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CERTAIN INEQUITIES IN THE LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959

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ABSTRACT

On June 25, 1959, the Life Insurance Company Income Tax Act of 1959 was signed into law. Now that there has been an opportunity to observe the 1959 act in operation for a number of years, it is clear that there are problem areas in which the act is working a hardship on life insurance companies that apparently was never intended. Some of these problem areas are (1) the "10-for-1" rule used in determining adjusted life insurance reserves, (2) the deduction for investment income attributable to qualified pension and profit-sharing plans, (3) the limitation on certain deductions imposed by section 809(f), (4) the policyholders surplus account, and (5) the shareholders surplus account. This paper discusses these five areas and suggests some possible ways in which the inequities in them could be corrected.

I. INTRODUCTION

THE Life Insurance Company Income Tax Act of 1959 has proved to be one of the most complex pieces of tax legislation ever enacted, both for the actuary who must consider its financial impact and for the lawyer who must interpret its meaning.

From the point of view of the government, the 1959 act has worked out reasonably well in raising tax revenue from the insurance industry. It has provided a substantial and steadily increasing source of revenue. Federal income taxes on operations in 1957, the last year prior to the effective date of the 1959 act, from United States life insurance companies were $294 million. By contrast, federal income taxes incurred on 1958 operations were $455 million. By 1973 this figure had increased to $1,803 million, for an increase over 1958 of 272 per cent, or 9.6 per cent annually.[1]

From the point of view of the life insurance industry, the 1959 act thus far generally has enabled stock and mutual companies to continue to

[1] *Life Insurance Fact Book, 1974* (Institute of Life Insurance), p. 64.

compete on a more or less equal basis, and with limited exceptions has allowed both stock and mutual companies to meet their noninsurance competition. However, it has also created a large number of problems. Many of these, relating to application of the 1959 act and the Regulations to particular fact situations, have not been resolved. Some of these involve many millions of dollars of tax, and, until they finally are resolved, tax planning and proper pricing will continue to be troublesome. Additionally, accounting for and allocation of current and deferred taxes are particularly difficult under the 1959 act.

In addition to these many problems, most of which eventually will be worked out through study, negotiation, or litigation, it appears that in some important respects the 1959 act is working a hardship on life insurance companies. In some cases, it appears on the basis of committee reports that the result was never intended by Congress. In other cases, although the committee reports are not so clearly contrary to the results, it is the author's contention that legislation is needed to fairly carry out the purposes of the act on a reasonable and equitable basis consistent with other sections of the Internal Revenue Code. The purpose of this paper is to discuss some of these hardships and to suggest some possible ways in which they could be corrected.

Section 802(b) of the Internal Revenue Code defines the tax base for life insurance companies. Under section 802(b), life insurance company taxable income is defined as "the sum of—(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809), (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus (3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815."

Section 804 of the Code relates to the determination of taxable investment income. Gross investment income is reduced by investment expenses, in order to obtain investment yield. Investment yield is then split between the "policyholders' share," which is not subject to tax, and the "company's share." The company's share of investment yield is reduced by the small-business deduction and the company's share of tax-exempt interest and the deductible portion (generally 85 per cent) of dividends received from other corporations. The balance is equal to taxable investment income. (The excess of net long-term capital gains over net short-term capital losses is also included in taxable investment income unless, as is usually the case, the alternative tax treatment is elected, in which case the capital gains tax rate applies.)

Section 809 of the Code relates to the determination of gain from

operations. In general, the gain from operations reflects the total profits, both investment and underwriting, earned by the company before federal income tax. However, the calculation of gain from operations is affected to a considerable extent by section 809(f), which states: "The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds (B) the taxable investment income for the taxable year." Paragraphs (3), (5), and (6) of subsection (d) of section 809 relate to the deductions permitted for dividends to policyholders, for 10 per cent of the increase in reserves for nonparticipating individual life insurance contracts (or 3 per cent of premiums for nonparticipating individual life insurance contracts issued or renewed for five years or more), and for 2 per cent of premiums for accident and health and group life insurance contracts.

Table 1 provides in graphic form an illustration of the calculation of taxable investment income, assuming the election of the alternative tax treatment for the excess of net long-term capital gains over net short-term capital losses. Table 2 illustrates the calculation of life insurance company taxable income under the four tax situations described by John C. Fraser in "Mathematical Analysis of Phase 1 and Phase 2 of 'The Life Insurance Company Income Tax Act of 1959' " (*TSA*, XIV, 51), using his notation, and assuming no additions to life insurance taxable income under section 802(b)(3) due to amounts subtracted from the policyholders surplus account.

For a large mutual life insurance company, the combined effect of sections 804 and 809 of the Code usually is that its life insurance company taxable income is equal to its taxable investment income less $250,000—commonly referred to as a "Phase 1" tax situation, or "Situation B" in Fraser's notation. A large stock life insurance company may be either in that tax situation or in a "Phase 2" tax situation ("Situation D" in Fraser's notation) and thereby have its life insurance company taxable income in effect based on the average of its taxable investment income and its gain from operations. A small company may find itself in Fraser's Situation A or Situation C and thereby have its life insurance company taxable income based solely on its gain from operations. Finally, some stock companies, generally smaller ones, have found themselves in the position of being forced to increase their life insurance company taxable income by subtracting amounts from their policyholders surplus account, thereby triggering the so-called Phase 3 tax.

This paper examines five areas where it is felt that problems have

TABLE 1

CALCULATION OF TAXABLE INVESTMENT INCOME

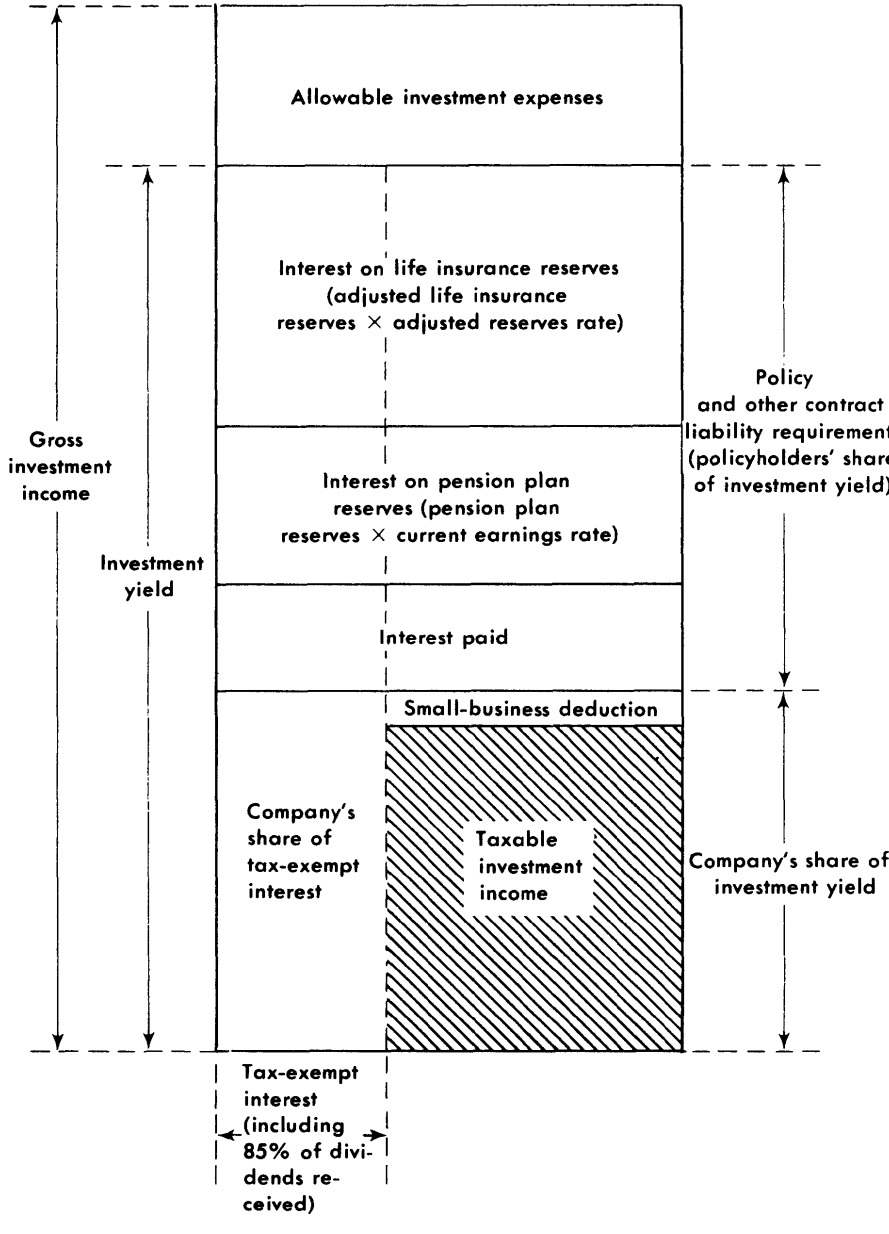
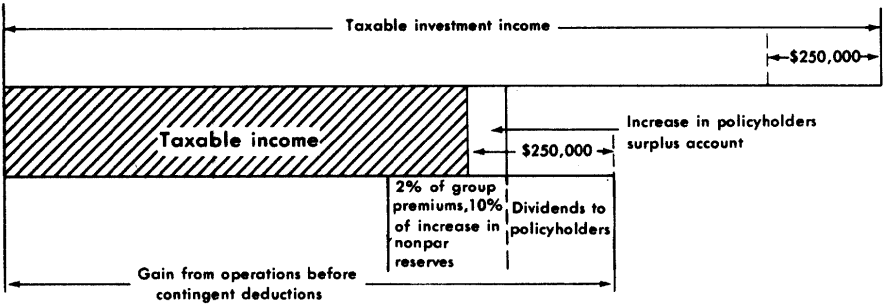


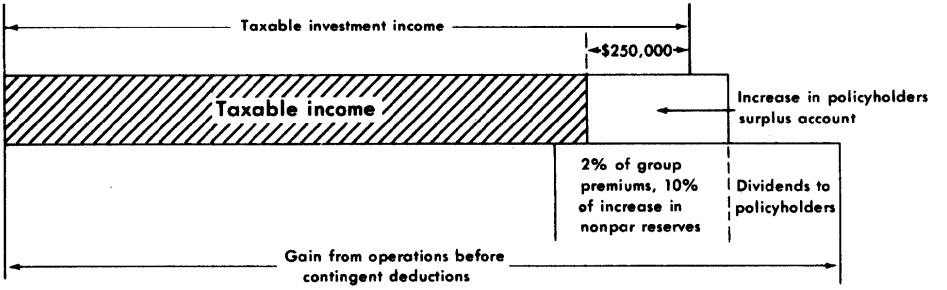
TABLE 2

CALCULATION OF TAXABLE INCOME AND INCREASE IN POLICYHOLDERS SURPLUS ACCOUNT

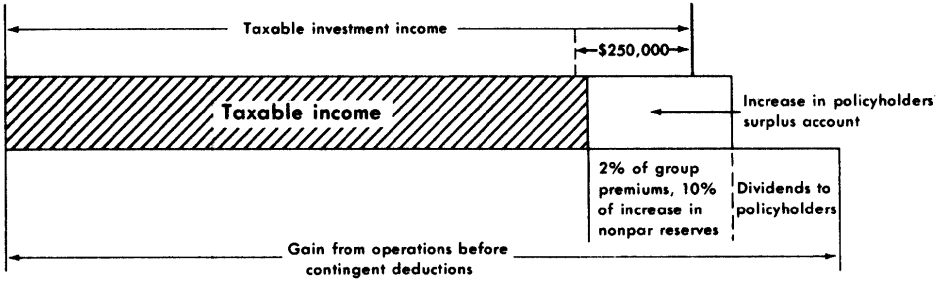
Situation A: $(G - I) < 0$, Taxable income $= G - \$250{,}000$*



