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DIGEST OF INFORMAL DISCUSSION

U.S. FEDERAL TAXATION OF LIFE INSURANCE COMPANIES

What are the latest developments in this matter?

The latest developments were reported by MR. ALFRED N. GUERTIN at the New York Regional Meeting and by MR. WILLIAM M. RAE at the Omaha Regional Meeting. Following is a summary of their reports:

After Congress extended the stop-gap legislation in March of 1958 making it applicable to the year 1957 it was obvious that this would be the last extension of the stop-gap laws and that life insurance companies would be taxed for 1958 either on the 1942 basis or on whatever new permanent legislation might be adopted. In April of 1958 the Treasury wrote a letter to Representative Mills, Chairman of the House Ways and Means Committee, and to Senator Byrd, Chairman of the Senate Finance Committee, outlining in general terms two permanent solutions. Their first choice was a total net income approach under which companies would be taxed at corporate rates on essentially their gain from operations before federal income tax. Their second choice was an investment income bill under which companies would be taxed on roughly 30% of their investment income, instead of 15%, and which would also take underwriting gains into account to some extent.

Shortly thereafter the joint tax committee of the Life Insurance Association, the American Life Convention and the Life Insurers Conference appointed two subcommittees to look into the matter. The first subcommittee investigated the total net income approach and drafted a possible bill along those lines. The second subcommittee investigated a number of different investment income approaches and finally settled on the adjusted reserve method frequently referred to as the Menge plan. It also drafted a possible bill. Both of these draft bills were furnished to the staffs of the Treasury and Congressional Committees.

Although Congress was not then in session, members of the subcommittee of the House Ways and Means Committee returned to Washington in November of 1958 and extensive hearings were held for three full days. The Treasury reiterated its preference for the total net income approach, but suggested as an alternative a new combination approach de-

signed to incorporate the best features of both the investment income and total net income methods. Many witnesses presented a wide variety of views. Some strongly supported an investment income approach, others supported the total net income approach, others supported the Treasury's combination approach, while others referred to particular issues. It was obvious that the industry was very far apart in its thinking on the subject.

The subcommittee of the House Ways and Means Committee then went into executive session, with the result that it instructed the Treasury to draft a tentative bill along the combination approach. Then in January the full House Ways and Means Committee gave extensive consideration to the matter and made some modifications in the Treasury bill. This modified bill was speedily passed by the House and is known as HR 4245. It has been estimated that it would produce in excess of 550 million dollars of revenue for 1958 which is up considerably from 335 to 340 million which would have been produced by the stop-gap formula. The 1942 law would have produced between 490 and 500 million dollars. The target of the Treasury tax leaders in Congress originally appeared to be in the neighborhood of 500 million for 1958.

During March of 1959 the Senate Finance Committee held six full days of hearings on HR 4245. All interested parties had an ample opportunity to express their views. It was obvious from the questioning that the senators had done their homework well and were anxious to arrive at a good and permanent solution to the problem. More unity was evident on the part of the industry than was shown in the House Ways and Means subcommittee hearings the previous November but there was still a substantial divergence of views.

HR 4245 as it now stands consists of four phases and the total taxable income is the algebraic sum of the taxable income under each of the four phases. Phase 1 arrives at taxable investment income. In doing this there must first be calculated the deduction rate. This is the mean of a company's earned interest rate and its valuation interest rate used in determining reserves or it is the mean of such earned interest rate and the industry's average valuation rate, whichever of the two means is higher. Next, the company's reserves are reduced by 10% for each 1% by which its deduction rate exceeds its valuation rate. These adjusted reserves are then multiplied by the deduction rate and the result is subtracted from the company's net investment income to obtain its taxable income under Phase 1. A number of witnesses at the Senate Finance hearings objected to this method of determining the deduction rate. They favored a deduction rate which would be the average of the company's earned interest rate during the five years ending with the tax year.

Phase 2 arrives at the taxable underwriting gain. The taxable income under it is 50% of the excess of the adjusted gain from operations over the taxable investment income in Phase 1. The adjusted gain from operations is essentially the gain from operations as shown in the annual statement before federal income tax, less certain deductions—for example, 10% of the increase in nonparticipating reserves, 2% of group premiums, and a pro-rata share of tax exempt interest and dividends received credit. If the adjusted gain from operations is less than the taxable investment income, the negative taxable income under Phase 2 is 100% of the difference. However, the 2% and 10% deductions mentioned above and the deduction for dividends paid to policyholders are not allowed to create negative taxable income under Phase 2. A number of witnesses objected to this, arguing that dividends paid to policyholders should be deductible in full or that, as a compromise, 50% of any negative amount arising from this source under Phase 2 should be allowed. Other witnesses argued for full deduction of tax exempt interest rather than a pro-rata allowance in both Phase 2 and Phase 1. Others recommended a transition period for the total tax and still others for Phase 2 only. Also suggested was more liberal treatment for small companies on both Phase 2 and Phase 1. There were more than 50 witnesses and many other suggestions for change were made.

Phase 3 applies to stock companies only. It provides for the establishment of two accounts: a stockholders' surplus account and a policyholders' surplus account. Into the former are placed all sums previously taxed, less taxes, all tax free interest and the full intercorporate dividends received and the amount of the small company deduction. Into the latter is placed that part of the Phase 2 income which is not taxed under Phase 2, that is, 50% of the excess of Phase 2 taxable income over Phase 1 taxable income. Dividends to stockholders may be paid only out of the stockholders' surplus account. When it is insufficient, the requisite amount must be transferred from the policyholders' surplus account and tax paid thereon. When the latter account is exhausted, dividends may be paid out of surplus existing prior to the effective date and without tax.

Phase 4 taxes realized capital gains at 25%. The amount thus taxed flows into the stockholders' surplus account. Insurance companies have not heretofore paid a tax on capital gains.

The Senate Finance Committee is scheduled to go into executive session April 9 at which time they will probably decide the changes they wish to make in HR 4245. If changes are recommended by the committee the bill with the proposed amendments will go to the Senate for action. If the bill as passed by the Senate differs from that as passed by the

House it will have to go back to the House for concurrence. However, if the two bodies do not agree it will go to a conference committee. This matter is being given most careful attention and it looks as though the outcome should be known within a couple of months. The odds are that very few will be happy with the final bill. Perhaps that may prove that the bill fairly and reasonably compromises the wide range of conflicting views and interests.