board last year on some of his econometric models. He pointed out that there is probably a point where capital formation is excessive and it does not, in fact, result in a diminishing return. When there are economic problems, he points to the fact there are scenarios which point to the lack of capital formation. He eludes to past history where we have seen this phenomenon. We have that today in effect. As we get into economic problems, we always come up with the scenario that we need increased capital formation. Professor Forrester points to a long-term economic cycle by a Russian economist and indicated that this cycle is due to manifest itself in about four years. The point is that Forrester indicates that we are probably reaching the stage where we may be beyond the point of useful capital deployment.

MR. SANDEN: We are getting very deep into the philosophy of capital markets. In order to have consumption, we have to have productivity. We go all the way back to the simple illustrations of Robinson Crusoe. He found out that he could not do any of the planning or fixing up of his house if he did not set aside capital. He was able to do that by fishing on some days; and by catching more fish than he needed that day, he could put them aside. The Stock Exchange studies, of which there have been four, could be completely faulted on the basis of what they did. They went to every industry, into every company that was major in that industry, and asked, "How much capital are you going to need in the next 10 years?" That would be like asking your wife what she would like for an allowance if she could have it. She would add up everything she could wish for. In effect, that is how they came up with this shortage of four and one-half trillion dollars in the next decade in our economy, but that is not reasonable. Many of these organizations, such as Chase Econometrics, showed that there was a tremendous gap between what they saw as the capital needs and what they saw as available capital. They showed that a tremendous amount should be spent for nonproductive facilities, such as in the environmental area. Of course, that adds a tremendous dimension, because we are talking currently something in the neighborhood ultimately of forty or fifty billion dollars a year. That is half the amount we now obtain from depreciation. We would have to take the money we extract from our productive facilities and put it in nonproductive facilities, which will not give us the consumption that we need. I have looked at all of these studies and have put them all down including Mr. Drucker's. In most instances their computations are extremely faulty; but whether the computations are faulty or not, we surely do not have this surplus. We surely are going to need more in order to do what we should do. But, the point I am trying to make is that regardless of these studies, we must examine how we accumulate capital in this country, how we put labor to work. If we consider the situation in Sweden, the Swedes are the most heavily taxed people perhaps in the world as individuals. The Swedes do not save anything either. There is absolutely no need for a Swede to buy a life insurance policy or put any money in a bank. He is taxed as high as 97% for what? Everything he needs is paid for by the government, all of his health expenses, all of his children's education. In fact, when your children go to school in Sweden, you do not pay any money for them, the government pays you. When you are in college, you receive $125.00 a month spending money plus all of the costs that you need to go to school, and you can stay in school as long as you want. After your formal education is completed, you enter the Army for a couple of years where you have a nice barracks and you are paid for being in the Army. When you become married, you receive allowances; when you become ill, they take care of you. When you retire, you receive indexed retirement allowance. A Swede does not save any money because he does not need to. So how do they obtain capital? They put up investment reserves. If any corporation in Sweden will put aside part of this money for additional investment, they can take that as a tax deduction and they do not have to pay taxes on it to the government. They can go out and build more and more plants and, of course, when they build more and more plants, it puts the people to work. They keep themselves efficient, modern, and competitive in world conditions. For a little country with only a few million people, they are one of the leading countries in the world competitively. They have been able to do this entirely through a tax system, entirely through a capitalistic tax system. The individuals are not part of it. But, when they get all through, all of their money is really invested in productive facilities because that is what they have done with the pension plan funds and invested reserves. We have a situation where a country has determined that capital is the name of the game; that there are only two things, consumption and savings. They are doing everything they can to reduce the consumption and increase the savings. They pay a 17.65% consumption tax on everything they buy. When you add almost 20% to everything you buy, because you do not want them to spend the money, you would think spending would be dampened; yet the Swedes still go out and spend it. What we are trying to say in this country is that our entire system is tilted toward consumption. We do not do anything for the saver except penalize him; inflation hurts him; our depreciation is no good; our capital gain rates are no good; we do not have any of these adjustments. Everything in our tax system is tilted toward consumption, away from investment. All that I have been trying to suggest in all of this is that we should do something to this tilt. To do something to overcome this would put us back in a better position than we would otherwise be.

MR. PETER W. PLUMLEY: We have listened to a discussion of the general impact of inflation on tax policy and considered possible tax reform measures which might be applied to correct some of the problems which have emerged. I would like to mention some of the ways in which inflation has affected the taxation of life insurance companies because of the particular features of the Life Insurance Company Income Tax Act of 1959.

