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**THE LIFE INSURANCE COMPANY
INCOME TAX ACT OF 1959—
PANEL DISCUSSION**

MR. RICHARD C. GUEST, Chairman of the Panel, explained that the topics to be presented were chosen so as to avoid complications of discussing topics which might have an intimate relationship with regulations. He then introduced the other members of the panel:

ANDREW DELANEY, F.S.A., author with Joseph W. Hahn of an actuarial note before the Conference of Actuaries in Public Practice, "Some Implications of Public Law 69," October, 1959, a member of the ALC-LIAA Joint Advisory Committee on interpretation of the Federal Income Tax Law.

CHARLES G. GROESCHELL, F.S.A., a member of the Joint Advisory Committee on Federal Income Tax Law.

J. EDWIN MATZ, F.S.A.

HENRY ROOD, F.S.A., Past President, member of the five-man group appointed to advise Secretary of the Treasury Humphrey in 1956, Chairman of the Joint Advisory Committee on Federal Income Tax Law.

WILLIAM E. LEWIS, F.S.A.

Mr. Guest opened the panel by stating some questions that are frequently asked and suggested some practical answers.

Question: You say you're taxed as heavily as I am; your tax seems ridiculously small compared with your \$90 million of earnings on investments. How do you explain this?

Answer: The contractual price of our product is already discounted to the extent of almost all of the \$90 million earned on investments. To this very large extent the interest must be earned and devoted to the fulfillment of the contracts; otherwise the company would rapidly become insolvent and would be unable to fulfill its obligations. If the premiums were not so discounted at the time of sale, they would in many instances be as much as five or more dollars per thousand per year more than they actually are.

Question: You paid \$40 million in dividends to your policyholders. When I pay such an amount in dividends from my company I must have paid a corresponding amount in taxes.

How do you explain the fact that your taxes are proportionately so much smaller?

Answer: Dividends to policyholders are in no way similar to dividends to stockholders. Chairman Mills of the House Ways and Means Committee, while reporting to the Congress, said, "Dividends to policyholders are essentially price adjustments."

It is quite commonly known that nonparticipating premiums are substantially lower than participating premiums. Certainly policyholders' dividends must be considered price adjustments at least to the extent that they reduce each year's net charge to the level of a corresponding nonparticipating premium charged by a well managed competing company.

Question: What is this I hear about some of your earnings being taxed at only half the corporate rate which I pay in my automobile manufacturing business?

Answer: For you to understand our problem let's assume that when you sell an automobile you guarantee that it will continue in a mechanical condition to provide equally comfortable and reliable transportation for 20 years, abuse or catastrophe being fully covered in the original price. We do not know our operating profits on a life insurance policy for 20, 30, 40 or more years, hence a large part of our current earnings, stated earnings, are taxed at the full rate; the balance is immediately taxed at one-half the corporate rate and the remaining tax on any true ultimate balance of earnings is assessed when the earnings are revealed sufficiently reliably to result in their disbursement as earning dividends to stockholders.

The foregoing commentary is changed somewhat as follows for mutual companies: The calculation of the taxable interest earnings is by law set at a high level which not only taxes all the interest earnings, but in fact taxes a substantial part of the price adjustment which appears as policyholder dividends. The excess tax on the investment earnings is a quite stable annual tax more than large enough to cover the full tax on any amounts other than truly taxable investment earnings which the Congress considers to be taxable earnings.

MR. ANDREW DELANEY's discussion was confined almost entirely to this one question: Should a company which has been valuing on a preliminary term basis make any change in its reserve pattern? Should it, for example, strengthen reserves in its convention statement, or should it make the election provided for in Section 818(c), or perhaps begin to issue new business on a net level basis, or follow still some other course?

At first glance, this appears to be a rather limited question which would seem to be amenable to a quick and easy solution. Upon closer examination, however, the question is a good deal more complicated, and as in the case of most complicated questions there is no easy solution. There are certain principles and landmarks which are helpful and can serve as partial guideposts, and it is these which Mr. Delaney discussed.

At the outset, it is recognized that the course of action to be taken by a company when it involves important changes in the convention statement is not primarily a mathematical problem. It is possible, as can be seen later, to shed a good deal of light on the best tax course by mathematical analysis, but this is not the same thing as saying the problem is primarily mathematical. Quite the contrary, it was Mr. Delaney's feeling that some

of the intangible considerations which differ widely from company to company may be dominant. For example, in a mutual company, the surplus position of the company, its dividend traditions, and the impact of reserve strengthening on policyholder relations are the principal non-mathematical elements requiring careful consideration. In a stock company, the distribution of the company's shares, *i.e.*, whether the stock is widely held or concentrated in a family or small group, stockholder as well as policyholder reaction to strengthening, the company's surplus position, and the importance attached to the policyholders' surplus account which is established by Section 815 are all highly pertinent considerations.

Because the nonmathematical elements of the problem described above differ so widely from company to company, it is impossible to incorporate them into a mathematical analysis of the new law. For this reason, the balance of the discussion was restricted for the most part to an attempt to determine which of the many courses open to a company will produce the least tax. It bears repeating once more that the course of action producing the least tax is not, for the reasons described above, necessarily the best possible course of action. On the other hand, the first step in deciding which path to travel is to determine the tax consequences of each possible course of action.

With the proviso that this discussion was now limited to the treatment of the income tax consequences of each possible course of action, Mr. Delaney proceeded.

Last October, Mr. Joseph W. Hahn and Mr. Delaney presented a paper dealing with federal income tax to the Conference of Actuaries in Public Practice.¹ The paper was divided into two parts; the second part dealt with the conditions under which a Section 818(c) election will be helpful in reducing income taxes. The mathematics is relatively simple and straightforward, and with the assumption that an exact revaluation will produce an identical result with the approximate method specified in 818(c), it is possible to draw some conclusions.

