SOCIETY OF ACTUARIES

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# The Actuary

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## WHEN OLD AGE COMES— DR. X's COCKTAIL

*by Arthur Pedoe*

One satisfactory trend of modern society of major interest to actuaries is the reduction in the rate of mortality. This reduction is still continung for female lives even to the limit of life; it is questionable whether at the oldest ages male mortality is still reducing.

Of major social significance in this trend is the increasing proportion of older people. In this article, "old" and "aged" mean those age 65 and over. In the United States there are 20 million people age 65 and over, almost 10 per cent of the population; in Canada about 8 per cent, and in France, 13 per cent, the highest of any country. Both numbers and ratios have been increasing, bringing the problem of old people to the forefront. The lower mortality of female lives compared to males means that a greater proportion of old people are women. In the U.S., 11.2 per cent of female lives are 65 and over as against 8.5 per cent of males.

Another aspect is the increase in the number of dependents; those under 20 and those age 65 and over. In both the U.S. and Canada they now exceed 45 per cent of the population and are near the 50 per cent mark—half the population! Many primitive peoples, when faced with this problem, opted for getting rid of the old. It was an American, Nascher, who is held to be the father of the study of the aged which he called *geriatrics*. Actuaries are aware of the exponential increase in disability at the older ages. Government health services are now realizing this fact through bitter experience and are attempting to cope with it.

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## C.B.H.W.

After the fashion of the tabloids, this note might have been headed "Barry Will Not Tarry." The members of the Society have already been advised that Charles B. H. Watson, who needs no identification, will return to private practice at the close of the annual meeting.

It is related elsewhere that Adam had a bad time of it because there were no precedents. Barry Watson may have experienced similar feelings in taking over the post of Executive Director. He has, however, successfully established a precedent in a way that has redounded to his credit and enured to the benefit of the Society. Many are the members, both individually and on committees, who are grateful for his help in time of trouble.

Fortunately this is a case not of "Hail and Farewell" but of "Farewell and Hail," since he will surely be seen at future meetings of the Society taking an active part. And so we wish him well in his new position and thank him for the fine job he did as Executive Director.

*A.C.W.*

## AB INITIO

J. Douglas Brown, *An American Philosophy of Social Security*, Princeton University Press, 1972, pp. 244, $8.50.

*by E. H. Wells*

The author is former Dean, and first Provost of Princeton. His views on Social Security obviously carry weight because he has been a member of all five of the Advisory Councils, since the first Council of 1937, of which he was Chairman. This Council consisted of 25 members, of whom 6 represented labor, 6 were employer members, and 13 represented the public, most of these being associated with universities. One of the employer members was an actuary, M. Albert Lin-

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## REFLECTIONS ON FEDERAL INCOME "PHASE 3" TAX

*by Clayton A. Cardinal*

The "Phase 3" tax is the description given to the federal income tax imputable to amounts withdrawn from the Policyholders Surplus Account maintained under the federal income tax law. This article discusses certain facets of the federal income "Phase 3" tax as it relates to these withdrawals.

The federal tax law provides that stock life insurers establish two separate accounts—a Shareholders Surplus Account (SSA) and a Policyholders Surplus Account (PSA). The SSA can be thought of as holding the insurer's already taxed or tax-exempt earnings, while the PSA contains earnings still to be taxed. Only post-1958 results are used in establishing each of these accounts.

Cash dividends are taken from the SSA, and if the SSA is exhausted the excess is obtained by transferring the necessary funds to the SSA from the PSA. Since no federal income tax has been previously paid on amounts in the PSA, it is necessary to withdraw $100 for each $52 of dividends. The $48 difference represents the "Phase 3" federal income tax. If the distribution to shareholders in a year exhausts both the SSA and PSA, the excess is considered to be paid from the "other accounts" which represent the surplus outstanding at the time the tax law was changed in 1958. No tax is imposed on a company with respect to disbursements imputable to these "other accounts."

A life insurer in a shareholder equity transaction, without knowing its SSA and PSA, could subject to taxation a lot of capital by an involuntary transfer of funds from the PSA to the SSA. The amount of any contemplated disburse-

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## Reflections

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ment of shareholders' equity must be compared with the estimated SSA at the end of the year in which the transaction is to be made. If a material transfer from the PSA will be called for, the decision to make the disbursement must be critically examined. Alternative courses of actions may exist.