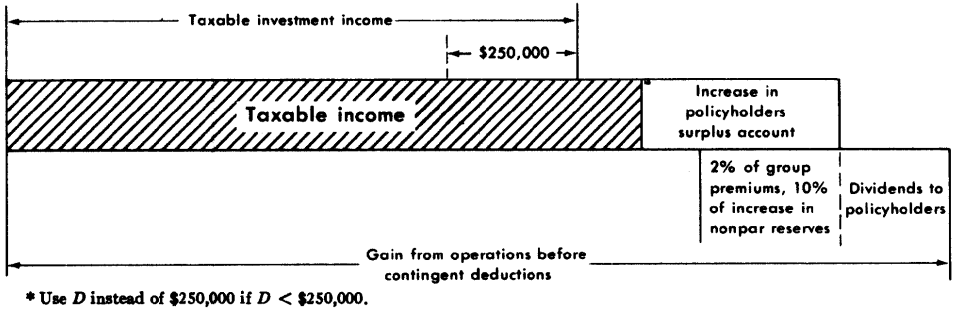
Situation B: $0 < (G - I) < D - \$250{,}000$, Taxable income $= I - \$250{,}000$



Situation C: $D - \$250{,}000 < (G - I) < D$, Taxable income $= G - D$



Situation D: $D < (G - I)$, Taxable income $= \frac{1}{2}(G + I - D)$



* Use D instead of $250,000 if $D < \$250{,}000$.

developed under the 1959 act that were not appreciated fully by Congress when the 1959 act was enacted, and suggests possible solutions to these problems. In brief, these problem areas are as follows:

1. The 10-for-1 rule in section 805(c)(1) is intended to include in the policyholders' share that portion of investment yield which would be required to maintain policy reserves if those reserves were valued on the basis of the adjusted reserves rate of interest. With the increasing gap between earned and valuation rates of interest, the approximation intended by the 10-for-1 rule is becoming increasingly inaccurate.
2. The deduction in section 805(a)(2) for investment income attributable to qualified pension and profit-sharing plans was designed to exclude such income from taxable investment income. However, because of the rapid growth of pension and profit-sharing reserves, combined with the substantial increase in the rates of interest earned on new investments, section 805(a)(2) is no longer performing its intended function.
3. The limitation on certain deductions imposed by section 809(f) causes portions of these deductions to be lost. Unlike deductions treated in other parts of the Code, these lost deductions may not be carried back or forward to another taxable year. Therefore, a company with fluctuating earnings may be subject to higher taxes than a company with the same total earnings but less year-to-year variation.
4. In years with favorable underwriting results, that is, in Fraser's Situation D, a stock life insurance company is allowed certain deductions under sections 809(d)(5) and 809(d)(6) in determining its gain from operations, and 50 per cent of the excess of gain from operations over taxable investment income is not subject to current tax. These tax-deferred amounts are added to the policyholders surplus account. Although this deferral of tax is designed to recognize the difficulty of arriving at true underwriting gains on an annual basis, when amounts are withdrawn from the policyholders surplus account they are added directly to life insurance company taxable income rather than to gain from operations.
5. The shareholders surplus account is intended to measure earnings on which tax has already been paid, or which are not subject to tax, and which therefore may be distributed to shareholders without payment of additional tax by the company. However, capital or surplus funds paid into a life insurance company since 1958 do not serve to increase the shareholders surplus account, even though the subsequent return of these funds to the stockholders will decrease the shareholders surplus account.

II. THE 10-FOR-1 RULE

Section 804(a)(2) of the Code defines taxable investment income as including "the sum of the life insurance company's share of each and every item of investment yield." The life insurance company's share of invest-

ment yield is equal to total investment yield reduced by the policyholders' share.

The problem of determining the proportion of investment income that equitably should be considered to be the policyholders' share, and therefore exempt from tax, has long been a difficult one. Laws in force prior to the 1959 act had made use of industry-wide ratios or other arbitrary percentages and were not satisfactory for a variety of reasons. When the 1959 act was enacted, the decision was made that, with respect to life insurance reserves other than reserves held under qualified pension plans, the amount of investment income included in the policyholders' share and therefore not included in taxable investment income would be equal to the tabular interest which would result if these reserves were revalued at a rate of interest equal to the lesser of the earnings rate for the current year and the average earnings rate for the current and four immediately preceding years. This rate of interest is defined as the adjusted reserves rate. In the language of the Senate Finance Committee report:

> Your committee concluded after considering the matter very carefully, that it was not desirable to make use of assumed rates, either the company's own individual rate or the industry average, in determining the policyholders' share of the investment income. These assumed rates not only vary from company to company but also can be either increased or reduced by individual companies as they see fit. Moreover, testimony before your committee indicated that permitting the use of the industry average assumed rate for some companies gives such companies an advantage over their competitors who under the House bill use their own assumed rate.
>
> Your committee concluded that it was appropriate to determine the reserve interest rate used in determining the policyholders' share of the investment income on the basis of each company's average investment earnings rate because of the view that the competitive pressures within the industry will in the long run force various companies to build into their price structure for their policies a credit for interest on something like this basis.[2]

It was recognized that requiring companies to value their policy reserves for federal income tax purposes at the rate of interest earned by the company on its assets would create very difficult compliance problems, particularly for smaller companies. The problem would be compounded by the fact that many audit adjustments result in a change in the earned rate of interest, and therefore an additional revaluation would be required. After some study, a formula was agreed on, which has been referred to as the "Menge formula" or the "10-for-1" rule, and which is

[2] *United States Code Congressional and Administrative News*, 86th Cong., 1st sess., 1959, p. 1579.

codified in section 805(c)(1). Under this formula, which had been used by actuaries as a rule of thumb long before 1959 (see, e.g., Horace Holmes, "The Standards of Policy Reserves in America and Their Effect on the Life Assurance Business," *TASA*, XXXIX, 285), life insurance reserves are adjusted to the adjusted reserves rate of interest by multiplying them by "that percentage which equals 100 percent—(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and (ii) reduced by that percentage which is 10 times the adjusted reserves rate." The justification for this method of adjusting reserves is discussed in the Senate committee report in the following language:

> As under the House bill, once the interest rate is determined, the next step is to determine the adjustment in the life insurance reserves. This is computed by taking the difference between the interest rate to be used in computing the policy requirements and the rate assumed by the company in establishing its own reserves. Then, based upon a rule demonstrated by industry experience, the reserves of the company are adjusted downward by 10 percent for every 1 percent by which the average earnings rate (or deduction rate under the House bill) exceeds the company's own assumed rate (or vice versa). The policy and other contract liability requirements then are determined by multiplying the life insurance reserves as so adjusted by the average earnings rate (deduction rate under the House bill). The adjustment is made to life insurance reserves to restate, in effect, the reserves as they would have been if the average earnings rate of the company (or deduction rate under the House bill) had been used by the company in establishing these reserves.[3]

The accuracy of the 10-for-1 rule depends on a variety of factors, including policy form, duration, and the difference between the adjusted reserves rate and the valuation interest rate. Table 3 shows the difference between the tabular interest requirement on an actual revaluation basis and that developed under the 10-for-1 rule for various earned interest rates based on model offices submitted by several large insurance companies. This table is based on a single year of issue and assumes 1958 CSO 3 per cent valuation reserves and lapse rates on the basis of the same experience mortality and lapse rates for all companies.

As Table 3 indicates, the 10-for-1 rule provides a larger deduction than the actual revaluation would for the earlier durations. However, at the higher durations, the 10-for-1 rule is very deficient. Thus the accuracy of the rule depends heavily on factors such as mortality and lapse rates and rapidity of growth which would affect the balance of business between the earlier and later durations.

[3] *Ibid.*, p. 1590.

TABLE 3

MODEL-OFFICE COMPARISON OF TABULAR INTEREST PER $1,000 ACTUAL RESERVES VERSUS RESERVES BASED ON 10-FOR-1 RULE RECALCULATED FROM 3 PER CENT VALUATION BASIS—1958 CSO NET LEVEL PREMIUM BASIS

(Single Year of Issue)

End of Year	Mean in Force per Million Issued	Comparison of Average Tabular Interest for Adjusted Reserves Rate of:														
		4%			5%			6%			8%			10%		
		10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference
		Company A														
1	817,229	0.46	0.44	−0.02	0.52	0.47	−0.05	0.54	0.50	− 0.04	0.52	0.52	0.00	0.39	0.53	0.14
5	554,439	2.32	2.18	−0.14	2.57	2.33	−0.24	2.70	2.40	− 0.30	2.57	2.45	− 0.12	1.93	2.41	0.48
10	421,818	4.95	4.72	−0.23	5.50	5.10	−0.40	5.78	5.33	− 0.45	5.50	5.53	0.03	4.13	5.53	1.40
20	286,083	10.98	10.81	−0.17	12.20	12.06	−0.14	12.81	12.99	0.18	12.20	14.28	2.08	9.15	15.13	5.98
40	122,672	20.36	20.75	0.39	22.62	23.81	1.19	23.75	26.27	2.52	22.62	29.83	7.21	16.97	32.13	15.16
60	26,512	28.09	29.77	1.68	31.21	35.48	4.27	32.77	40.61	7.84	31.21	49.33	18.12	23.41	56.42	33.01
80	580	33.06	36.01	2.95	36.73	44.10	7.37	38.57	51.85	13.28	36.73	66.33	29.60	27.55	79.60	52.05
		Company B														
1	891,231	0.39	0.38	−0.01	0.44	0.41	−0.03	0.46	0.43	− 0.03	0.44	0.45	0.01	0.33	0.46	0.13
5	582,925	1.99	1.87	−0.12	2.21	2.00	−0.21	2.32	2.06	− 0.26	2.21	2.09	− 0.12	1.66	2.05	0.39
10	427,687	4.56	4.35	−0.21	5.07	4.69	−0.38	5.32	4.88	− 0.44	5.07	5.01	− 0.06	3.80	4.97	1.17
20	282,844	10.41	10.21	−0.20	11.57	11.31	−0.26	12.15	12.08	− 0.07	11.57	12.94	1.37	8.68	13.28	4.60
40	124,781	20.88	21.46	0.58	23.20	24.82	1.62	24.36	27.60	3.24	23.20	31.77	8.57	17.40	34.65	17.25
60	23,692	28.24	30.02	1.78	31.38	35.88	4.50	32.95	41.16	8.21	31.38	50.24	18.86	23.53	57.69	34.16
80	445	33.00	35.96	2.96	36.67	44.05	7.38	38.50	51.80	13.30	36.67	66.29	29.62	27.50	79.56	52.06