In looking at the Life Insurance Company Income Tax Act of 1959, I recognize that the development of any piece of complicated legislation such as the 1959 Act is always the result of a great deal of negotiation and compromise. I know that many of the provisions in the Act were the result of compromises, and that sometimes the legislative history is merely a rationale for some deal which was made so that all the parties at interest could be satisfied, or perhaps dissatisfied, in equal degrees.

Recognizing that the record cannot really reflect these "back room" deals, it is nevertheless instructive to examine the printed record which went into the development of the 1959 Act and see just how the stated intention of Congress has been carried out.

There are five areas where I contend that the 1959 Act is working a hardship on the life insurance companies that was not intended in the original enactment of the law.

The first, and probably most important, inequity is certainly no secret to any of you who are working on life insurance company tax matters. This is the inequity which is resulting from the error which develops in the so-called "10-for-1" rule, otherwise known as the "Menge formula", in Section 805(c)(1), when the difference between the adjusted reserves rate and the valuation interest rate exceeds a certain amount. Section 805(c)(1) provides that life insurance reserves are to be adjusted by multiplying them by "that percentage which equals 100%, increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and reduced by that percentage which is 10 times the adjusted reserves rate."

The "10-for-1" rule dates back to long before the 1959 Act. For example, in 1938 it was mentioned in TASA XXXIX, at page 285. It is a rule of thumb which can be applied to adjust a portfolio of life insurance business for small differences in the rate of interest without too much error. However, if the rates of interest vary by more than 2% or 3%, the error can become quite large. The extreme example is the case when the valuation rate of interest for non-pension reserves is 3% and the adjusted reserves rate is 13%. In this case, there would be no reserve deduction allowed at all, since the formula would reduce life insurance reserves to zero.

The error in the "10-for-1" rule also varies considerably according to policy form and duration, and therefore a small, rapidly-growing company, for example, will have a much different result than a large, more mature company. The effect of differing types of business on the accuracy of the rule can be shown. The effect of a changing level of new business also can be quite significant.

About three years ago, I recognized that, with the continuing increase in interest rates earned on new investments, and therefore the continuing increase in the overall portfolio rate, it was only a matter of time before the difference between the valuation and earned interest rate would become so great that a very substantial error would develop in determining adjusted life insurance reserves, with the result that companies would be paying far more in taxes than they equitably should. Recognizing that this was a problem which was best corrected before the correction would result in substantial loss of current revenue, I gathered together several actuaries from some of the major companies to develop data, which it was my hope would eventually be used as a basis for obtaining corrective legislation.

There are a number of possibilities for corrective legislation. Three such possibilities readily come to mind. One is to abandon the "10-for-1" rule through the use of an improved approximation formula. One such formula which seems to work pretty well is an expansion of the algebraic expression $(.9)^n$, where n is equal to 100 times the difference between the adjusted reserves rate and the average valuation interest rate. For n equal to 1, i.e., a 1% difference in the two rates, the formula is identical with the "10-for-1" rule. For n greater than 1, the formula always results in adjusted reserves greater than those determined by the "10-for-1" rule.

The formula was originally believed to create statutory and compliance problems, and as a result, I suggested a modified formula, using the first three terms of the algebraic expression. However, I understand that the committee working on this problem has come up with statutory language which adjusts reserves 1% at a time. Thus, for a 3% difference in interest rates, for example, the reserves would be multiplied by .9, and the result multiplied by .9, and the result of that calculation multiplied by .9. As you can see, this gives the same result as using $(.9)^n$, but is easier to understand and easier to express in a statutory bill.

A second possibility would be to permit companies the option of adjusting their reserves to the adjusted reserves rate of interest on an exact basis. This would be analogous to the option presently in the law in Section 818(c), allowing companies to revalue preliminary term reserves to the net level premium basis on either an exact basis, or using the approximation formula in Section 818(c)(2).

A third alternative would be to combine the first two; that is, to provide for an improved formula, and also to permit an exact revaluation.

I might add that the use of an exact revaluation formula would probably require that the final adjustment be made using some approximation such as the "10-for-1" rule, because the adjusted reserves rate of interest is one of the last items to be determined in calculating the tax return figures, and because it inevitably changes on audit. Even for the large company, it would be costly to have to recalculate reserves on an exact basis because of some small change which had been made in the adjusted reserves rate at the last minute, or because of an audit. For the small company, the cost would be very unreasonable.

The current inflationary climate has very much aggravated the need for corrective legislation. Obviously, when inflation rates are high, new money rates are high also. If we did not have inflation, we could probably assume that over the long run the valuation rate would remain close enough to the adjusted reserves rate so that we wouldn't need to worry too much about the error in the present formula. However, with the current inflation rate running at 6% or 7%, and with the possibility of double-digit inflation at some time in the future again, there is little chance that rates of return on new investments are going to drop to anywhere near the valuation rates which are used in most life insurance policies.

