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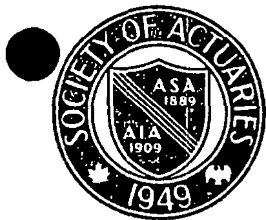

The Actuary

The Newsletter of the Society of Actuaries

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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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An Unloaded Question?

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a common condition for many companies. Therefore, a strict interpretation of the decision might require filing amended returns from 1968 forward to establish precise historical earnings rates. For a company that has been taxed only on gain from operations and not taxable investment income, using these historically established rates as approximations would seem to be sufficient.

Since the current earnings rate is investment yield divided by mean assets, a reduction in assets increases the current earnings rate. The adjusted reserves rate is the lesser of, the current earnings rate or the average earnings rate for the current year and the preceeding four years. An increase in the adjusted reserves rate will increase the policy and other contract liability requirements when it is multiplied by the adjusted life insurance reserves. This will lead to an increased policyholders' share for computing taxable investment income, which should lead to a lower company share and therefore a lower taxable investment income. Right?

Not always.

"Why?" you may ask. Because the Life Insurance Company Tax Act of 1959 is a very complicated law. The result stipulated above will occur if investment yield does not change. It is possible for investment yield to also change as a result of the decrease in assets. This is because the limit on the deduction for investment expenses in computing taxable investment income may increase or decrease when assets decrease, depending on the mix of mortgage assets with and without service fees. If the limit increases, and is applicable, investment yield decreases and lowers the current earnings rate, which is the opposite of what was previously described. If the limit decreases, and is applicable, investment yield and the current earnings rate increase. For some companies, the change in the investment expense limit will have no effect. When the investment expense limit does apply, in whichever direction, it will change investment yield, and since policyholders' share is policy and other contract liability requirements divided by investment yield, policyholders' share will also change. It is difficult to say which of these effects will predominate without running the numbers through the return.

An insurer who is affected by the investment expense limitation may actually increase taxable investment income by filing amended returns. This is of no consequence to the insurer who is taxed only on gain from operations. If, however, investment yield has changed as a result of the investment expense limitation changing, this would also change the policyholders' share and company's share calculated for determining gain from operations in the same direction as both shares for determining taxable investment income. Also, a decrease in the investment yield will change the small business deduction for companies whose investment yield is less than $250,000, since the small business deduction is the lesser of 10% of investment yield or $250,000. This, in turn, will reduce the amounts accumulated in the shareholder's surplus account.

The Supreme Court decision also stipulated that loading on deferred and uncollected premiums could not be included in gross premium income in computing the company's tax liability. The amount that a company previously included and now must exclude is the increase in loading on deferred and uncollected premiums. This change is an income item used in determining the company's gain from operations. One might expect this deduction of the increase in loading to have an exact dollar for dollar effect on the gain or loss, reducing the gain or increasing the loss to be carried forward. This is not always the case.

First, if there was a change in investment yield, as described above, there will be a change in the company's share for computation of gain from operations, and consequently a change in other items of investment yield, the small business deduction, and the company's share of various investment income items, as well as the remainder of investment expense deductions over the Schedule H limit. Second, the change in gross premiums changes the subtotal of income which is used in Schedule E-2, Part I to determine the limitation on special deductions which may therefore also change. This may also affect amounts accumulated in the shareholders' surplus account. Again, the surest way to determine what actually will happen is to make the adjustment and all resultant changes in the tax return.

Note that a company in any given year may have an increase in loading or a decrease in loading. Therefore, the gain from operations may increase or decrease accordingly. If a company has a decrease in loading as measured from the beginning of the tax year for which it is filing amended returns to the end of 1976, gain from operations may be increased during the critical period, increasing tax liability or reducing operations loss deductions. A line by line recalculation of the tax returns will determine whether the company gains or loses by amending its returns.

I have described some of the implications of a "simple" change in tax returns emanating from a Supreme Court decision generally welcomed by the life insurance industry. In the process, we have found that where the Life Insurance Company Tax Act of 1959 is concerned, even "simple" adjustments can become quite complex, expected gains may be illusory, and recomputation of tax returns during the critical period is the best way to form definitive conclusions about the effect on a particular company. □

REPORT ON RISK CLASSIFICATION

Through an oversight, this Report as issued did not contain the usual list of members of the Task Force. They are as follows:

Michael J. Mahoney, *Chairman.*

John P. Clark, William S. Gillam, Barbara J. Lautzenheiser, W. James MacGinnitie, Richard M. Stenson, Ethel C. Rubin.

In addition, Daniel F. Case and Stephen G. Kellison attended the Committee Meetings as observers.