TABLE 3—*Continued*

End of Year	Mean in Force per Million Issued	Comparison of Average Tabular Interest for Adjusted Reserves Rate of:														
		4%			5%			6%			8%			10%		
		10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference
		Company C														
1.....	889,142	0.34	0.32	−0.02	0.38	0.35	−0.03	0.40	0.36	− 0.04	0.38	0.38	0.00	0.29	0.39	0.10
5.....	563,741	1.80	1.67	−0.13	2.00	1.77	−0.23	2.10	1.81	− 0.29	2.00	1.81	− 0.19	1.50	1.77	0.27
10.....	411,545	4.03	3.80	−0.23	4.48	4.07	−0.41	4.70	4.22	− 0.48	4.48	4.30	− 0.18	3.36	4.26	0.90
20.....	267,815	9.24	8.97	−0.27	10.26	9.84	−0.42	10.78	10.44	− 0.34	10.26	11.09	0.83	7.70	11.35	3.65
40.....	109,646	21.20	21.53	0.33	23.55	24.66	1.11	24.73	27.18	2.45	23.55	30.91	7.36	17.67	33.43	15.76
60.....	25,752	28.17	29.69	1.52	31.30	35.23	3.93	32.86	40.15	7.29	31.30	48.44	17.14	23.47	55.08	31.61
80.....	665	33.39	36.29	2.90	37.10	44.38	7.28	38.95	52.11	13.16	37.10	66.58	29.48	27.82	79.84	52.02
		Company D														
1.....	813,663	0.45	0.44	−0.01	0.50	0.48	−0.02	0.53	0.51	− 0.02	0.50	0.54	0.04	0.38	0.56	0.18
5.....	522,724	2.30	2.20	−0.10	2.56	2.38	−0.18	2.69	2.48	− 0.21	2.56	2.57	0.01	1.92	2.57	0.65
10.....	379,809	5.04	4.87	−0.17	5.60	5.32	−0.28	5.89	5.61	− 0.28	5.60	5.88	0.28	4.20	5.94	1.74
20.....	244,839	11.01	10.90	−0.11	12.23	12.17	−0.06	12.85	13.10	0.25	12.23	14.24	2.01	9.18	14.80	5.62
40.....	97,399	21.71	22.41	0.70	24.13	26.03	1.90	25.33	29.06	3.73	24.13	33.74	9.61	18.09	37.08	18.99
60.....	16,409	28.64	30.47	1.83	31.82	36.47	4.65	33.41	41.89	8.48	31.82	51.28	19.46	23.86	59.05	35.19
80.....	263	33.03	35.98	2.95	36.70	44.08	7.38	38.53	51.82	13.29	36.70	66.31	29.61	27.52	79.58	52.06

TABLE 3—*Continued*

End of Year	Mean in Force per Million Issued	Comparison of Average Tabular Interest for Adjusted Reserves Rate of:														
		4%			5%			6%			8%			10%		
		10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference
		Company E														
1	830,140	0.48	0.46	−0.02	0.53	0.51	−0.02	0.56	0.54	− 0.02	0.53	0.59	0.06	0.40	0.62	0.22
5	520,322	2.42	2.32	−0.10	2.69	2.51	−0.18	2.82	2.63	− 0.19	2.69	2.74	0.05	2.02	2.76	0.74
10	372,572	5.35	5.17	−0.18	5.94	5.67	−0.27	6.24	6.00	− 0.24	5.94	6.34	0.40	4.46	6.45	1.99
20	231,132	12.35	12.29	−0.06	13.73	13.82	0.09	14.41	15.01	0.60	13.73	16.67	2.94	10.30	17.76	7.46
40	85,449	22.66	23.39	0.73	25.18	27.19	2.01	26.44	30.37	3.93	25.18	35.28	10.10	18.89	38.76	19.87
60	11,631	29.82	31.96	2.14	33.14	38.51	5.37	34.79	44.56	9.77	33.14	55.26	22.12	24.85	64.39	39.54
80	39	32.98	35.94	2.96	36.64	44.04	7.40	38.47	51.78	13.31	36.64	66.28	29.64	27.48	79.55	52.07
		Company F														
1	619,817	0.24	0.24	0.00	0.27	0.26	−0.01	0.28	0.29	0.01	0.27	0.32	0.05	0.20	0.35	0.15
5	318,938	1.14	1.09	−0.05	1.27	1.19	−0.08	1.33	1.25	− 0.08	1.27	1.31	0.04	0.95	1.33	0.38
10	208,883	2.65	2.55	−0.10	2.95	2.78	−0.17	3.09	2.93	− 0.16	2.95	3.08	0.13	2.21	3.12	0.91
20	113,748	6.74	6.64	−0.10	7.49	7.38	−0.11	7.87	7.91	0.04	7.49	8.53	1.04	5.62	8.81	3.19
40	31,947	20.18	20.75	0.57	22.42	24.01	1.59	23.54	26.70	3.16	22.42	30.73	8.31	16.82	33.47	16.65
60	5,664	28.38	30.19	1.81	31.53	36.12	4.59	33.10	41.48	8.38	31.53	50.73	19.20	23.65	58.34	34.69
80	98	33.05	36.00	2.95	36.72	44.09	7.37	38.56	51.83	13.27	36.72	66.32	29.60	27.54	79.59	52.05

TABLE 3—*Continued*

End of Year	Mean in Force per Million Issued	[Comparison of Average Tabular Interest for Adjusted Reserves Rate of: 4%			5%			6%			8%			10%		
		10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference
		Company G														
1.....	885,929	0.64	0.63	−0.01	0.71	0.72	0.01	0.74	0.78	0.04	0.71	0.88	0.17	0.53	0.94	0.41
5.....	550,737	3.27	3.26	−0.01	3.64	3.66	0.02	3.82	3.96	0.14	3.64	4.37	0.73	2.73	4.59	1.86
10.....	385,699	7.33	7.39	0.06	8.14	8.41	0.27	8.55	9.23	0.68	8.14	10.42	2.28	6.10	11.21	5.11
20.....	225,694	15.12	15.54	0.42	16.80	18.01	1.21	17.64	20.09	2.45	16.80	23.37	6.57	12.60	25.80	13.20
40.....	58,423	24.82	26.13	1.31	27.58	30.96	3.38	28.95	35.24	6.29	27.58	42.44	14.86	20.68	48.19	27.51
60.....	4,825	29.81	31.99	2.18	33.13	38.60	5.47	34.78	44.71	9.93	33.13	55.59	22.46	24.84	64.94	40.10
80.....	30	33.08	36.02	2.94	36.75	44.12	7.37	38.59	51.86	13.27	36.75	66.35	29.60	27.56	79.61	52.05
		Company H														
1.....	889,180	0.79	0.75	−0.04	0.87	0.82	−0.05	0.92	0.87	− 0.05	0.87	0.93	0.06	0.65	0.96	0.31
5.....	656,192	3.68	3.52	−0.16	4.09	3.83	−0.26	4.29	4.02	− 0.27	4.09	4.21	0.12	3.07	4.26	1.19
10.....	515,267	7.47	7.24	−0.23	8.30	7.95	−0.35	8.72	8.44	− 0.28	8.30	8.99	0.69	6.23	9.19	2.96
20.....	345,270	15.40	15.27	−0.13	17.11	17.13	0.02	17.96	18.56	0.60	17.11	20.49	3.38	12.83	21.62	8.79
40.....	110,469	25.03	25.93	0.90	27.81	30.28	2.47	29.20	34.04	4.84	27.81	40.11	12.30	20.86	44.74	23.88
60.....	11,717	29.64	31.53	1.89	32.93	37.76	4.83	34.58	43.44	8.86	32.93	53.39	20.46	24.70	61.78	37.08
80.....	163	33.18	36.11	2.93	36.87	44.21	7.34	38.71	51.95	13.24	36.87	66.43	29.56	27.65	79.69	52.04

By far the most important error demonstrated in Table 3 relates to that which develops as the difference between the earned and valuation interest rates becomes large. (The existence of this error is well known and was the subject of a letter by John C. Fraser in the November, 1972, issue of *The Actuary*.) For the higher earned interest rates, the rule develops consistently lower tabular interest than the actual revaluation would develop. Furthermore, the differences become extremely large, and when the earned rate reaches 13 per cent and the valuation rate is 3 per cent, the 10-for-1 rule gives no interest deduction for life insurance reserves.

In order to determine the magnitude of the error inherent in the 10-for-1 rule for a mature company, figures were also developed for the same selected group of large companies on two additional bases. The first basis assumed a level amount of new business each year, using the model office provided by the company. The second basis assumed that the new business would grow at a rate of 10 per cent per year. Comparisons between actual and tabular interest were then made for each of the first eighty-five durations. The results at duration 85 should be representative of the company's situation under these two assumptions. Table 4 shows the results based on eighty-five years of a constant volume of new business, also assuming a 10 per cent average annual growth rate.

Table 4 indicates the following:

1. A rapidly growing company need have less concern over the inaccuracies of the 10-for-1 rule than a company which is more mature and is growing less rapidly. This, of course, is because the 10-for-1 rule works in favor of the company at the earlier durations.
2. The overall error in the 10-for-1 rule is relatively minor up to about a 4 per cent difference between valuation and earned rates for the company growing at 10 per cent per year, and up to about a 2 per cent difference for the company which is not growing. Beyond these differences, the error grows rapidly.

With the sharp rise in new-money rates which has taken place in the past few years, and with the continuing prognosis of high interest rates in the foreseeable future, companies are becoming increasingly concerned about the cost of the 10-for-1 rule on their federal income tax liability. Assuming a continuation of current high interest rates, within a few years the understatement of the adjusted reserves caused by the error in the 10-for-1 rule will be costing the industry many millions of dollars per year in federal income taxes. Furthermore, even though for the major companies the error in the 10-for-1 rule is only beginning to build to substantial tax costs, for some companies the problem is much more current.