No purpose would be served by an attempt to describe the formulas of this note. It is shown there that the question of whether to make the 818(c) election depends upon several items—the percentage of investment income that is "tax exempt," the average net amount at risk, the valuation interest rate, the adjusted reserves rate, the annual increase in reserve per thousand, and the termination rate from all causes, *i.e.*, death, maturity, surrender, end of the premium-paying period, and end of the modification period.

¹ Conference of Actuaries in Public Practice, *The Proceedings, 1959-60*, IX, 62-80.

If the only choice under the new law were to continue under the preliminary term valuation or make the 818(c) election, the relationship between these items is such that for nearly every company (about the only exception is a new company or a company whose total business has leveled out or turned downward) it would be better to make the 818(c) election. To make sure that there was no misunderstanding of this important point, Mr. Delaney emphasized that if a company valuing on preliminary term had only two choices—(a) to continue to value on preliminary term for both the convention statement and federal income tax, or (b) to continue to value on preliminary term for the convention statement but make the 818(c) election for federal income tax purposes—then it would almost certainly be wise to elect the latter course, *i.e.*, to continue to value on preliminary term for the convention statement and to make the 818(c) election for federal income tax purposes.

If these were the only choices open, the problem would be simple. The complications are introduced because Public Law 69 grants additional options. One of the additional possibilities open to a company is to strengthen part or all of its existing reserves as of December 31, 1959 (or any year thereafter for that matter) to a net level basis and to make the 818(c) election for new business. In effect, Public Law 69 grants a company the right to divide itself into two companies, designated as Company A and Company B. Company A is represented by all of the insurance in force as of a particular date, and Company B is a new company which has yet to issue a policy.

The actuarial note previously referred to makes clear that for Company A, which is a closed block of business, it can hardly be beneficial from an income tax standpoint to make the 818(c) election. Now, as has previously been pointed out, if we consider our company as a unit, *i.e.*, combine Company A and Company B, then it is nearly always advantageous to make the 818(c) election. Since the 818(c) election is favorable for Company A and Company B combined, but unfavorable for Company A alone, it is clear that it must be very favorable indeed for Company B alone, *i.e.*, for a new company. (An exception to be noted here is the case in which a new company, as a result of operating losses without the 818(c) election, would be paying no tax and would lose the benefit of loss carry-forward because it might not have sufficient earnings within five years.)

In effect, then, we conclude that for Company A (existing business) we should not make the election, and for Company B (new business) we should make the election. It is clear that the 818(c) election would always act to reduce the Phase 1 taxable income for Company A, and this makes

it apparent that the disadvantage to the election so far as Company A is concerned arises from Phase 2 considerations. The law provides a means to avoid this Phase 2 disadvantage by strengthening existing reserves and thus securing a Phase 2 deduction of the amount of the strengthening (or possibly 110% of such amount) spread over ten years (with the exception of the increase in reserves for issues of the particular calendar year under consideration which is a deduction during the year) and will also permit the 818(c) election to be made in the year following the strengthening. Whenever it is possible for a company to revalue existing reserves to net level and make an 818(c) election for new business, it is very likely to be the single best course for federal income tax purposes.

As previously pointed out, a new company may be an exception to this rule. There are a few other exceptions which come readily to mind:

Companies for which the extra tax payable during 1958 and 1959, as a result of the reserve strengthening course as compared to an 818(c) election, may more than offset the tax savings to be effected from 1960 to 1969—such a situation might arise, *e.g.*, in a company which had a large carry-over loss from the years 1955 through 1957 as a result of the 818(c) election in 1955.

Another possible exception is a company which feels confident of its ability to increase new business rapidly during the decade 1960 through 1969. Since the superiority of the reserve strengthening followed by an 818(c) election over a simple 818(c) election is confined to the ten-year period following strengthening, a company with sufficient new business might find that because of the limitation imposed by Section 809(f) there would be no tax savings through the reserve strengthening program. In these circumstances, the company would probably find its tax bill less in 1958 and 1959 under the 818(c) election and could maintain a stronger surplus position by not strengthening. The only disadvantage to this company would be the increase in policyholders' surplus. Even though this might not appear to result in any additional taxes for the foreseeable future it could be regarded as a very serious disadvantage.

Another exception would be an established company which may have had, for whatever reason, sufficient operating losses, including the 809(f) deductions, to owe a very small tax or even no tax at all for a few years. Such a company ideally could defer its reserve strengthening program until a significant tax emerges and would then strengthen and make the 818(c) election the following year.

For practical purposes, however, we find that for most companies a strengthening of reserves at the earliest moment to net level followed by an 818(c) election is the best course for federal income tax purposes. If

a company is not in position to strengthen its existing reserves to net level, *e.g.*, because of fear of adverse stockholder or policyholder reaction or because the company's surplus would be inadequate or even nonexistent after such valuation, the problem becomes much more difficult.

We have already observed that if such a company had to choose between no action and an 818(c) election, it would almost certainly be better off with an 818(c) election. There are, however, several other possible courses open to our company. It may continue its existing business on preliminary term and begin to issue new business on a net level basis, or it may take action to strengthen its reserves over a period of years and make no election until such time as the strengthening is completed.

It is difficult to develop mathematical criteria which make clear the best course of action under these circumstances. General reasoning and some crude model office studies seem to indicate that a company which does not have sufficient surplus to strengthen its reserves would be unwise to begin issuing new business on a net level basis. In such circumstances, the best course of action seems to be for the company to engage in a reserve strengthening program over a long period and having finally completed this program to make the 818(c) election. It is to be noted that in general the company will not only pay more taxes than the company which completes its reserve strengthening in one chunk but will also finally be required to do a great deal more strengthening because of the additional issue years involved.

