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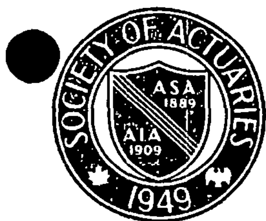

The Actuary

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AGAINST TAX-EXEMPT INVESTMENT INSTRUMENTS

by Clayton A. Cardinal

Many considerations enter into the determination of investment strategy. Important among these considerations is the maximization of investment income on an after-tax basis rather than on a before-tax basis. Because of the complexity of the federal income taxation of life insurance companies, the determination of after-tax investment income and thus the realization of maximizing such income are not easy undertakings.

Beginning in the early 1960's after-tax investment yield for each of the major classes of investment instruments has been analyzed by many life insurers by what is commonly referred to as the marginal tax rate approach. For a number of insurers such analysis of the impact on these investment instruments of the marginal tax rates resulted in a change in investment strategy from corporate bonds to municipal and other similar tax-exempt bonds. The assets of some of these insurers are heavily invested today in such tax-exempt instruments. For these insurers much of the increase in corporate assets since the early 1960's has been invested in the tax-exempt instruments.

Two important considerations in the determination of investment strategy receiving more attention today than in the recent past are (1) the servicing of an investment instrument and (2) the preservation of the principal of the investment. Servicing an investment instrument embodies for the most part the payments such as interest, dividend, mortgage, or the like which are required by the terms of the instrument. It is a consequence of these additional considerations which leads me to the following recommendation.

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THE TRUST FUNDS

1977 Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, of the Federal Hospital Insurance Trust Fund, and the Federal Supplementary Medical Insurance Trust Fund.

by Benjamin R. Whiteley

An excellent introduction to the 1977 Annual Reports of the Board of Trustees of the Social Security Trust Funds, in this reviewer's estimation, may be obtained by reading the Commentary Prepared to Assist in the Reading and Interpretation of the Reports. The Commentary was prepared by A. Haeworth Robertson, Chief Actuary of the Social Security Administration. This is the second year we have had the benefit of Mr. Robertson's Commentary which is easily readable and extremely helpful.

As in previous recent years, there are three 1977 Trustees Reports: one for the Federal Old-Age and Survivors Trust Funds; one for the Federal Hospital Insurance Trust Fund; and one for the Federal Supplementary Medical Insurance Trust Fund. Each of the reports is organized similarly. Major sections are devoted to highlights, an explanation of the nature of the trust funds, a summary of operations of the funds for the past fiscal year, projected operation and status of the funds, a statement of the actuarial status of the trust funds, conclusions and appendices. The appendices contain assumptions, methodology and other details.

Old-Age and Survivors Insurance and Disability Insurance Trust Funds

Continuing the pattern of recent years' reports, this report calls attention to the need for additional financing for the Old-Age and Survivors Insurance and Disability Insurance Trust Funds in both the short and long range. The excess of

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AN UNLOADED QUESTION?

by John W. Grantier

On June 23, 1977 the Supreme Court ruled that a life insurance company must include the net valuation portion (but not the associated loading) of deferred and uncollected premiums in its assets and gross premium income as well as in its reserves in computing its tax liability. Some companies have been using this procedure or a modification of it for the past few years. Other companies have been filing returns conforming to IRS regulations which required including gross deferred and uncollected premiums. These companies may need to file amended returns for open tax years if they paid taxes not due or understated usable operations loss carryforwards.

The purpose of this article is to review the implications of the court's decision for companies filing amended returns. It does not discuss: the IRS's extension of the deadline for filing Form 3115, Request for a Change in Accounting Method, to September 30, 1977; whether or not these changes represent a Change in Accounting Method; or any alternative procedures for handling these changes.

One question to be answered is "How far back must amended returns be filed?" One possible answer is five years back, since operations loss carryforwards developed after 1972 will have expired before 1977. (For "new" companies, substitute eight years and 1969). The 1972 return, however, includes understated earnings rates for each of the four previous years (based on overstated assets), which may be used in computing the policyholder's share of taxable investment income. These earlier year earnings rates will be used in 1972 and later if their average is less than the current earnings rate, which will be

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Investment Instruments

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A Recommendation

One recommendation for a company heavily invested in tax-exempts is to not invest further in that class of instruments. Consistent with this recommendation is a corollary recommendation that the company judiciously divest itself of most of its tax-exempt holdings.

This recommendation is based upon my belief that a major economic depression will occur within the next ten years, possibly sooner.