TABLE 4

MODEL-OFFICE COMPARISON OF TABULAR INTEREST PER $1,000 ACTUAL RESERVES VERSUS RESERVES BASED ON 10-FOR-1 RULE RECALCULATED FROM 3 PER CENT VALUATION BASIS—1958 CSO NET LEVEL PREMIUM BASIS

(Reserves after 85 Years of Cumulative Issues)

COMPANY	COMPARISON OF AVERAGE TABULAR INTEREST FOR ADJUSTED RESERVES RATE OF:														
	4%			5%			6%			8%			10%		
	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference	10-for-1	Actual	Difference
	Level Annual Amounts of New Issues														
A	9.36	9.34	−0.02	10.40	10.53	0.13	10.92	11.46	0.54	10.40	12.73	2.33	7.80	13.52	5.72
B	9.08	9.12	0.04	10.09	10.33	0.24	10.60	11.27	0.67	10.09	12.58	2.49	9.08	13.03	3.95
C	8.45	8.40	−0.05	9.39	9.42	0.03	9.86	10.20	0.34	9.39	11.25	1.86	7.05	11.88	4.83
D	9.13	9.20	0.07	10.14	10.45	0.31	10.65	11.44	0.79	10.14	12.86	2.72	7.61	13.76	6.15
E	9.21	9.26	0.05	10.24	10.51	0.27	10.75	11.51	0.76	10.24	12.94	2.70	7.68	13.87	6.19
F	5.34	5.37	0.03	5.94	6.10	0.16	6.23	6.67	0.44	5.94	7.48	1.54	4.45	8.00	3.55
G	9.63	9.89	0.26	10.70	11.44	0.74	11.24	12.74	1.50	10.70	14.76	4.06	8.03	16.20	8.17
H	11.71	11.75	0.04	13.01	13.33	0.32	13.66	14.60	0.94	13.01	16.46	3.45	9.76	17.71	7.95
	10% Annual Growth in New Issues														
A	3.66	3.52	−0.14	4.06	3.85	−0.21	4.26	4.07	−0.19	4.06	4.30	0.24	3.05	4.38	1.33
B	3.35	3.24	−0.11	3.73	3.55	−0.18	3.91	3.75	−0.16	3.73	3.95	0.22	2.79	4.01	1.22
C	2.91	2.78	−0.13	3.24	3.01	−0.23	3.40	3.15	−0.25	3.24	3.28	0.04	2.43	3.29	0.86
D	3.58	3.50	−0.08	3.98	3.86	−0.12	4.18	4.11	−0.07	3.98	4.40	0.42	2.98	4.53	1.55
E	3.70	3.62	−0.08	4.11	4.00	−0.11	4.32	4.27	−0.05	4.11	4.60	0.49	3.09	4.76	1.67
F	1.72	1.68	−0.04	1.91	1.85	−0.06	2.01	1.97	−0.04	1.91	2.11	0.20	1.43	2.19	0.76
G	4.54	4.58	0.04	5.04	5.22	0.18	5.29	5.73	0.44	5.04	6.46	1.42	3.78	6.94	3.16
H	5.55	5.42	−0.13	6.16	6.01	−0.15	6.47	6.43	−0.04	6.16	6.97	0.81	4.62	7.24	2.62

A company which, for example, either because of its newness or because of its ability to improve its earnings rate more rapidly, has an earnings rate currently of 8 or 9 per cent already may be facing the same kind of situation which for the major companies would not occur for another five to ten years or even longer.

It is evident that the increasing magnitude of the error in the 10-for-1 rule and the unfair tax burden being placed on the life insurance companies because of it invite corrective legislation. There are several possibilities for accomplishing this:

1. Section 805(c) could be amended by replacing the 10-for-1 rule with an improved approximation formula. Several possible formulas have been discussed, one of the most promising being $(0.9)^n$, where n is 100 times the difference between the adjusted reserves rate and the average valuation interest rate. For $n = 1$ (i.e., a 1 per cent difference between the adjusted reserves rate and the average valuation interest rate) the formula is identical with the 10-for-1 rule; for $n > 1$ the formula always results in adjusted reserves greater than those determined by the 10-for-1 rule.

   A formula of the type of $(0.9)^n$ creates certain statutory and compliance difficulties. One way to reduce these difficulties would be to use the first three terms of its algebraic expansion, which is

$$1 - 0.1n + \frac{n(n-1)}{2!}(0.1)^2 - \frac{n(n-1)(n-2)}{3!}(0.1)^3 + \frac{n(n-1)(n-2)(n-3)}{4!}(0.1)^4 - \ldots.$$

   Table 5 compares, for different values of n, the 10-for-1 rule with $(0.9)^n$ and with the three-term approximation to $(0.9)^n$ of $1 - 0.1n + 0.01[n(n-1)/2!]$. Also shown in Table 5 are the exact adjustment percentages which would be applicable for the selected companies after eighty-five years of level issues and after eighty-five years of issues increasing 10 per cent per year.

   Table 5 indicates that, although the formula of $(0.9)^n$, or the modification of it, is an improvement over the 10-for-1 rule for larger differences in interest rates, a significant error still can be involved, depending on the mix of business in force in a company and the interest rate it is earning on its assets.
2. A second alternative would be to amend section 805(c) to permit companies to elect to revalue their reserves to their adjusted reserves rate of interest on an exact basis. Since many companies might not have the computer capability to do this, such an exact revaluation almost certainly would have to be on an elective basis. Precedent for permitting companies to revalue reserves on either an exact or an approximate basis is found in section 818(c), relating to revaluing preliminary term reserves to the net level

premium basis for tax purposes on either an exact basis or using the approximation formula in section 818(c).

If an exact revaluation option were permitted, it would be necessary to permit companies to use some type of final approximation, since the adjusted reserves rate is one of the last items determined in developing figures for the typical tax return, and since audit adjustments nearly always result in some change in the rate.

3. A third alternative would be to combine the first two—that is, to provide for an improved formula to replace the 10-for-1 rule and to permit some type of exact revaluation approach as an elective alternative. This alternative would permit those companies that were unable to take advantage of an exact revaluation option to gain the benefit of a more improved approximation formula, while allowing those companies able to do so to revalue exactly.

At the present time, an increasing amount of interest is being shown by the companies in some type of corrective legislation to section 805(c). It seems clear from the data presented here that such legislation is necessary in the near future to avoid serious injustice to many companies in the determination of the portion of their investment income which reasonably should be considered reserved for policyholders and thereby not included in taxable investment income.

III. DEDUCTION FOR INVESTMENT INCOME ATTRIBUTABLE TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Section 805(a)(2) defines a portion of "policy and other contract liability requirements" as "the mean of the pension plan reserves at the beginning and end of a taxable year, multiplied by the current earnings rate." In section 805(d)(1) pension plan reserves are defined. The purpose of this special treatment of investment income attributable to qualified pension and profit-sharing reserves is best explained by quoting the Senate committee report on the 1959 act. The report states that

> in determining the share of the investment income to be attributed to the policyholders and, therefore, not subject to taxation with respect to the life insurance company, one element taken into account both under your committee's bill and the bill as passed by the House is the investment income earned in connection with reserves accumulated for qualified employer pension and profit-sharing plans. In determining this element, which is not to be taken into account in determining the tax base of the life insurance company, both versions of the bill provide that an amount is to be attributed to the policyholders equal to the current earnings of the company on its book reserves held for qualified pension and profit-sharing plans.[4]

[4] *Ibid.*, p. 1582.

TABLE 5

COMPARISON OF APPROXIMATE REVALUATION FORMULAS WITH EXACT REVALUATION OF RESERVES

Adjusted Reserves Rate (%)	n	Adjustment to Reserves Based on:			Adjustment Based on Exact Valuation of Model Offices														
					Level New Issues								10% Annual Increase on New Issues						
		10-for-1 Rule	$(0.9)^n$	3-Term Approximation*	Co. A	Co. B	Co. C	Co. D	Co. E	Co. F	Co. G	Co. H	Co. A	Co. B	Co. C	Co. D	Co. E	Co. F	Co. G	Co. H
4.....	1	.9	.900	.90	.898	.903	.894	.907	.905	.905	.924	.903	.868	.871	.860	.879	.879	.877	.908	.880
5.....	2	.8	.810	.81	.810	.818	.802	.824	.822	.822	.855	.819	.758	.762	.744	.776	.778	.774	.828	.780
6.....	3	.7	.729	.73	.734	.744	.724	.752	.750	.749	.794	.748	.667	.671	.649	.689	.692	.687	.757	.696
7.....	4	.6	.656	.66	.669	.679	.657	.689	.687	.685	.739	.686	.592	.594	.571	.616	.620	.615	.695	.625
8.....	5	.5	.590	.60	.612	.623	.599	.634	.632	.630	.689	.632	.529	.530	.506	.554	.559	.553	.641	.565
9.....	6	.4	.531	.55	.563	.574	.549	.585	.584	.581	.645	.585	.476	.476	.452	.501	.507	.502	.593	.514
10.....	7	.3	.478	.51	.520	.531	.506	.543	.542	.539	.605	.544	.431	.431	.407	.455	.463	.458	.550	.470
11.....	8	.2	.430	.48	.483	.493	.468	.505	.505	.501	.569	.508	.393	.392	.369	.417	.424	.420	.513	.432
12.....	9	.1	.387	.46	.450	.460	.435	.472	.472	.468	.537	.476	.361	.358	.336	.383	.391	.387	.479	.399
13.....	10	.0	.349	.45	.421	.430	.406	.442	.443	.439	.508	.447	.333	.330	.309	.354	.362	.360	.450	.370

*$1 - 0.1n + 0.01[n(n - 1)/2!]$.

The report goes on to state that

> the favorable treatment for qualified pension and profit-sharing business is believed desirable in view of the fact that investment earnings of a qualified pension or profit-sharing trust are completely exempt from tax while they are accumulated in the trust. Generally speaking, it is the smaller employers who are forced to set up insured pension plans rather than trusteed pension plans because of the greater risk and higher ratio of expenses connected with the operation of a small trust. A higher tax on similar earnings in the hands of insurance companies than is provided in the case of trusteed plans therefore is generally discriminatory against small businesses.

The theory of this approach is fine. In determining taxable investment income, interest attributable to qualified pension plans is to be deducted and therefore not included in the tax base. With respect to the determination of gain from operations, the profit taken by the company is taxable, as it should be. To accomplish this result, the framers of the 1959 act allowed a deduction equal to the reserves held under qualified pension and profit-sharing plans, multiplied by the rate of interest earned by the company on its assets. The intention, as evidenced by the language of the Senate committee report, was that this deduction would leave earnings attributable to such plans free from tax except as regards profits taken by the company, thus placing them on a par with trusteed plans.

Unfortunately, however, this approach did not anticipate subsequent events. First of all, since 1959 the combination of high new-money rates and more severe competition has caused most companies to adopt the investment year method of allocating income. Coupled with this has been a substantial growth in the pension plan business of the insurance industry, with qualified pension reserves increasing at a significantly faster rate than other life insurance reserves. The 1974 pension reform act may accelerate this differential.

Unfortunately, the combination of higher earnings rates and the more rapid growth of qualified pension reserves has created a serious tax problem for many companies. This is shown in Tables 6 and 7, which give comparative results for a company under certain hypothetical situations.

For illustrative purposes the exhibits use a very simplified company and to some extent a simplified tax law. The simplified company has life insurance reserves (either $1 or $2 million) with a valuation interest rate of 3 per cent, qualified pension reserves, and total assets equal to the sum of the two types of reserves (i.e., no surplus funds). Current assets have an average earnings rate of 5 per cent, and new assets earn 8 per cent. Small-business deductions have been ignored.