In this connection, we might note particularly that a company which completes all of its reserve strengthening in one year and has part of this deduction wasted during the following decade because of the limitation in 809(f) should consider stretching out its strengthening program over several years to secure the maximum tax advantage.

To summarize the discussion to this point—if we assume the increase in reserve resulting from the 818(c) approximate method is equal for practical purposes to the increase resulting from an exact revaluation and if we ignore considerations other than the amount of income tax—we can say that for most companies the best course is to strengthen reserves at the earliest moment and then make the 818(c) election in the year following. Even here, however, there are numerous exceptions to this rule.

It was mentioned earlier that it is impossible to deal with the many other factors in addition to the amount of income tax which require consideration. It is possible, however, for a company to measure the relationship between the additional reserve increase resulting from the approximate method specified in 818(c) and an exact revaluation. If the increase in reserves by the 818(c) approximation is significantly different

from the increase produced by an exact valuation, then a whole new element is introduced into our considerations. Mr. Delaney checked the relationship between the 818(c) approximation and an exact valuation for several companies varying from a few hundred million to several billion dollars and found that it is possible for an individual company in exceptional circumstances to have a difference in reserves by the two methods which may affect the tax significantly.

All of the previous considerations must be modified in light of this difference, if it exists, and this complicates the problem considerably; it also suggests the possibility that even companies which have traditionally valued on a net level premium basis might give some consideration to change. It seemed pointless, however, to attempt to build any elaborate mathematical fabric on this difference because it would vary so much from company to company and also because in establishing any course of action a company would surely wish to recognize the possibility that the factors specified in Section 818(c) will change.

In conclusion, Mr. Delaney stated again that the problem is an extremely complex one, and it is almost impossible to generalize about it. Only a thorough study of the application of the new law to the individual company's circumstance by competent tax men is likely to produce the correct course.

MR. CHARLES G. GROESCHELL pointed out that since 1950 it had been very easy to tell the equivalent taxable yield rate of tax-exempt securities. Under the 1951 stop-gap law, the "tax-yield equivalent" rate was found by dividing the tax-exempt yield rate by 1 minus the tax rate of 6.5%, or .935. Under the Mills bill, the tax-exempt yield rate was divided by .922. In other words, the tax-yield equivalent rate was about 107% of the yield on tax-exempt securities under the 1951 stop-gap law, and 108.5% under the Mills law. These figures applied equally for all companies and for all the years in which the laws were in effect.

Mr. Groeschell then emphasized that under Public Law 69 this situation has changed. No longer can one take the effective tax rate expressed as a percentage of the net investment income and develop the percentage to be used in determining the tax-yield equivalent of tax-exempt securities. Neither can one take the current incremental tax rate and find the appropriate percentage. The problem is much more complex than that and the actual result will not only vary company-by-company as does the basic tax formula, but also it will vary from year to year for the same company. As such, it behooves everyone to make the best forecast of future results and see what factors are likely to hold for the next 10 to 20 years—the average life of tax-exempt securities that might be currently pur-

chased. This is the only way by which the actuary can give his investment people an understanding of what tax-exempt income is worth when compared to taxable income.

Then Mr. Groeschell recommended most highly the Actuarial Note written by Mr. Andrew Delaney and Mr. Joseph Hahn, entitled "Some Implications of Public Law 69." He said this gave a mathematical analysis of the law which provided a background for the study not only of tax-exempt interest, but of almost all other phases of the new law. Then, assuming this paper as background, Mr. Groeschell presented the following formula for use in determining the equivalent percentage increase in tax-exempt income:

Tax-Exempt Interest under Public Law 69

n = number of years after an investment change was effected

I_n = net investment income in n th year

I_n^x = exempt interest plus dividend credit included in I_n

I_n^t = taxable interest in I_n ($I_n = I_n^t + I_n^x$)

$T_n = I_n^t/I_n$ = ratio of taxable interest to total interest

A_n = mean assets in n th year

$$\frac{1}{A'_n} = \frac{1}{5} \left(\frac{1}{A_n} + \frac{1}{A_{n-1}} + \dots + \frac{1}{A_x} \right),$$

where $x = n - 4$, but not less than 0

V_n = mean life insurance reserves subject to revaluation

P = mean pension life insurance reserves

i = average assumed interest rate in reserves

i' = current earnings rate = I_n/A_n

i'' = 5 year average earnings rate = $\frac{1}{5} \left(\frac{I_n}{A_n} + \frac{I_{n-1}}{A_{n-1}} + \dots + \frac{I_{n-4}}{A_{n-4}} \right)$

i_v = revaluation earnings rate = smaller of i' and i''

V'_n = adjusted reserves = $V_n(1 + 10i - 10i_v)$

I_n^p = interest paid, credited or accrued

$$K = \frac{1 + 10i - 20i_v}{1 + 10i - 10i_v}$$

RI = Phase 2 required interest as defined in 809 (a) (2)

$S_1 = 1 - \frac{V'_n i_v + P i' + I_n^p}{I_n}$ = Phase 1 company's proportionate share of interest

$S_2 = 1 - RI/I$ = Phase 2 company's proportionate share of interest

$F_1 = 1 - \frac{K V'_n}{A_n} - \frac{P}{A_n}$, if $i' < i''$, or $1 - \frac{K V'_n}{A'_n} - \frac{P}{A_n}$, if $i' > i''$

$F_2 = 1$

If company is taxed under Phase 1 only, $S = S_1$; $F = F_1$

If company is taxed under Phase 2 only, $S = S_2$; $F = F_2$

If company is taxed under both Phase 1 and Phase 2, $S = \frac{1}{2}(S_1 + S_2)$;
 $F = \frac{1}{2}(F_1 + F_2)$