Impact of Major Depression on Tax-exempt Instruments As a Class

The market for tax-exempt instruments is very narrow and is becoming narrower with each recession. For example, a primary holder of tax-exempts has been the banking industry. However, with each new recession the banking industry increasingly finds itself in an illiquid position. To alleviate these liquidity problems, the banking industry has been, among other activities, selling its holdings of tax-exempts.

During a major depression, the taxing base from which income is derived by issuers of tax-exempts to service their debts would shrink considerably. During such times it would be difficult initially for such issuers to cut back on their public services. Instead, they would likely first default on the interest payments on their debts and then default on the repayment of the debt principal as the instruments would mature.

Because all issuers of tax-exempt instruments would have reduced tax bases during a depression, investments made in tax-exempts as a class would not be a good haven for any investable assets. As a class of investments, tax-exempts probably offer as little security as conventional mortgages during a depression.

A valuable lesson can be learned from the recent New York City bond debacle. Although New York City has proven to be politically irresponsible, it was not this irresponsibility per se which caused the debacle. The debacle was caused by the acute *attrition* in the city's tax base which resulted from the economic slowdown.

Contrast the likely impact of a major depression on the security of investments in tax-exempts with its likely impact on the security of investments in "quality" corporate bonds. By "quality" corporate bonds is meant bonds of corporations (1) which produce meaningful and necessary products or services, (2) which have relatively unleveraged capital, and (3) which have good positions of liquidity.

Short of a complete collapse of the economy "quality" corporate bonds offer plenty of security to investors. First, in any economic slowdown they do not immediately experience a liquidity problem. Second, when their net income decreases they are able to forego dividend payments in order to continue servicing their debts. Third, they have surpluses which can be used as a source of funds, if necessary. Finally, they can sell off assets to service their debts if that should become necessary.

The Coming Depression

An examination of the last 40 years discloses that over that period the government for seemingly "valid" reasons has increased the amount of its deficit spending, with the yearly level of such deficit spending reaching many billions of dollars today. In order to accommodate the financing of that deficit spending the Federal Reserve Board has had to monetize much of it, that is to say the Federal Reserve Board has had to increase the money supply over and above the increase in real value of goods and services produced. Each such increase in the money supply has resulted in stimulation of the economy through the creation of "easy" credit by the banks which have had to handle the government's deposits.

As the money supply/credit cycle has continually repeated itself, the economy has become more and more credit dependent, requiring with each cycle more stimulus through greater deficit spending with its consequent further expansion of credit. Thus, the economy is feeding on itself, and the economic system as we have known it must self-destruct since, as common sense tells us, there is a credit level toward which we are accelerating and which cannot be exceeded. When that level is reached, a major depression will be upon us. (An alternative consequence that government becomes fascist and totalitarian is not explored here). No one knows at what point the ultimate credit level will be reached. What that amount of credit is which represents the breaking point should not concern us; all that we need be aware of is that inevitably the breaking point will be reached.

Some monetarists are suggesting th rather than depression the economy will experience runaway inflation similar to that in Brazil. Under such a situation, investments in "quality" corporate bonds still would offer initially greater security than investments in tax-exempt bonds.

Impact of Recommendation on Net Income

If any insurer accepts the recommendation and if the considerations which have precipitated the recommendation never materialize, the loss of net income after tax each year will depend on the aggregate spread between the after-tax yields of alternative investment instruments. On $10,000,000 such foregone net income might average between $25,000 and $37,500, and would decrease over time as interest rates generally would come down.

If the recommendation is accepted and if the considerations upon which it has been based materialize, the *relative preservation* of net income resulting from preservation of investment return and investment principal could run in millions of dollars. The temporary foregoing of greater investment yield can be considered an asset charge for insurance against investment default. Depending on an insurer's tax situation, this charge on an after-tax basis likely would fall between ¼ and ½ of 1% of related assets.

Timing

Some may feel that the underpinning of the recommendation is proper but that the timing is wrong. This is a common retort of some investment people in response to recommendations made by "outsiders." The effect of such a retort, and its intent, is usually to eliminate any real consideration of any such recommendation.

For the economic situation at hand there can never be a good time for implementing such a recommendation. If implementation of the recommendation is delayed until the need for such is "more obvious," then it may be too late. Since it cannot be known in advai exactly when the need for implementation will be "more obvious" but can only be known that it will become "more obvious," an insurer can protect itself now by implementing the recommendation. □