Table 6 shows the relative effect of various amounts of life insurance

TABLE 6

QUALIFIED PENSION BUSINESS AND NONQUALIFIED LIFE INSURANCE BUSINESS IN THE SAME COMPANY

	$1 Million Life Res. @ 3% $1 Million Qual. Pens. Res. Total Assets: $2 Million @ 5% (1)	$2 Million Life Res. @ 3% $1 Million Qual. Pens. Res. Total Assets: $2 Million @ 5% $1 Million @ 8% (2)	$1 Million Life Res. @ 3% $2 Million Qual. Pens. Res. Total Assets: $2 Million @ 5% $1 Million @ 8% (3)	$2 Million Life Res. @ 3% $2 Million Qual. Pens. Res. Total Assets: $2 Million @ 5% $2 Million @ 8% (4)
Net investment income	$100,000	$ 180,000	$180,000	$ 260,000
Current earnings rate and adjusted reserves rate (after 5 years)	5%	6%	6%	6½%
Adjusted life insurance reserves	$800,000	$1,400,000	$700,000	$1,300,000
Deduction for:				
Life insurance reserves	$ 40,000	$ 84,000	$ 42,000	$ 84,500
Qualified pension reserves	50,000	60,000	120,000	130,000
Total	$ 90,000	$ 144,000	$162,000	$ 214,500
Taxable investment income	$ 10,000	$ 36,000	$ 18,000	$ 45,500

TABLE 7

QUALIFIED PENSION BUSINESS AND NONQUALIFIED LIFE INSURANCE BUSINESS IN SEPARATE COMPANIES

	COMPANY A (INDIVIDUAL LIFE ONLY)		COMPANY B (QUALIFIED PENSION BUSINESS ONLY)	
	$1 Million Life Res. @ 3% Total Assets: $1 Million @ 5% (1)	$2 Million Life Res. @ 3% Total Assets: $1 Million @ 5% $1 Million @ 8% (2)	$1 Million Qual. Pens. Res. Total Assets: $1 Million @ 5% (3)	$2 Million Qual. Pens. Res. Total Assets: $1 Million @ 5% $1 Million @ 8% (4)
Net investment income	$ 50,000	$ 130,000	$50,000	$130,000
Current earnings rate and adjusted reserves rate (after 5 years)	5%	6½%	5%	6½%
Adjusted life insurance reserves	$800,000	$1,300,000	$ 0	$ 0
Deduction for:				
Life insurance reserves	$ 40,000	$ 84,500	0	0
Qualified pension reserves	0	0	$50,000	$130,000
Total	$ 40,000	$ 84,500	$50,000	$130,000
Taxable investment income	$ 10,000	$ 45,500	$ 0	$ 0

reserves and qualified pension reserves held in a single company. Column 1 shows that with $1 million of each type of reserve and 5 per cent earnings there would be taxable investment income of $10,000. Column 2 shows that if an additional $1 million of nonqualified life insurance reserves were added and the money invested at 8 per cent, taxable investment income would increase to $36,000. Column 3 shows that if, instead, the additional $1 million had been qualified pension reserves, taxable investment income would have increased only to $18,000. Column 4 shows that an additional $1 million of nonqualified life insurance reserves and an additional $1 million of qualified pension reserves, both invested at 8 per cent, would result in total taxable investment income of $45,500.

Table 7 assumes that the life insurance reserves are held by Company A and the qualified pension reserves are held by Company B. Columns 1 and 3 show the taxable investment income for the two companies which would result if the $1 million of each type of reserve shown in column 1 of Table 6 were split between the two companies. As might be expected, total taxable investment income is still $10,000, and all of it falls in Company A. Columns 2 and 4 of Table 7 show the effect of splitting the business shown in column 4 of Table 6 between the two companies. Again, there is no change in the total taxable investment income of $45,500, and again it falls entirely in Company A.

Thus we can see that, if qualified pension reserves increase at the same rate as nonqualified life insurance reserves, the intent of Congress as evidenced by the Senate committee report is being carried out. The problem, however, comes when qualified pension reserves increase proportionately faster than nonqualified life insurance reserves. This is shown by comparing column 3 of Table 6 with the sum of columns 1 and 4 of Table 7. By adding $1 million of qualified pension reserves at 8 per cent, with no increase in nonqualified life insurance reserves, to the company which already has $1 million of each invested at 5 per cent, taxable investment income increases from $10,000 to $18,000. On the other hand, if the qualified pension reserves were in a separate company, as shown in Table 7, there would be no increase in taxable investment income. This latter result would seem to be the one originally intended by Congress.

It should also be pointed out that in the relatively less common situation where nonqualified life insurance reserves are increasing at a faster rate than qualified pension reserves the company derives a benefit from having the two types of business in the same company. Thus column 2 of Table 6 shows total taxable investment income of $36,000 for the company that adds $1 million of nonqualified life insurance reserves, while,

if the qualified pension reserves were in a separate company as shown in Table 7, taxable investment income would instead be $45,500.

It seems a reasonable assumption that the intent of Congress in enacting the 1959 act was to permit investment income earned in connection with qualified pension and profit-sharing plans to flow through to policyholders without affecting taxable investment income in any manner. Quite clearly, the present law does not accomplish this. The exact manner in which this might be done involves complex issues not covered in this paper, but in general it appears that treatment of funds held in connection with qualified pension and profit-sharing plans in a manner similar to that currently applicable to segregated assets accounts under section 801(g) would offer the best opportunity for an equitable result if solutions could be found to the complex administrative problems involved.

IV. DEDUCTIONS LOST BECAUSE OF SECTION 809(f)

Section 809(f) provides that certain of the deductions used in computing gain from operations are limited in that they "shall not exceed $250,000 plus the amount (if any) by which—(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds (B) the taxable investment income for the taxable year." The deductions so limited are (1) the deduction under section 809(d)(5) equal to the greater of 3 per cent of the premiums for the taxable year attributable to nonparticipating contracts (excluding annuity and group contracts) that are issued or renewed for five years or more, and 10 per cent of the increase for the taxable year in the reserves for nonparticipating contracts, other than group contracts; (2) the deduction under 809(d)(6) for 2 per cent of the premiums for the taxable year attributable to accident and health contracts and group life insurance contracts (limited to an aggregate of 50 per cent of the premiums of the taxable year attributable to such contracts); and (3) the deduction under section 809(d)(3) for dividends to policyholders.

The purpose of the limitations imposed by section 809(f) can best be explained by the following language from the Senate committee report:

> Your committee's bill provides that although, generally, underwriting losses can offset investment income otherwise subject to tax, underwriting losses attributable to policyholder dividends (and certain other compensating deductions for stock companies) cannot be offset against the investment income tax base except in the case of a limited offset provided for small mutual companies. This restriction is provided so that policyholder dividends will not create more than a limited underwriting loss which may be offset against taxable income. Thus, it will not generally be possible for mutual companies to reduce their

investment income tax base by distributions to policyholders. In general, mutual companies will pay a tax on their share of investment income whether or not it is distributed to policyholders.[5]

Now consider the comparative results for the two companies, shown in Table 8. Company A has taxable investment income of $10 million in each of the two years illustrated. It has a gain from operations of $11 million in each year before the deductions under sections 809(d)(3), 809(d)(5), and 809(d)(6). For simplicity it has been assumed that the total of these three deductions equals $1,250,000 in each year, or just enough to bring the gain from operations to taxable investment income less $250,000. As a result, Company A loses no deductions because of the operation of section 809(f). For the two years combined, it has taxable income of $19,500,000, pays a tax of $9,348,000, and has a resulting increase in its shareholders surplus account of $10,152,000. In addition, the amounts deducted under sections 809(d)(5) and 809(d)(6) are added to the policyholders surplus account, for a total increase in that account of $900,000.

Company B, on the other hand, has the same financial data as Company A, except that $1 million of underwriting gain is shifted from year 2 to year 1, so that its gain from operations in year 1 is $12 million and in year 2 is $10 million. In year 1, Company B pays an additional $300,000 in tax. However, because of the limitations under section 809(f), it gains no tax reduction in year 2 even though its gain from operations before the deductions under sections 809(d)(3), 809(d)(5), and 809(d)(6) is $1 million less than that for Company A. As a result, Company B pays a total of $9,648,000 in tax for the two years combined, as compared with $9,348,000 for Company A.

The problem illustrated here is of no importance to the typical large mutual company, which always determines its taxable income on the basis of taxable investment income less $250,000. Nor is it of any importance to the company whose gain from operations after the deductions under sections 809(d)(3), 809(d)(5), and 809(d)(6) is always in excess of its taxable investment income. However, there are a number of companies that find themselves in the situation of losing deductions because of the section 809(f) limitation in some years but not in others. This fluctuation in underwriting gain can occur for many reasons. The very nature of the insurance business is such that variations occur from year to year in mortality and morbidity. Estimates of claim or other nonlife reserves may turn out to be too high or too low and then need correcting the following year. Deductions may be disallowed on audit, or transferred to another taxable year. For a company which is typically close to the

[5] *Ibid.*, p. 1585.

TABLE 8

EFFECT OF DEDUCTIONS LOST UNDER SECTION 809(f) ON TAXABLE INCOME

(000 Omitted)

	COMPANY A			COMPANY B		
	Year 1	Year 2	Total	Year 1	Year 2	Total
Taxable investment income	$10,000	$10,000	$20,000	$10,000	$10,000	$20,000
Gain from operations before deductions under sec. 809(d) (3), (5), and (6)	11,000	11,000	22,000	12,000	10,000	22,000
Deductions under sec.:						
809(d)(3)	$ 800	$ 800	$ 1,600	$ 800	$ 800 ($250)	$ 1,600 ($1,050)
809(d)(5)	200	200	400	200	200 (0)	400 (200)
809(d)(6)	250	250	500	250	250 (0)	500 (250)
Total	$ 1,250	$ 1,250	$ 2,500	$ 1,250	$ 1,250 ($250)	$ 2,500 ($1,500)
Gain from operations after deductions under sec. 809(d) (3), (5), and (6), subject to limitation of sec. 809(f)	$ 9,750	$ 9,750	$19,500	$10,750	$ 9,750	$20,500
Life insurance company taxable income	9,750	9,750	19,500	10,375	9,750	20,125
Tax paid	4,674	4,674	9,348	4,974	4,674	9,648
Increase in:						
Shareholders surplus account	5,076	5,076	10,152	5,401	5,076	10,478
Policyholders surplus account	450	450	900	825	0	825

NOTE.—Usable portion of deductions under sec. 809(d)(3), (5), and (6) shown in parentheses.

borderline between Situation B and Situation D, these chance fluctuations can be very costly.

In this respect section 809(f) seems unfair. In general, the Internal Revenue Code provides that deductions not usable in one taxable year may be used in some other year, subject to certain limitations. For example, under section 812 of the Code, a life insurance company may carry an operating loss deduction back for three taxable years and forward for five taxable years. Similar treatment is given other corporations under section 172. Thus, losses (and any deductions which go into creating losses) are usable in up to nine taxable years. There are comparable provisions for other similar items such as foreign tax credits, investment credits, and charitable contributions. In other words, the Code generally does not make the tax liability differ in the aggregate because a deduction is taken in one year instead of another. The timing of the tax may be affected, but the total amount of tax owed is not changed unless carry-back or carry-over limits are exceeded.

Section 809 should be amended suitably so that deductions which could not be used in the current year because of the limitations imposed by section 809(f) could be carried back for three years and forward for five years, subject of course to the limitation of section 809(f) in the year in which applied. This would enable companies to avoid being penalized because of relatively short-term fluctuations in underwriting results. Amounts added to the shareholders surplus account and policyholders surplus account would of course be adjusted suitably because of the carry-back or carry-over. At the same time, the intent of Congress to provide a "floor" on taxable income so that companies could not create an underwriting loss through the payment of dividends to policyholders would continue to be carried out.

The result would be the situation illustrated in Table 9. Here the same basic data are used as in Table 8, except that Company B has been permitted to carry back the deductions lost in year 2 because of the limitation in section 809(f). As a result, Company B has been placed in the same overall tax position as Company A for the two years combined.