Then the derivatives with respect to taxable and exempt interest are:

$$D_1TB = TF + (1 - T)S$$

$$D_2TB = TF - TS = T(F - S),$$

and the equivalent taxable interest yield of tax-exempt securities can be found by multiplying the yield rate of tax-exempt securities by:

$$\frac{1 - .52T(F - S)}{1 - .52T(F - S) - .52S},$$

or the percentage increase in yield is:

$$\frac{100S}{\frac{1}{.52} - T(F - S) - S}.$$

Mr. Groeschell then pointed out that the formula is quite simple in form and involves only three factors: the company's proportionate share of investment income which is the most important factor; the ratio of taxable income to total income; and the factor, F . This latter factor is quite complicated for Phase 1, especially if the revaluation rate is the five year average, but is simply equal to 1 for Phase 2.

He then discussed the differences in the formula when a company is taxed under just Phase 1, just Phase 2, or both. This brought out the practical problem of forecasting the basis of a company's tax in the future. The phase or phases under which a company is taxed are most important. As to the forecast of yearly trends in surplus, interest rates, reserves and assets, Mr. Groeschell pointed out that the future course of surplus was most important, and this decision should be made first, letting the life insurance reserves be the balancing figure. He then encouraged each company to forecast its results and keep an up-to-date idea of the worth of tax-exempt income in the minds of the people investing the company's money.

In summary, Mr. Groeschell thought that the formula would produce a percentage increase in the tax-exempt yield of about 15% to 18% for most companies taxed under Phase 1. Under Phase 2 the percentage increase will probably be more in the neighborhood of 30% to 35%, or twice that for a company taxed only under Phase 1. For a company taxed under both phases, the percentage will be approximately the mean of these ranges.

Finally, Mr. Groeschell just briefly mentioned some additional problems or complicating factors. The \$250,000 corridor is especially important for smaller companies; there is no additional value in tax-exempt interest in any company whose tax is zero under Phase 2; but a company being taxed under Phase 3 will find tax-exempt income even more valuable. Also, in answer to a question from the floor, Mr. Groeschell pointed out that the incremental tax rate can easily be found by the use of D_1TB and D_2TB given above.

In introducing his discussion of taxes on purchase leaseback properties, MR. J. EDWIN MATZ referred to previous illustrations showing the effect of specific properties on the tax returns of hypothetical companies. While this technique is useful, he felt that it leaves open the question of whether the result depended on the particular example. In addition, it is not really necessary to go through the entire income tax formula to lay bare the principles which determine the tax impact on any given type of property.

It is useful in discussing the principles, however, to illustrate with an example. For this purpose Mr. Matz chose the purchase of a building for \$1,000,000 with net rental payments of \$70,000 a year for 25 years. The insurance company assumes that the investment principal should be written off completely over the 25-year period. On this basis, the rental income represents a 5% return. For tax purposes the building is assumed to have a useful life of 50 years and depreciation is a level 2% per year.

Over the full 25-year period the insurance company will receive rental payments aggregating \$1,750,000. These aggregate payments break down into \$750,000 investment income and \$1,000,000 return of principal. This breakdown does not necessarily represent the book records since book-keeping practices vary among the companies, but it does represent the breakdown on the basis on which the investment was judged to be a good 5% investment.

For tax purposes, in contrast, the aggregate payments of \$1,750,000 will break down into \$1,250,000 investment income and \$500,000 return of principal.

This makes it immediately clear why the tax on the investment is higher than the tax on a corresponding mortgage or on an equivalent bond investment with identical sinking fund amortization provisions. It is also clear that the situation is not entirely a new one, since even under former tax laws the tax on a \$1,250,000 taxable income would have been proportionately higher than the tax on the "investment basis" \$750,000 of income. Logically, then, the question arises as to what new elements are introduced by the new tax law. Mr. Matz enumerated several.

In the first place the basic tax rates are higher. In place of the 7.8% rate the company will be paying a tax at corporate rates on a company share which typically may be assumed to be about 25%. The resulting rate would, of course, be 13%.

Secondly, the tax effective for "incremental income" will be higher than a company average tax rate. Since there is no corresponding increase in reserves accompanying incremental income, this in a sense is income added on the top. It does not carry a tax of 52%, since the increase in the average earned rate does have an effect on the reserve exemptions. The actual effect is dependent upon many factors regarding a company's business but, in the case of companies paying an average Phase 1 tax of about 13% of investment income, a reasonably typical rate applicable to incremental income, after the full effect has been felt on the five-year average rate, might be about 26%. This is equivalent to saying that, while a company's share of over-all income is 25%, the company's share of incremental income becomes 50%. It also follows then that, if the company has a positive Phase 2 tax, the other 50% of the incremental income will act to increase that tax base, with a resulting additional tax of 13%.

Mr. Matz carried these results back to his example to get a gauge of the practical effects. The company originally planned to realize investment income of \$750,000 and would like to be paying a tax on that amount at a typical rate of, say, 13%. Instead it will find itself paying a tax of 13% of the \$750,000, plus a tax of 26% of the \$500,000 that shows up as incremental income on the tax return, plus, if it has a Phase 2 tax, another 13% of the additional \$500,000. If all the taxes are related to the assumed income of \$750,000, the total tax rate will be 30 $\frac{1}{3}$ % if there is no Phase 2 tax, and 41% if there is a Phase 2 tax.

These figures, he pointed out, represent aggregates over the full 25-year period. The unfortunate effect is somewhat exaggerated. Amortization of the \$1,000,000 investment to yield a level 5% return is a sharply increasing function, whereas the depreciation assumed here is level. Thus, over the 25-year period the bulk of the incremental income and, therefore, the additional tax burden will show up in the later years of the investment. The additional tax burden in the early years will be quite small, but in the last years will be substantially in excess of the average figures quoted.