One alternative is to defer paying more dividends than the SSA allows. Another alternative, commonly encountered in the acquisition of a life insurance company, calls for using a different vehicle such as stock dividends or exchanging shares in one form or another. A third alternative for avoiding involuntary transfer of funds from PSA to SSA calls for affecting in advance of the end of the transaction year to the extent permitted by law those variables which determine the amount of funds in the SSA.

In general terms, the variables which are subject to control are (1) taxable income excluding amounts withdrawn from PSA; (2) the excess of net long-term capital gains over net short-term capital losses; and, (3) tax-exempt investment yield. Inasmuch as the effective federal tax rate applicable to each of these three entities is never greater than and is usually less than the corporate tax rate applicable to funds transferred from the PSA, all attempts to "manage" any or all of the three variables in order to avoid involuntary transfer of PSA funds seem warranted.

Efforts to increase tax exempt yield may have relatively little value for any urgent problem because diversion of all normal cash flow to tax-exempt securities may not generate enough exempt yield to alleviate the problem. Wholly taxable securities from an existing portfolio can be sold and the resulting funds reinvested in tax-exempt securities. To be meaningful, however, a huge transaction may be required which could negate any anticipated gain if improperly executed.

The preceding approach to avoiding an involuntary transfer of PSA funds has the disadvantages of being somewhat complicated, requiring more than the limited time available for execution, and disturbing an investment program of an investment department. This approach is not strongly recommended as an effective means of increasing the SSA of a life company being acquired.

However, if a holding company plans to periodically draw on any life insurance subsidiaries' SSA's in the form of dividends, subsidiaries should invest heavily in tax-exempt securities if their yield can be expected to be greater than the tax-exempt portion of stock dividends plus anticipated after-tax long-term capital gains.

Increasing net capital gains (see section 1201 of Internal Revenue Code) may be the surest and quickest means of effecting an increase in the SSA of a life insurance company; however, the posture of a company's equity investment portfolio or of the marketplace or the company's tax situation may not always permit this action. In general, long-term capital gains should never be taken without a demonstrated need. However, taking capital gains is not a concern here but the amount of such gains to be taken is what matters. And therein lies a problem.

If the amount of taxable income cannot be reliably estimated within a limited range, the minimum amount of long-term capital gains necessary to avoid involuntary transfer of PSA funds cannot be accurately determined. At the very least, an upper and lower limit of the range that the effect of taxable income can have on SSA should be determined. Such a determination may indicate that it would be better to "manage" in advance the amount of taxable income rather than to take a long-term capital gain.

The PSA is limited to the largest of (1) 15% of a company's life insurance reserves at the end of the taxable year; (2) 25% of the increase in such reserves since the time the PSA was first established; and (3) 50% of the premiums and other considerations taken into account in the computation of the gain from operations for that taxable year. Amounts in excess of this limitation are subject to tax at the corporate rate with the balance after tax being transferred to the SSA. The effect on this limitation of any action by management or governments must not be overlooked. For example, the federal tax consequences of nationalization of health insurance would be burdensome on a "health" insurer which before nationalization qualified as a "life" insurer under the tax laws (a) since its PSA limit would likely change from (i) the "premium" base to (ii) a lower "reserve" base or (b) since it could lose its "life" qualification.

If this situation exists, financial planning designed to change the base of limitation from "premium" to "reserve" has merit. Such planning might include merger with a life insurer, purchase of a block of life insurance business, or arrangements of life reinsurance (see Section 820, Internal Revenue Code). □

## LETTERS

### Audit Guide

*Sir:*

The Joint Actuarial Committee on Financial Reporting has submitted a Response to the AICPA regarding their August 1972 Exposure Draft of "Audits of Stock Life Insurance Companies." The Response consists of 42 pages of commentary on issues that are of some concern to the Joint Actuarial Committee.

Our general view of the current Exposure Draft is best given in the introduction:

> "As a result of our discussions with the AICPA Committee the August, 1972 Exposure Draft of 'Audits of Stock Life Insurance Companies' has incorporated many of the views we have developed since the time of our formation. We therefore regard the current Exposure Draft as a significant improvement over the December, 1970 Exposure Draft of 'Audits of Life Insurance Companies'."
>
> "The Joint Actuarial Committee has concluded that the current Exposure Draft is a practical initial set of guidelines to auditors concerning the reporting of stock life insurance company earnings according to generally accepted accounting principles."

Copies of our Response are available free of charge from the Chicago office of the Society.

*Richard G. Horn,*
*Chairman*