V. THE POLICYHOLDERS SURPLUS ACCOUNT

The third of the three elements of life insurance company taxable income specified in section 802(b) is "the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815." Section 815(c) provides that "each stock life insurance company shall, for purposes of this part, establish and maintain a policyholders surplus account. The amount in such account on January

TABLE 9

EFFECT OF PERMITTING CARRY-BACK OF DEDUCTIONS LOST UNDER SECTION 809(f) ON TAXABLE INCOME

(000 Omitted)

	Company A			Company B		
	Year 1	Year 2	Total	Year 1	Year 2	Total
Taxable investment income	$10,000	$10,000	$20,000	$10,000	$10,000	$20,000
Gain from operations before deductions under sec. 809(d)(3), (5), and (6)	11,000	11,000	22,000	12,000	10,000	22,000
Deductions under sec.:						
809(d)(3)	$ 800	$ 800	$ 1,600	$ 800	$ 800 ($ 800)	$ 1,600
809(d)(5)	200	200	400	200	200 (200)	400
809(d)(6)	250	250	500	250	250 (250)	500
Total	$ 1,250	$ 1,250	$ 2,500	$ 1,250	$ 1,250 ($1,250)	$ 2,500
Carryback of deductions lost because of limitation of sec. 809(f)	$ 0	$ 0	$ 0	$ 1,000	$ 0	$ 1,000
Gain from operations after deductions under sec. 809(d)(3), (5), and (6) subject to limitation of sec. 809(f)	9,750	9,750	19,500	9,750	9,750	19,500
Life insurance company taxable income	9,750	9,750	19,500	9,750	9,750	19,500
Tax paid	4,674	4,674	9,348	4,674	4,674	9,348
Increase in:						
Shareholders surplus account	5,076	5,076	10,152	5,076	5,076	10,152
Policyholders surplus account	450	450	900	450	450	900

NOTE.—Usable portion of deductions under sec. 809(d)(3), (5), and (6) shown in parentheses.

1, 1959, shall be zero." It further provides for additions to the policyholders surplus account equal to the sum of "(A) an amount equal to 50 percent of the amount by which the gain from operations exceeds the taxable investment income, (B) the deduction for certain nonparticipating contracts provided by section 809(d)(5) (as limited by section 809(f)), and (C) the deduction for accident and health insurance and group life insurance contracts provided by section 809(d)(6) (as limited by section 809(f))."

Subtractions from the account, on which tax is paid under section 802, are "(A) the amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and (B) the amount (determined without regard to section 802(a)(3)) by which the tax imposed for the taxable year by section 802(a) is increased by reason of section 802(b)(3)."

In general, there are five ways in which amounts may be treated as withdrawn from the policyholders surplus account and a tax paid on the decrease. First, a company may elect voluntarily to transfer amounts from the policyholders surplus account to the shareholders surplus account under section 815(d)(1). In such event, a tax is paid at the then corporate rate on the amounts so transferred, and the shareholders surplus account is increased by the balance remaining after the payment of the tax. This situation should not create any difficulty for a company, since it is entirely under its control. Such a transfer normally would occur only in the event of an imminent increase of some magnitude in the corporate tax rate combined with the expectation that amounts would have to be subtracted from the policyholders surplus account in the near future in any event.

The second situation in which amounts may be subtracted from the policyholders surplus account and tax paid on them occurs when the account exceeds the limits specified in section 815(d)(4). Under section 815(d)(4) the limit is the greatest of "(A) 15 percent of life insurance reserves at the end of the taxable year, (B) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or (C) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1)."

During the early years of the 1959 act, only a few life insurance companies having very specialized types of business found that the limits of section 815(d)(4) were forcing them to withdraw any amounts from their policyholders surplus account. However, seventeen years have now passed since the effective date of the 1959 act, and sixteen years have

passed since the first amounts were added to the policyholders surplus account. (Section 815[c][1] provides: "The amount in [the policyholders surplus] account on January 1, 1959 shall be zero," even though the 1959 act was effective for the 1958 taxable year.) During this period, the amount in the policyholders surplus account has been steadily increasing for most stock life insurance companies. By now, these balances are nearing or are at the limit for some companies, although they are still only a fraction of the limit for other companies.

If all companies could be sure that the limits specified in section 815(d)(4) would continue to increase, or remain level, every year in the future, any taxes owed because of the limits being exceeded would be no problem. At worst, there might be some increase in taxes once no further deferral in taxes could take place through annual increases in the policyholders surplus account. Unfortunately, however, the future is much less certain than that. Consider, for example, the impact on a company whose balance in the policyholders surplus account is close to the limit of 50 per cent of premiums, of a major reduction in premium volume in a given year. This might occur, for example, in the case of the discontinuance of an unprofitable line of insurance, or if federal legislation resulted in the loss or major diminution of health insurance premium income. Tax would be owed immediately on the excess over the new and lower limit.

It might be argued that, since the company no longer was at risk, it properly should pay the tax in such a situation. However, consider a situation in which there is a sharp drop in premium volume in one year followed by a return to previous levels in the following year. Such a situation could occur in the case of reinsurance of a large block of business to another company. The reinsurance premium would be treated as a negative premium, thus resulting in an artificially low premium for one year. In this case no recovery of taxes paid is provided for in the Code, even though in the following years the limits might once again be well in excess of the balance in the policyholders surplus account.

A third situation under which amounts may be subtracted from the policyholders surplus account and a tax paid thereon occurs if a company fails to meet the definition of an insurance company or fails for two successive years to meet the definition of a life insurance company. In this case the entire amount in the policyholders surplus account is subject to immediate tax.

Regulation 1.801-3(a) states that "the term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or

the reinsuring of risks underwritten by insurance companies. Thus, although its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."

A "life insurance company" is defined in section 801(a) as "an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or non-cancellable contracts of health and accident insurance, if—(1) its life insurance reserves (as defined in subsection (b)), plus (2) unearned premiums, and unpaid losses (whether or not ascertained), on non-cancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c))."

Although most life insurance companies normally would have no trouble meeting the requirements of either an insurance company or a life insurance company as defined by the Code and Regulations, there are situations where these definitions could give and have given companies trouble. Such situations occur, for example, when a company has several subsidiaries and decides to close down one of them and transfer the business elsewhere. It can also occur when a company is heavily engaged in the accident and health business, with a relatively small volume of life and annuity business. In this case, its life insurance reserves plus its reserves on noncancelable life, health, or accident policies may comprise 50 per cent or less of its total reserves. Because of this provision the operation of the policyholders surplus account can greatly inhibit a company's flexibility.

The fourth situation under which amounts can be subtracted from the policyholders surplus account and a tax paid thereon arises from the operation of section 815(a), relating to distributions to shareholders. Section 815(a) provides that "any distribution to shareholders after December 31, 1958, shall be treated as made—(1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally out of other accounts."

At first glance, it would seem that a company would be able to control payment of distributions to shareholders so as to avoid any tax arising out of distributions out of the policyholders surplus account rather than out of the shareholders surplus account. Normally this is the case; however, it should be pointed out that in the case of a company which

determines the amounts distributed to shareholders in such a manner as to leave the balance in the shareholders surplus account near zero, there can be several problems. For example:

1. The company may not be able to determine accurately the amount in its shareholders surplus account in time to decide on its quarterly dividend.
2. The company may calculate that it has a certain amount in the shareholders surplus account, only to find on audit that the amount is less than previously calculated.
3. The company may have a loss carry-back from a subsequent year. In such a case, the loss carry-back reduces the life insurance company taxable income and thereby reduces the amount added to the shareholders surplus account for that year.

A fifth condition under which amounts in the policyholders surplus account are subject to tax arises when a company is liquidated or mutualized. This type of situation should be controllable by the company and should not be of concern, except that it indicates that in determining a true "liquidating value" for the company the potential tax arising from amounts in the policyholders surplus account should be taken into account.

In summary, therefore, there are five basic ways in which amounts in the policyholders surplus account can become subject to tax. Depending on the particular company involved, potential taxes arising from withdrawals from the policyholders surplus account can be remote or can be a real possibility in the near future. Particularly in today's environment, where continued growth of everything is by no means the assumed certainty that it was just a few years ago, one should be increasingly concerned about the fact that hundreds of millions of dollars of "surplus" funds are still subject to potential federal income tax under certain conditions.

Certain changes appear needed in the Code. These would reflect more properly the intention of Congress in providing for the deferral of tax on amounts which are added to the policyholders surplus account. In the Senate committee report we find the following language:

> After determining the underwriting gain, one-half of this amount is then added to the taxable investment income to obtain the combined tax base under phases 1 and 2. This 50 percent reduction in underwriting gains is made because it is difficult to establish with certainty the actual annual income of a life insurance company. It has been pointed out that because of the long-term nature of life insurance contracts, amounts which may appear as income in the current year, and as proper additions to surplus, may as a result of subsequent events be needed to fulfill life insurance contracts. Because of this difficulty in

arriving at true underwriting gains on an annual basis, both the House bill and your committee's bill provide for the taxation of only 50 percent of this gain on a current basis.[6]

Both the House bill and your committee's bill also provide a second surplus account called the policyholders surplus account. Into this account is placed the half of the underwriting profits which are not taxed on a current basis. Your committee has also amended the bill to add to this account the amounts deducted with respect to nonparticipating policies (either the 10 percent of additions to reserves or the 3 percent of premiums) and also the amount equivalent to 2 percent of premiums on group insurance. The effect of placing these amounts in this account is to impose a tax on these amounts at any time they are withdrawn from the life insurance company, or when any of the other circumstances occur which result in the imposition of a phase 3 tax. Your committee approves of the allowance of these deductions and believes that they provide a desirable "cushion" for special contingencies which may arise in the case of the policies involved. However, your committee concludes that if the insurance company itself decides to distribute these amounts to stockholders it has demonstrated that this "cushion" is no longer needed.[7]

Although elsewhere in the committee reports it is clear that Congress intended that amounts withdrawn from the policyholders surplus account should be added directly to life insurance company taxable income, it is suggested that this is in conflict with the above-quoted language from the Senate committee report, which comments on the fact that it is difficult to establish with certainty the actual annual income of a life insurance company because of the long-term nature of life insurance contracts.

In Section IV of this paper, relating to the deductions limited by section 809(f), the need for allowing a carry-back and carry-over of these lost deductions was illustrated. Such a procedure would solve the difficulty arising from short-term fluctuations in underwriting gain. However, as the Senate committee report suggests, there also can be long-term variations in underwriting gain. These can arise from such longer-term factors as underlying changes in mortality or interest rates which are not reflected in the net level premium reserves required by law and used in determining gain from operations.

In order to allow for such long-term changes in underwriting gain without unfairly penalizing the companies, it is suggested that amounts subtracted from the policyholders surplus account should be added to gain from operations rather than to life insurance company taxable income. If such additions then result in an increase in life insurance company taxable income, then the tax owed should be suitably increased.

[6] *Ibid.*, p. 1595.

[7] *Ibid.*, p. 1601.

However, it would enable a company which had built up amounts in the policyholders surplus account during a relatively favorable underwriting period to draw down that account during a less favorable era without incurring additional tax.

Table 10 illustrates the application of this proposed change. The company illustrated in Table 10 had taxable investment income of $20 million per year for each of twenty years. During each of the first fifteen years, its gain from operations before the deductions under sections 809(d)(3), 809(d)(5), and 809(d)(6) was $30 million. For the last five years, however, because of less favorable underwriting results, the gain decreased to $20 million per year. Deductions under section 809(d)(3) were $5 million for each of the first fifteen years and $4 million for each of the last five years. The deduction under section 809(d)(5) was $2 million per year for all years and under section 809(d)(6) was $1 million per year for all years.