There is an offsetting effect in the capital gains features of the new tax law. If the investing company should dispose of the property at the end of the 25-year term, its capital gain will be smaller (or loss will be greater) by \$500,000 than it would have been if depreciation were allowed on the normal amortization schedule. The effect on the capital gain then is exact-

ly equal to the amount of incremental income taxed over the 25-year period. Since the tax on capital gains is 25% and the tax on the incremental income is typically around 26%, the two substantially offset each other except for the incidence of payment of the excess tax and recovery of it.

Just how much this recovery possibility is worth, Mr. Matz felt is a matter of individual judgment. In some circumstances it might be valued rather highly. There is substantial opinion, however, that loss situations will outnumber gain situations and that even if they don't, capital loss is not much good as tax relief, since it requires the taking of a capital gain to be effective.

In view of the significant tax impact of the law on purchase leaseback properties, Mr. Matz raised the question of whether such investments have, therefore, become undesirable. There is certainly no universal answer, he felt, since the circumstances of each lease vary so widely. The particular illustration he used was chosen to show somewhat dramatically how high the tax effect could be. He thought that there are three circumstances which, individually or in combination, could still make individual leaseback properties attractive investments.

1. The yield on the leaseback could be high enough to compensate for the additional tax incurred. This is difficult to visualize under present yield conditions, but it may be applicable from time to time.
2. If the basic lease term and the useful life for tax purposes are not greatly different, the tax discrimination would be greatly lessened and could even disappear. In the extreme case where the lease term and useful life were identical, it is apparent that tax depreciation would exceed amortization in the early years, with the exact reverse situation applying in the later years. The net result would thus be a beneficial tax deferral.

The use of accelerated depreciation schedules could be very helpful. In the example used, the large additional tax arose because in the 25-year lease period only 50% of the building was written off for tax purposes. By use of the double declining balance method or sum-of-the-digits method, two-thirds to three-fourths of the property could have been written off for tax purposes, thus cutting the taxed incremental income from \$500,000 to as little as \$250,000. If the useful life were not much in excess of the basic lease period the tax deferral realized in the early years might be adequate compensation for the somewhat higher total tax paid over the total lease period.

3. Individual leaseback properties may still be attractive if reconsideration is given to the question of residual values at the end of the basic lease period. Many leaseback arrangements have a surprisingly different point of view between seller and buyer. The seller frequently views the initial lease period as a period during which he accepts a lower return on his operations while acquiring, tax-free through his rental payments, the right to use a valuable property at greatly reduced rentals during renewal option periods. The

buyers, however, conservatively assume the properties would be worthless at the end of the initial lease.

It is evident that both parties are not correct in such cases. If there is a genuine probable residual value in a property at the end of the initial lease period (the value would be determined, of course, with due regard for the renewal option provisions), then the investing company will have an investment which genuinely yields a higher rate of return than the one computed allowing for complete amortization of principal over the initial lease period. Payment of additional tax on the additional yield to that extent, at least, will be completely justified. This situation seems likely to obtain in some cases where the investment is predominantly in land in locations where land values can be reasonably expected to hold up not only over initial lease periods but through the full duration of all renewal options as well.

In view of the wide variations in the factors he had mentioned, Mr. Matz felt that the only way for a company to determine the value of its leasebacks was to take them, property by property, and compute a yield after tax on each one. He felt no general rule was possible.

In concluding, Mr. Matz mentioned one other effect produced by purchased leaseback transactions which is significant under present yield conditions. Since the properties are real estate, their fair market values must be entered in the asset base for computing investment yield. While the basis for determining fair market values is debatable, he felt it is reasonable to conclude that, currently, leasebacks in company portfolios have fair market values considerably less than their amortized values. The result is a reduction in the asset base. Any such reduction, by increasing the company's earned rate, exerts leverage on the tax. Here, also, the results can be expected to vary widely by company, but he believed the tax reduction would lie in the range of $\frac{3}{4}\%$ to 1% of the reduction in assets for companies with a Phase 1 tax only. If there were a Phase 2 tax the reduction would be halved.

Mr. Matz felt that, currently, many companies would find the asset reduction sufficient to largely offset the extra tax incurred on incremental income. He pointed out that this is probably a temporary situation, however, with the tax impact on leaseback properties likely to rise substantially as the contracts grow older.

MR. GUEST stated that he was glad Mr. Matz mentioned the collateral impact on the tax of using the fair market value for the asset value. In that connection, there is an equally significant impact in the direction of increased annual tax in connection with equities held at a market value substantially higher than the book value.

MR. HENRY F. ROOD said that it is most important that federal income taxes be equitably charged to the various lines of business. If a life

insurance company is to properly compute nonparticipating premiums and policyholder dividends on participating policies, it must accurately allocate the taxes, first by line of business and then to the actual plans of insurance.

Although every actuary realizes the importance of this problem, most of them have not had an opportunity to think it through thoroughly at this time. Many companies completed their final 1958 tax returns just a week or two ago and their primary concern has been the computation of the total tax without worrying too much about its allocation as yet. Some of them made tentative allocations for the 1959 annual statement with the thought that it will probably be possible to adjust these allocations in the 1960 statement if they have proved to be unreasonable.

Before looking at the insurance industry's problem, it may be worth while to consider the methods of allocation in general practice among other types of corporations which have various branches of business and which attempt to determine the profits from those various lines.

It was his understanding that most corporations do not attempt to allocate income taxes by line or product. They compute earnings from all sources and taxes are then a charge against net earnings or against surplus.