The second inequity has also been created, in major part, by the relatively high new money rates in recent years. This second inequity relates to the deduction granted under Section 805(a)(2) for pension plan reserves. The original concept of the 1959 Act was to permit interest attributable to qualified pension and profit sharing plans to flow through to the policyholder without being taxed at the insurance company level. Only the profits realized on these plans would be subject to tax, and this only in Phase 2, of course. By this procedure, it was intended to leave insurance companies on a competitive par with trusteed plans.

Unfortunately, however, two things have happened. First of all, the rate of return on new investments has been very high in recent years, and probably will continue that way. Second, and this is also an essential ingredient of the inequity, the rate of growth of reserves under qualified pension and profit sharing plans has been very much in excess of the rate of growth of life insurance reserves other than qualified pension reserves. The result is that if you have both pension and non-pension business in the same company, you get a demonstrable tax inequity. This is essentially because the high interest return on new money is only partially credited to the qualified pension reserves. The portion of it which is, in effect, credited to life insurance reserves does not get a full tax deduction, and therefore some increase in tax results when qualified pension business is brought in at an interest rate higher than the portfolio rate.

This inequity is also being carefully considered by industry people because it has caused a great deal of competitive problems, particularly for certain companies. Unfortunately, there does not seem to be any easy answer to this one, since there are many administrative problems involved in giving qualified pension reserves treatment analogous to separate account treatment; and the other logical solution, which is to allow these reserves to be considered as funds at interest, in some cases gives companies a much larger tax reduction than they equitably are entitled to. I am not trying to propose a specific solution, but I am suggesting that it is a matter which needs corrective legislation.

The next two inequities relate to the failure of the 1959 Act to make proper allowance for fluctuations in underwriting income. Primarily a stock company problem, the first of the two inequities relates to the fact that contingent deductions lost because of the limitation imposed by Section 809(f) cannot be carried back or carried forward. In most places in the Code, deductions which cannot be taken in a particular year because of a loss situation, or otherwise, can be carried back, or carried forward, into another taxable year, generally subject to some limitations. For example, a net operating loss can be carried back three years and carried forward five years, except in the case of a new life insurance company, in which case the carryover is eight years.

In the case of contingent deductions lost because of Section 809(f), however, there is no such opportunity for a carryback or carryover. The lack of such a deduction has been of some importance to some companies in prior years, but is even more important today as companies which are sometimes in a Phase 2 tax situation and which have lines of insurance which are particularly subject to inflationary pressures, such as accident and health, for example, are experiencing rather substantial underwriting losses in certain years. These losses frequently give them little or no useable tax deductions because of the Phase 1 floor, whereas a year or two later a significant underwriting profit will create a tax at a rate of 24%. A provision in the code to allow a carryback or carryover of these lost contingent deductions would still permit the Phase 1 floor to be operative, thereby maintaining competitive equality and avoiding substantial loss of tax revenues. At the same time, it would allow companies which have fluctuating earnings to be taxed on a reasonably equal basis with those which are able to stabilize their earnings.

For much the same reasons, it seems to me that amounts withdrawn from the policyholders' surplus account should be added to gain from operations, rather than to life insurance company taxable income. Amounts added to the policyholders' surplus account were so added because of underwriting gains, and it seems only logical that when amounts are subtracted from this account, they should be added to the gain from operations. This would enable companies which had long-term variations in their underwriting gains to offset the gains in one era with the underwriting losses of another era without ending up with additional taxes as a result. Overall long-term changes in economic climate which appear to be taking place must inevitably cause this type of problem to become more important.

The final inequity relates to the operation of the shareholders' surplus account. The problem is not directly related to inflation, but is one which has been aggravated by inflationary conditions. The purpose of the 1959 Act, in establishing the shareholders' surplus account, was to split the surplus of the company between that which had been developed prior to the effective date of the Act and that which developed subsequent to the effective date of the Act. Amounts developed subsequent to the effective date of the Act were, in turn, split between amounts on which tax had been paid, or was not owed, and untaxed amounts which were being held for the benefit of policyholders. Those amounts on which tax had been paid, or no tax was owed, are included in the shareholders' surplus account and could be paid as dividends to shareholders without any further tax. Amounts in the policyholders' surplus account are subject to tax before being paid to shareholders, and pre-existing surplus may not be paid to shareholders until after the other accounts have been depleted.