Under the law as it now stands, in each of the first fifteen years, $4 million would have been added to the policyholders surplus account. Of this, $1 million would have come from 50 per cent of the excess of gain from operations ($22 million) over taxable investment income ($20 million), and the other $3 million from the deductions taken under sections 809(d)(5) and 809(d)(6).

During each of the last five years no amounts would have been added to the policyholders surplus account, nor would any have been subtracted unless the company had wished to increase its life insurance company taxable income. This would be true in spite of the fact that only $250,000 out of the $4 million deduction under section 809(d)(3) would have been available to reduce gain from operations.

Under the proposed change, the results for the first fifteen years would have been the same as under present law. However, during each of the last five years the company would have been able to transfer $3,750,000 out of its policyholders surplus account. This amount would be added to gain from operations each year, thereby increasing the gain from operations before the deductions under sections 809(d)(3), 809(d)(5), and 809(d)(6) to $23,750,000 per year. This would make it possible to deduct the full amount of $4 million under section 809(d)(3).

The net result would be that the policyholders surplus account, instead of being maintained at $60 million in spite of the underwriting losses incurred in years 16–20, would have been reduced from $60 million to $41,250,000 by year 20. This result seems more equitable than present law, since it reflects more accurately the true long-term financial results of the company.

TABLE 10

EFFECT OF LONG-TERM VARIATIONS IN UNDERWRITING RESULTS ON THE POLICYHOLDERS SURPLUS ACCOUNT

(000 Omitted)

	Under Present Law				As Proposed			
	Years 1–15	Total after 15 Years	Years 16–20	Total after 20 Years	Years 1–15	Total after 15 Years	Years 16–20	Total after 20 Years
Taxable investment income	$20,000	$300,000	$20,000	$400,000	$20,000	$300,000	$20,000	$400,000
Gain from operations before deductions under sec. 809(d)(3), (5), and (6) and before voluntary transfer from policyholders surplus account	30,000	450,000	20,000	550,000	30,000	450,000	20,000	550,000
Addition due to voluntary transfer	.....	.....	.....	.....	.....	.....	3,750	18,750
Total	$30,000	$450,000	$20,000	$550,000	$30,000	$450,000	$23,750	$568,750
Deductions under sec.:								
809(d)(3)	$ 5,000	$ 75,000	$ 4,000 ($250)	$ 95,000 ($ 76,250)	$ 5,000	$ 75,000	$ 4,000 ($4,000)	$ 95,000 ($ 95,000)
809(d)(5)	2,000	30,000	2,000 (0)	40,000 (30,000)	2,000	30,000	2,000 (0)	40,000 (30,000)
809(d)(6)	1,000	15,000	1,000 (0)	20,000 (15,000)	1,000	15,000	1,000 (0)	20,000 (15,000)
Total	$ 8,000	$120,000	$ 7,000 ($250)	$155,000 ($121,250)	$ 8,000	$120,000	$ 7,000 ($4,000)	$155,000 ($140,000)

NOTE.—Usable portion of deductions under sec. 809(d)(3), (5), and (6) shown in parentheses.

TABLE 10—*Continued*

	Under Present Law				As Proposed			
	Years 1–15	Total after 15 Years	Years 16–20	Total after 20 Years	Years 1–15	Total after 15 Years	Years 16–20	Total after 20 Years
Gain from operations after deductions under sec. 809(d)(3), (5), and (6) subject to limitation of sec. 809(f)	$22,000	$330,000	$19,750	$428,750	$22,000	$330,000	$19,750	$428,750
Voluntary transfer from policyholders surplus account to shareholders surplus account							3,750	18,750
Life insurance company taxable income	21,000	315,000	19,750	413,750	21,000	315,000	19,750	413,750
Tax paid	10,074	151,110	9,474	198,480	10,074	151,110	9,474	198,480
Change in:								
Shareholders surplus account	10,926	163,890	10,276	215,270	10,926	163,890	10,276	215,270
Policyholders surplus account	4,000	60,000	0	60,000	4,000	60,000	−3,750	41,250

VI. THE SHAREHOLDERS SURPLUS ACCOUNT

Section 815 of the Code, relating to distributions to shareholders, defines the shareholders surplus account. Section 815(b)(1) states that "the amount in such account on January 1, 1958, shall be zero." Section 815(b)(2) determines the additions to the account as follows:

> The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which—(A) the sum of—(i) the life insurance company taxable income (computed without regard to section 802(b)(3)), (ii) in the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, reduced (in the case of a taxable year beginning after December 31, 1961) by the amount referred to in clause (i), (iii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B)), and the amount of interest excluded from gross income under section 103, and (iv) the small business deduction provided by section 809(d)(10), exceeds (B) the taxes imposed for the taxable year by section 802(a), determined without regard to section 802(d)(3).

Section 815(b)(3) determines subtractions from the account as follows:

> (A) In general.—There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.
>
> (B) Distributions in 1958.—There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of distributions to shareholders made during 1958.

The purpose of the shareholders surplus account can best be described by quoting from the "Report of the House Committee on Ways and Means" on the 1959 act:

> This phase 3 portion of the tax base is provided for by establishing two special surplus accounts for tax purposes. One of these accounts, called the shareholders surplus account, is a record of all tax-paid amounts (less the amount paid in taxes) for calendar years beginning on or after January 1, 1959. Thus each year from 1959 on any amounts taxed under phases 1, 2, or 3 itself which remain after payment of Federal tax are added to this account. In addition, this account reflects amounts intentionally not taxed (such as tax-exempt interest, and the small business deduction) and amounts taxed at special rates or partially excluded from income (such as net long-term capital gains, partially tax-exempt interest and 85 percent of dividends received). When dividends are paid the balance in this tax-paid account is reduced first and this does not result in any further tax under phase 3.[8]

[8] "Report of the House Committee on Ways and Means," No. 34, 86th Cong., 1st Sess., *Internal Revenue Bulletin*, Cumulative Bulletin 1959-2, p. 746.

The report then describes the operation of the policyholders surplus account. Finally it states the following:

> Distributions in excess of the balances in these two accounts do not entail any tax consequences to the company since they are considered as being made out of surplus accumulated prior to January 1, 1959 (the effective date of phase 3), to the extent of such surplus.[9]

It seems clear that Congress intended to split the surplus of stock life insurance companies into three pieces: surplus acquired after January 1, 1959, on which tax had been paid or was not owed (the shareholders surplus account), surplus acquired after January 1, 1959, on which tax was deferred because it was being held for the benefit of policyholders (the policyholders surplus account), and surplus accumulated prior to January 1, 1959. Payment of dividends to shareholders out of either the first or the third of these accounts would not subject the company to any additional tax; however, no distributions could be made out of the third account until the first two were depleted.

Unfortunately, Congress apparently failed to appreciate that there would be an increasing number of life insurance companies that are wholly owned subsidiaries of nonlife holding companies. It also failed to anticipate that, with the present economic conditions, some life insurance companies are becoming increasingly concerned about the level of their surplus. They may have a real need to obtain additional surplus through contributions from their parent holding company. This may be particularly true for certain subsidiaries which are growing rapidly.

Unfortunately, this creates an injustice with respect to the shareholders surplus account, as illustrated by Table 11. In Table 11 three years are illustrated for a hypothetical company that for some reason needs to acquire an additional $1 million in surplus from its parent holding company in year 2, and then pays it back as a dividend in year 3. For simplicity, it has been assumed that there is no year-to-year change in the figures for the company except as caused by these transactions.

Under present law, the contributed surplus would have no effect on the balance in the shareholders surplus account. As a result, this account, which was assumed to be $500,000 at the end of year 1, remains the same at the end of year 2. Then, when the $1 million dividend is paid in year 3, it is necessary to deplete both the shareholders surplus account and the policyholders surplus account, to pay $240,000 in phase 3 taxes, and to reduce surplus "accumulated prior to January 1, 1959," by $240,000.

This is an unfair and illogical result. The contributed surplus represents

[9] *Ibid.*

TABLE 11

EFFECT OF CAPITAL OR SURPLUS PAID IN ON SHAREHOLDERS SURPLUS ACCOUNT

(000 Omitted)

	UNDER PRESENT LAW			AS PROPOSED		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Assets—end of year	$12,000	$13,000	$11,760	$12,000	$13,000	$12,000
Liabilities—end of year	10,000	10,000	10,000	10,000	10,000	10,000
Capital and surplus—end of year	2,000	3,000	1,760	2,000	3,000	2,000
Shareholders surplus account—end of year	500	500	0	500	1,500	500
Policyholders surplus account—end of year	500	500	0	500	500	500
Paid-in surplus during year	0	1,000	0	0	1,000	0
Dividends to shareholders during year	0	0	1,000	0	0	1,000
Phase 3 taxes paid for year	0	0	240	0	0	0

an amount "intentionally not taxed." It clearly is not "surplus accumulated prior to January 1, 1959." Yet the present operation of section 815(b)(2) treats it as the latter when it fails to add such amounts to the shareholders surplus account at the time of contribution.

Section 815(b)(2) of the Code should be changed by the addition of another subsection to provide for additions to the shareholders surplus account of amounts of paid-in capital and surplus since January 1, 1959. Such an amendment would permit the free flow of funds among companies within an affiliated group without the payment of federal taxes at the time of transfer, in the same manner as is now permitted between companies other than life insurance companies. The result would be as illustrated in the right-hand columns of Table 11. There the paid-in surplus increases the shareholders surplus account in year 2, so that when the amount of paid-in surplus is returned to the stockholders in the form of a dividend, the shareholders surplus account is returned to its original balance of $500,000 and no phase 3 tax is incurred.

VII. SUMMARY

This paper has selected five of the features of the Life Insurance Company Income Tax Act of 1959 which appear not to be carrying out the basic purposes of the act, as evidenced by committee reports, and thereby are causing problems for life insurance companies. The paper has also suggested possible statutory changes which would correct these problems.

It is recognized that there are many other features of the act and of the regulations relating to it which have been criticized by others, and that there are also many difficulties pertaining to the administration of the act which have not been discussed—for example, the many audit issues pertaining to interpretation of the Code and Regulations in particular fact situations. It is also recognized that some of the problems discussed here are being studied currently by industry groups. It is hoped that the ideas presented herein will be useful to these groups in their work.

As stated earlier, it has not been the purpose of this paper to criticize the basic structure of the 1959 act. No fundamental changes in the act's basic structure are suggested; however, certain features of the act which over the years seem to have been deficient in carrying out the original intention of the act have been examined, and suggestions have been made for changes to accomplish what, in the author's opinion, constitute the basic purposes of the act.

DISCUSSION OF PRECEDING PAPER

D. H. SAMUEL BATEMAN AND JAMES LEW:*

This timely paper concentrates on five problem areas in which Mr. Plumley feels that the Life Insurance Company Income Tax Act of 1959 is working a hardship on life insurance companies. We agree with Mr. Plumley that neither the 10-for-1 rule used in determining adjusted life insurance reserves nor the interest deductions from investment income attributable to qualified pension and profit-sharing plans are producing the results intended by Congress, and that eventually they may prove to be the two most critical tax problems for the life insurance industry. In our opinion the other three areas covered by Mr. Plumley are relatively insignificant as measured by their tax impact.