There are exceptions to the practice, of course. General Motors certainly allocates taxes by division, and some corporations make a finer breakdown. Generally speaking, though, there is no need for an allocation. Earnings before taxes are an adequate management control, and all of the earnings and surplus belong to the stockholders. There are no customer interests, such as with policyholders, to be considered.

The various reasons for allocating federal income taxes may be summarized as follows:

- a) *Annual Statement.* It is necessary to allocate taxes into the various categories required in the Gain and Loss Exhibit of the convention blank.
- b) *Fund accounting.* Many companies maintain funds either for the classes of business required by the convention blank or in even smaller groups. For example, some companies will wish to distinguish direct business from reinsurance business and participating policies from nonparticipating contracts, or they may desire to maintain separate funds for various classes of participating business, in order to equitably distribute earnings, or for other reasons.
- c) *Dividends to policyholders.* If dividends to policyholders are to be properly determined, the impact of the Federal tax, first by line of business and then by plan of insurance, becomes important.
- d) *Premium rates.* The same type of study must be made to determine premium rates as is necessary for the distribution of dividends to policyholders.

- e) *Asset shares*. The incidence of taxes as they relate to a plan of insurance must be known if asset shares are to be calculated.
- f) *Net earned interest on funds*. The interest rate allowed on dividends left on deposit, supplementary contracts and other similar funds will be affected by the decision as to whether the tax is all assumed to be a charge against investment income or whether part of it is an insurance expense.

Before deciding what method to use in allocating the tax, it is necessary to think through the basis of the tax. There seem to be three different concepts:

- 1) It is a tax on net investment income. For many years it has been stated that the only true income of a mutual company is investment income and that this should be the only basis for taxation. Mutual companies that pay only a Phase 1 tax could seem to make a good case for this concept.
- 2) It is a tax on net operating gains with a floor computed on the basis of net investment income. The purpose of the federal income tax is to tax all the net income of a person or corporation. Phase 1 may be said to be only a device to solve the perplexing problem of what sort of a limitation should be placed on policyholder dividends in order to levy an equitable tax on companies that issue participating business. For a stock company this seems to be a more reasonable approach than the first concept.
- 3) It is a tax of 26% on net investment income and 26% on net gain from operations, with the first item adjusted if the net gain from operations is less than net investment income. This is a compromise solution but seems to have some merit.

The use which is to be made of the final figures may be an important consideration in the determination of basis. If a mutual company that issues only ordinary life insurance is concerned solely with the allocation of taxes for life, disability and accidental death benefits, it doesn't make much difference which basis is selected. On the other hand, a stock company that issues different lines of business had better carefully think through its problem. If it allocates all the tax by net investment income, it will have a heavy charge against interest earnings. This will produce a small tax on term policies, group insurance, and accident and sickness policies and result in lower premiums or net costs for those plans, but it will decrease the net rate of interest to be used for premium rates or dividends on higher premium plans and for funds left on deposit. This may place the company in a good competitive position for term insurance but make it more difficult to satisfy the agents and policyholders with respect to other plans.

One of the major problems to be settled before taxes can be allocated is the distribution of surplus funds. If a stock company issues only non-

participating policies, it may not be necessary to allocate the surplus. It belongs to the stockholders but is held for the benefit of all policyholders to be used whenever it is needed. Consequently, earnings from all sources might be credited to surplus and the total taxes might then be charged against those funds.

A mutual company that issues only participating policies might take the same position, but usually it does not. Mutual companies try to distribute earnings as equitably as possible, and many of them maintain funds with the surpluses which have been contributed by the various classes of policyholders. It is true, of course, that these surpluses are available for the protection of all policyholders and that deficits must be made up from the earnings of other classes. However, mutual companies have a better opportunity to control surplus by class of business through dividend action, and, presumably, the surpluses developed by line bear a closer relationship to the surplus needed by each line than in a company issuing nonparticipating contracts.

The greatest difficulty arises in a stock company that issues participating policies. Some of the earnings from the participating line may be transferred to the company's general surplus account. In fact, this is virtually mandatory if the company desires to make any of these earnings available to protect nonparticipating policyholders or for payment to the shareholders. Charter limitations, statutes, and departmental rulings in both the United States and Canada force many companies to transfer earnings annually or forever hold them in the participating fund.

General surplus funds, whether contributed by the shareholders, earned on nonparticipating policies or earned on participating contracts are held for the benefit of all classes of policyholders and belong to the stockholders only when all policyholders' claims have been settled.

This suggests the possibility of charging the various lines with the tax incurred on interest earned on general surplus. To take an extreme example, a stock company which issues both participating and nonparticipating policies pays out 90% of its participating earnings to policyholders each year and transfers 10% to general surplus. All earnings on nonparticipating business go to general surplus. Should not both the participating and nonparticipating lines pay some of the tax levied on interest earned on this surplus? Perhaps for this purpose surplus can be allocated to the various lines on the basis of probable need. This could be in proportion to reserves on the assumption that surplus is held for capital losses or part might be on the basis of tabular mortality to cover catastrophic losses from epidemics or war. Perhaps a combination of reserves and premiums would be suitable for a practical allocation.

Another complication arises when a company transfers surplus to policy reserves in a reserve strengthening program. This tends to reduce taxes and may even produce negative taxes in the line which has been strengthened. What class should benefit, especially if the surplus has been borrowed from another line or from general surplus?

Mr. Rood stated that in some of his discussion he assumed that companies maintain funds by line of business. Actually, he explained, many companies do not need and do not maintain such funds. Consequently, some of these companies will be limited in their choice of allocation methods.