The problem is that, if a life insurance company is a subsidiary of a holding company, and the holding company decides to contribute surplus to the life insurance company, these amounts of paid-in surplus are not added to the shareholders' surplus account. At some time, it would seem logical that the life insurance company should be allowed to return the paid-in surplus to its parent holding company without payment of any federal income taxes at the time of the dividend. However, because the 1959 Act does not add paid-in surplus to the shareholders' surplus account, such repayment is not possible until the policyholders' surplus account has been depleted and a tax paid on it. It seems to me this is a logical inequity which can be corrected by simple legislation. It would result in the free transfer of surplus between companies within a controlled group. Such a free transfer is possible in nearly all other areas of a holding company group, and there does not seem to be any reason why it should not be possible for a life insurance company.

MR. GOEBEL: Since it may be some time before the "10-for-1" rule is changed, what can we do to live with it in the meantime? Would it help to have higher valuation interest rates on insurance reserves; would it help to shift investments from fully taxable bonds to something else?

MR. ALBERT GUBAR: The distribution of your company's business is an important element in the impact of the "10-for-1" rule. Also remember, the 10-for-1 rule operates on interest rates only and ignores the mortality table. If you use a 6% valuation interest rate, it does not necessarily follow that the "10-for-1" rule converted you to a place where you are disadvantaged.

MR. BILLY N. JOYNER: Does the tax treatment of policyholder dividends create any additional increased inequity during times of inflation? I visualize a larger portion of the policyholder dividends might be attributed to higher interest rates and, hence, become more and more nondeductible.

MR. PLUMLEY: If you correct the "10-for-1" rule, don't you end up with the inequity that's inherent in the Phase 1 floor itself? I did not consider that question, because that inequity, if it is an inequity, is inherent in the whole structure of the law.

MR. LAWRENCE SILKES: Do many states adopt the federal income tax law for state taxes? If we do not correct the inequities, we will compound these problems fifty times, if all the states adopt the federal income tax law.

MR. ABBOT: Illinois, Connecticut, Florida, New York, and perhaps a few others use the federal income tax base as a base for state income taxes. In those instances where the federal income tax is fully deductible from the premium tax, it really does not matter how you compute the state income tax.

MR. EDWARD H. COLTON: The question has been raised as to whether inflation affects differently mutual companies or stock companies or companies that are taxed solely on investment income as opposed to those taxed on gain from operations. This is a very difficult question to answer without making many assumptions. Let us assume that a company has priced its product in such a manner that the premiums and interest are the income items and the expenses and the benefits are the outgo items; the remainder provides for the dividends and taxes. Then, let us assume that the economic environment is one in which investment yield is increasing and expense is increasing. Then, if we stop at a point in time where the investment income increase is just sufficient to offset the expense increase and take a company that is taxed on its gains from operations, we would find the same dividend or at least the same amount available. Since the gain from operations would not change, the tax would not change. Next, consider a company that is taxed only on investment income and in that exact situation. It would not have exactly the same amount left for dividends, because the taxes would have increased as the investment income increased. Thus, under certain economic environments, a company taxed on its investment income will bear a disproportionately larger share as yields and expenses increase as opposed to yields and expenses decreasing.

MR. PLUMLEY: I might suggest that it is fairly rare for a company to be taxed solely on its gains from operations. The Phase 2 company is being taxed essentially on 50% of its gain from operations and 50% of its taxable investment income.

MR. GUBAR: If you consider the tax to be based on 100% of taxable investment income, plus a half of the excess, then they are both being treated equally with respect to the interest base part. Both the Phase 1 company and the Phase 2 company would have the same taxable investment income.

MR. PLUMLEY: They both have the same taxable investment income but life insurance company taxable income in one case increases or decreases with the taxable investment income and, in the other case, it increases or decreases fifty percent with taxable investment income and fifty percent with gains from operations.

MR. RÉMI H. HOULE: Concerning the fifth problem, if you have a parent company that loans money to the subsidiary, I do not see that there would be a problem in paying the money back.

MR. PLUMLEY: If you had a loan, there would not be.

MR. HOULE: Then, why not use a loan instead of increasing the surplus? Why do you want to increase the surplus?

MR. PLUMLEY: The loan generates a liability. Money received is added to assets, but since the liabilities are also increased because of the loan, surplus is not increased unless the loan is a form of subordinated debt, which can be put below the line. This has been done by a good many companies.

MR. COLTON: The tax law recently enacted in Canada for life insurance companies had the benefit of the experience of the United States and it would be well for people in the United States who are considering changes to take a look at the Canadian system. It is a well-thought-out system; it does tax what it intends to tax.