Mr. Plumley's premise that thus far the 1959 act generally has enabled stock and mutual companies to compete on a more or less equitable basis is subject to some debate. For example, in the *Yale Law Review* (LXXXIV [July, 1975], 1648–50) Professor Robert Clark points out that the Senate Finance Committee tailored the provisions of the 1959 act so that the proportion of the tax burden borne by mutual life insurance companies would be geared to the proportion of assets and business in force accounted for by such companies at that time. He goes on to state that "by the apparent standard of the Senate Finance Committee, the mutual companies are now paying considerably more than their fair share."

We agree with Mr. Plumley's implication that in some instances the act hinders life insurance companies in meeting their noninsurance competition. We are pleased that in his paper he actually cites one important example, namely, that a portion of the investment income arising from qualified pension plans unintentionally is being included in the tax base of life insurance companies.

We also agree that the approximations produced by using the 10-for-1 rule to determine adjusted life insurance reserves will cause increasing hardships as the difference between the adjusted reserves rate and the valuation interest rate widens. As far back as 1973, the Ad Hoc Committee to Study the 10-for-1 Rule considered the use of the formula $(0.9)^n$ as a substitute for the 10-for-1 rule, and such recommendation

* Mr. Lew, not a member of the Society, is assistant vice-president, Metropolitan Life Insurance Company.

was included in its April, 1975, report to the ALIA Subcommittee on Federal Taxation—Company. However, we feel that to include a binomial expansion in the law as part of the solution would be inappropriate. A much better solution would be to amend the law to provide that the 10-for-1 rule be applied 1 per cent at a time. First, this would be consistent with the fact that during the 1958 congressional hearings it was established that the 10-for-1 rule is a satisfactory approximation for differences in reserves caused by small changes in the valuation interest rate. Second, we believe that it would be extremely difficult to convince members of Congress of the validity of a mathematical expression which to them would appear quite awesome. However, were the law to be so amended, this binomial expansion could prove very useful in the IRS Regulations, since, when the expansion is carried out to a sufficient number of terms, it produces results identical to those obtained with $(0.9)^n$. It is difficult for us to see what statutory and compliance difficulties would be created by an amendment that would, in effect, provide for a formula of the $(0.9)^n$ type.

To indicate how readily the 1959 act could be amended to provide, in effect, for a formula of the $(0.9)^n$ type, an illustrative draft for the revision of section 805(c) is shown below. This draft was developed for the April, 1975, report of the Ad Hoc Committee to Study the 10-for-1 Rule.

(c) Adjusted Life Insurance Reserves—

(1) Adjusted Life Insurance Reserves defined—for purposes of this part, the term "Adjusted Life Insurance Reserves" means—

(A) The mean of the life insurance reserves (as defined in Section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100% reduced (or increased) by 10% for the first 1% difference between the adjusted reserves rate and the rate of interest assumed by the taxpayer in calculating such reserves.

(C) The resulting products (A) and (B) shall be further successively multiplied as in (B) for each additional 1% difference between the adjusted reserves rate and the rate of interest assumed by the taxpayer in calculating such reserves.

Mr. Plumley's alternative solution for correcting the increasing inaccuracy in the 10-for-1 rule also had been under consideration by the ad hoc committee and is currently under consideration by the ALIA Menge Formula Task Force, which was established in 1975 for further study of problems in connection with the 10-for-1 rule. It is possible for

a company with an adjusted earnings rate of, say, 6.25 per cent to revalue exactly at 6 per cent and use the present 10-for-1 rule to adjust for the other 0.25 per cent. Very properly, one actuary has pointed out a possible shortcoming in this solution. Inasmuch as there would be no valuation certificate to cover reserves revalued at the 6 per cent rate, revenue agents would be unable to rely on such revaluation and therefore objections to the use of this procedure might arise.

Mr. Plumley suggests a carry-back in order to cope with the deductions that might be lost because of the limitation imposed by section 809(f). Since the root cause of the problem is the limitation on the deductions, it seems much more logical to consider the elimination or substantial reduction of the limitation before resorting to the use of a carry-back.

There appears to be a likelihood that the 1959 act will be reviewed by Congress within the next year or two. It is hoped that the industry will limit itself to requests for changes that must be made because the law inflicts unintended general hardship, and that very low priority will be given to amendments that would have a relatively insignificant tax impact.

JOHN J. FRUCELLA:

Mr. Plumley is to be commended for a most lucid and well-organized paper on a difficult topic. This discussion will contain comments on each of the five areas examined in the paper.

1. The 10-for-1 rule works remarkably well for companies with a small difference between the current earnings rate and the average valuation rate. It does not work well at all when the difference is substantial. However, I disagree with the author's contention that an exact revaluation should be permitted. I would prefer that a better approximation be used. We are now in the age of computers, and stock companies have proved that any company can convert to GAAP. We can no longer argue that the smaller companies need the approximate option. The author's contention will ultimately lead to exact revaluations for required interest and for section 818(c) calculations for all companies.

2. A question related to the problem of the pension plan investment income deduction is whether all annuity reserves qualify as life insurance reserves. In several instances IRS field agents have excluded deferred annuity reserves from life insurance reserves because the reserve calculation is independent of a mortality assumption. The IRS national office has supported the field agents in at least two Technical Advice Memoranda. In at least one instance this has led to disqualification as a life

insurance company. As the companies sell more IRA's and other pension plans, this question will be raised more frequently.

3. The limitation on certain deductions produces the greatest harm to Situation A companies. Some of these companies have a block of participating insurance; others write experience-rated group policies. For these companies the dividends frequently exceed $250,000 and are not fully deductible. Because of this limitation many companies pay a large federal income tax. As a matter of fact, some companies have paid federal income tax even though they had pretax statutory losses.

4. Mr. Plumley suggests that withdrawals from the policyholders surplus account be added to the taxable gain from operations rather than directly to the tax base. Such an approach would be of benefit to companies with expiring loss carry-overs. However, a better approach would be to carry losses forward for ten or more years rather than the five years now permitted by law. In that way, a company could be assured the utilization of its loss carry-over. As a matter of fact, many new companies would elect section 818(c) immediately if they had a reasonable chance of utilizing the resulting losses.

5. In recent years several holding companies have sold life insurance subsidiaries to repay loans. This is a direct result of the difficulty of paying profits from a life insurance company by the dividend mechanism. A few holding companies have avoided this problem by purchasing surplus debentures from their subsidiaries when additional surplus was needed. These instruments allow principal and interest payments that are independent of the shareholders and policyholders surplus accounts. However, the author's suggestion is a more direct solution to this problem.

JAMES E. KILMER:

Mr. Plumley's presentation of a number of inequities in the Life Insurance Company Income Tax Act of 1959, and especially his suggestions on how these inequities may be overcome, is interesting and well written. I wish to offer comments on Part V, "The Policyholders Surplus Account." Under current law, amounts withdrawn from the policyholders surplus account must be added directly to life insurance company taxable income. Mr. Plumley suggests that amounts subtracted from the policyholders surplus account should be added to gain from operations rather than to life insurance company taxable income. The illustration in Table 10 shows how the policyholders surplus account can be reduced without incurring an additional tax.

My observation is that the illustration is quite limited in applica-

bility. In it, the policyholders surplus account transfer serves to increase the limit on the deduction under paragraphs 809(d)(3), 809(d)(5), and 809(d)(6) as imposed under section 809(f). In the illustration, the limit is increased just enough to ensure a full deduction of dividends deductible under section 809(d)(3). This is of limited benefit because only stock companies are required to establish and maintain the policyholders surplus account. There are only a few stock companies paying sizable dividends on participating contracts. Assume that all circumstances in the illustration remain unchanged, except that dividends are zero, and that the deduction before limitations under sections 809(d)(5) and 809(d)(6) still totals $8,000 per year during years 1–15 and $7,000 per year during years 16–20. In such a case, a $3,750 withdrawal from the policyholders surplus account would increase both the gain from operations before special deductions and the special deductions themselves by such amount. However, this $3,750 increase in the special deduction would merely increase the policyholders surplus account by the same amount. Consequently, nothing has been gained by the transfer.

If a Phase 2 (Situation D) company reaches its policyholders surplus account limit for a given taxable year, then an amount P is added to the gain from operations. Consequently, only half of that policyholders surplus account withdrawal amount is taxed at a 48 per cent rate. However, the other half goes back into the policyholders surplus account. The limit forces a 48 per cent tax on one-half of $\frac{1}{2}P$. This series continues infinitely until P is finally taxed at a full 48 per cent rate! A company in Situation A would, of course, be taxed at a full 48 per cent tax rate on withdrawals from policyholders surplus account that are added to the gain from operations rather than to taxable income.

The primary advantage of Mr. Plumley's proposal would go to stock companies in Situation B or Situation D that have depleted their shareholders surplus accounts and must either cut dividends to shareholders or pay dividends through withdrawals from the policyholders surplus account. Assume that a company is in Situation B by a wide margin, and it pays a dividend out of the policyholders surplus account. The amount of withdrawal is added to the gain from operations, but the tax situation remains unchanged. The company has paid a dividend to shareholders "tax-free." The amount of dividends will find its way back into the policyholders surplus account to the extent that there is an increase in the section 809(d)(5) and section 809(d)(6) deductions when it is added to the gain from operations. The policyholders surplus account has been established as an additional fund to meet future contingencies. Since it has been set aside for the benefit of policyholders, there is

no current tax on additions to the fund. Should the company make the decision that a portion of the funds is no longer needed for the protection of its policyholders, it may distribute such portion to its shareholders. At this time, the purpose of the tax deferral no longer exists, and the amount withdrawn becomes taxable. This is in keeping with the basic purpose of the policyholders surplus account as Congress saw it. Under Mr. Plumley's proposal a withdrawal from the policyholders surplus account to pay dividends is *again* not taxed currently but is *again* put in the tax deferral account. I doubt that this was the congressional intent.

In conclusion, the proposal that policyholders surplus account withdrawals be added to the gain from operations rather than to taxable income is of limited benefit and, in those cases where it can be used to advantage, is subject to abuses and is probably contrary to congressional intent.

(AUTHOR'S REVIEW OF DISCUSSION)

PETER W. PLUMLEY:

Messrs. Bateman and Lew have been most helpful in discussing the work of several industry committees in developing proposed solutions for the inequities of the present 10-for-1 rule. I agree with them that the approach of adjusting for changes in interest rate 1 per cent at a time would accomplish the same result as would the binomial expansion described in my paper but would be considerably more understandable and thus have a better chance of being enacted.

Mr. Frucella also points out, with regard to the 10-for-1 rule, that a better approximation formula might be preferable to an exact revaluation. As with many tax matters, an approach that is theoretically correct may differ from one that is in the best interests of companies. As those who have been involved in the enactment of legislation know, the final result can be worse than nothing at all.

Both Mr. Frucella and Mr. Kilmer have commented on my suggestions concerning the handling of withdrawals from the policyholders surplus account. I agree with them and with Messrs. Bateman and Lew that this is not a major item of consideration for very many companies. However, for certain companies, it can involve a considerable amount of tax dollars. In a determination of which tax items are most important from an industry point of view, this would not rank high on the list; nevertheless, I believe it does represent an inequity that deserved mention in the paper.

Finally, I would like to thank all those who provided helpful discussions of my paper.