One other problem which arises is the possible segregation of assets or allocation of interest earned on assets. It is now common practice to allocate all policy loan interest to the line in which the policy involved belongs. Some funds won't obtain the same benefits under the new tax law as others for certain types of investments. For example, pension funds and lines with small surpluses will not benefit from tax-exempt securities although the company as a whole may have more "take-home pay" from tax-exempts than from regular corporate bonds. Some of these companies are seeking a means of crediting all the interest on such securities to the lines of business which will benefit the most.

MR. WILLIAM E. LEWIS first proposed to examine the operations data on which the federal income tax allocation might be based. He assumed the most comprehensive situation in which the company conducts all of the various lines of business that appear on page 5 of the convention blank and, in addition, writes both participating and nonparticipating policies, accepts reinsurance and has both commercial and noncancelable accident and sickness policies. Fund accounts are maintained for each major line of business. If secondary lines, such as disability or double indemnity, are not segregated, the allocation of their tax for page 5 may be viewed as a separate problem. This suggests that closely related lines can be grouped together for the basic tax computation. Later, a split of the subgroups can be made by methods which do not require as much accuracy. Group life and accident and sickness insurance, for example, may be carried through as a single line and any tax that develops later split on some appropriate basis.

He also assumed that the surplus actually developed for each line is carried in that line, although there may be a separate account for capital and contributed surplus. Investment income has been apportioned to lines on the basis of the mean funds or by a similar method. Each dollar of investment income is derived proportionately from the Company's various assets; consequently the same average net rate of interest earned is applicable to each line.

The tax base for either the company as a whole or for each line of business considered individually will be one of the following:

- 1) Phase 1 only less a deduction up to \$250,000. This situation applies when the limitation on group, nonparticipating and dividend deductions is effective.
- 2) Phases 1 and 2.
- 3) Gain from operations, being less than Phase 1 with the limitation inoperative.
- 4) Loss from operations with the limitation inoperative.

It can be noted that for many, if not most, companies the sum of the taxes for the individual lines will not produce the company's total tax. For example, the deductions which are disallowed one line, because of the \$250,000 limitation, may be used to offset the Phase 2 income of another line. Similarly, the loss from operations of a line cannot produce a tax savings if the total company tax is based on Phase 1 only.

He then considered the company that is paying a Phase 1 tax only. A simplified approach has been adopted by a number of companies in this situation. The entire tax has been apportioned in the ratio of one of the following sets of data:

- 1) Mean funds
- 2) Mean of reserves
- 3) Mean of interest bearing liabilities
- 4) Investment income.

The simplicity of these methods is most attractive; however, the basic structure of the law is, in part, disregarded. For example, accident and sickness insurance would be charged a modest Phase 1 tax where, in reality, there may be substantial underwriting gains or even losses. It may be argued, however, that despite the complexity of the taxing formula, the tax for these companies is, in essence, a tax at a uniform rate on each dollar of investment income or other function. There is expected to be quite a difference of opinion on this point.

Certain assumptions are inherent if one of these methods is adopted. The use of mean funds assumes that the policy reserve requirements are distributed proportionately. Allocation based on reserves makes a similar assumption and assumes a distribution of surplus in proportion to reserves. The tax on interest earned on surplus is deemed to be at the same average rate as interest earned on reserves. The special provision relating to qualified pension plans would be disregarded, as would Phase 2. Many companies may consider one of these methods appropriate and sufficiently accurate for their particular operation. Other companies may wish to go one step further and compute Phase 1 for each line under the "separate company" approach.

This can be done on the basis of investment income actually allocated together with a computation of the policy reserve requirements for each line of business. This calculation employs the company's average earned rate and the assumed valuation rate for the individual line. Pension reserves are recognized along with interest paid. The deduction for tax-exempt interest and intercorporate dividends might be apportioned to lines on the basis of excess interest above policy reserve requirements. The \$25,000 small business deduction could be allocated in a similar manner or else related to some other appropriate function. The special deductions up to \$250,000, for dividends, nonparticipating and group business, may be divided in a number of ways including excess interest or the total of the deductions without limitation. The total tax would then be distributed in proportion to the excess interest less the deductions apportioned to the various lines of business.

A further step would be to give recognition by line of business to Phase 2, to gains from operation which are less than Phase 1, and to losses—that is, the elements that are disregarded in an allocation by Phase 1 only. One approach is as follows. Consider first the lines of business that produce a Phase 2 tax and those lines whose tax is reduced below the Phase 1 tax because of actual losses (but not because of the special deductions). It might then be considered appropriate to charge the Phase 2 taxes, in addition to Phase 1, and to reduce the Phase 1 tax where actual losses exist. The net amount of tax charged in this manner would have to be credited to other lines of business because the total amount under Phase 2 is zero for these companies. There seems to be no clear cut claim by any particular line to this tax credit. One possibility is to credit the lines which have a portion of their special deductions for group, nonparticipating and dividends disallowed, based on the theory that it is the excess deductions of one line which permit the Phase 2 tax of another line to be eliminated. Also, it is the limitation in a sense which prevents losses from producing tax credits. Other possible solutions may suggest themselves to companies desiring to make an allocation of the theoretical tax on underwriting in Phase 2.

An interesting result can occur if there are losses, and the tax for a particular line is negative, but the company's tax is based on Phase 1 in total. Is it feasible to give a tax credit or should the tax be considered zero? If negative taxes are not credited, it may be appropriate to carry losses forward internally to be offset against future gains. Should the carry-over be permanent, or should it be restricted to five years as under the law?

For a Phase 1 only company, this general approach emphasizes the

Phase 1 tax and treats Phase 2, if at all, as a modification of the basic tax. If, instead, the basic tax is Phase 1 and Phase 2, some companies might prefer to start from a different point. This point might be the tax computed under the separate company approach for each line of business. Under this approach, any combination of basic taxes is possible, that is, one line may produce a Phase 1 tax only, another line Phases 1 and 2, etc. Alternatively, they might start from a tax based on 26% of the taxable investment income under Phase 1 plus or minus 26% of the gain or loss from operations.

Under the separate company approach, the individual taxes would not equal the company's total tax. In part this would be due to the limitations on the special deductions, when applied to individual lines, which limitations do not apply in total. Also, full recovery of tax cannot be realized on loss lines since, for stock companies, one-half of the tax on both gains and losses is deferred to Phase 3, while for mutual companies there is no Phase 3.

One question to decide is how to treat negative taxes. One view holds that the line itself should be credited. Another view contends that it is the company as an entity, and in particular the company's total surplus, that permits a line to operate in the red. The company, it is argued, and not the line should benefit from any tax savings. It would be necessary, of course, to apportion the tax credit to some line or lines of business. At this point a special account for surplus suggests itself, since it is not clear that any one line is entitled to the tax credit which is contributed by another line.

If a basic tax of 26% of Phase 1 income plus or minus 26% of the net gain from operations is assumed, the sum of the taxes would approximately equal the whole. This might be a satisfactory allocation without modification. There may be an advantage, however, to treating surplus as a separate fund rather than including it in the individual lines. Such a corporate account would be credited with interest income. Negative taxes from other lines would be credited to the corporate account. The account would be charged with the Phase 1 tax on interest earned on surplus which is without policy reserve requirements.

All of the preceding discussion accepts the company's gain from operations by funds as a suitable starting point. Further reflection on present allocation methods may suggest that certain adjustments are desirable before taxes are computed. The first adjustment was hinted at in the suggestion that surplus may be treated as a separate line. Since the law places a relatively heavy tax on interest earned on surplus, the thought is that this tax should be borne by all lines in some manner. If the actual ac-

cumulated surpluses only are used, a line with a low surplus would bear little tax. The need for surplus by this line might be great, however, depending on the size of assets subject to capital losses and the mortality element subject to fluctuation. The company's surplus is for the protection of all policyholders, but it is not known when or how this surplus will be needed or used. Under this method, the tax for each line would be determined exclusive of any tax on interest earned on surplus accumulated by the line. The tax for the total corporate account would likewise be determined. Allocation of this latter tax might be based on an index which measures the protective value of surplus to each line of business. This index might be the funds, premiums, insurance in force or some combination of these factors.

The second point concerns the allocation of the tax-exempt interest credit. Our previous assumption has been that investment income for each line is derived proportionately from taxable investments, tax-exempt bonds, etc., and that the company's average earned rate of interest applies to each line. The company as a whole may find it advantageous to invest in tax-exempt bonds. Nevertheless, this investment policy could work to the disadvantage of certain individual lines of business. For example, pension business would gain very little benefit from the tax-exempt interest deduction because of the relatively low company's share ratio on this class of business. This line would, however, suffer competitively from a lower net interest return as compared to a company that did not invest heavily in tax-exempt securities because of their over-all situation. A company that has a line of business with a low surplus would also find that this line has a lower net return after tax than it would if the company did not invest in tax-exempt income. A solution to this problem is not readily apparent, but Mr. Lewis opened up the thought principally for discussion and ideas.

He mentioned a few miscellaneous problems for completeness. First is the treatment of foreign tax credit. One solution is to allocate the U.S. tax before the credit is taken. The credit would be allocated in exactly the same way as the tax paid to the foreign country, thus effecting a cancellation of the tax.

Net long-term capital gains tax may be apportioned on the same basis as investment income.

Potential Phase 3 tax will be a factor for consideration by some companies. This is the amount which together with prior Phase 1 and Phase 2 taxes results in a tax on the entire net gain from operations (computed without regard to the nonparticipating and group deductions). Each year, the gain or loss from operations can be computed for each line of

business. The taxable income actually allocated to each line is known. The difference would be the deferred taxable income, or credit if negative, that is represented by the amount in the policyholders' surplus account. The total in the account should equal the sum of the amounts computed in this manner for each line of business.

If a tax is actually incurred under Phase 3, either by distributions to stockholders or by operation of the limitations on the account, the tax could be allocated by line of business in proportion to the amounts in the account both positive and negative. Alternatively, allocation might be based on the positive amounts only. Other possibilities are the positive nonparticipating lines of business, if the tax is due to stockholder distributions, or the lines causing the imposition of Phase 3 tax when the limitations on the account are exceeded.

Once having determined the distribution of tax according to lines of business, a somewhat different allocation may be needed for page 5. The Ordinary line, for instance, must be subdivided by life, disability, double indemnity, annuities and supplementary contracts. A subdivision of the Ordinary Phase 1 tax on the basis of either reserves or investment income may be considered sufficiently accurate by some companies. Other companies, however, may prefer to compute policy reserve requirements fairly closely for these secondary lines. Phase 2 can be apportioned on the basis of operations gains which are in excess of Phase 1 taxable investment income.

In past years, some companies have allocated their federal income tax to investment expense on page 5, while others have considered it an insurance expense. Although the tax was computed on the basis of investment income, many actuaries felt that it was a tax on total gains from operation from all sources, and they treated the tax as an insurance expense. It has been convenient, however, in computing gross premiums and policyholders' dividends to treat the item as investment expense and to use the net rate of interest earned after tax.

There is apt to be less rather than more accord on this point under the new tax law. Many companies that are paying a Phase 1 tax only may wish to continue their previous philosophy, whether it be insurance or investment expense. Some companies in this group, however, especially if they give recognition to Phase 2, may change from investment to insurance expense, at least with respect to the Phase 2 portion.

Companies which also pay a Phase 2 tax, or whose tax is based on the gain or loss from operations, will likely favor insurance expense. The law is clearly designed to be a tax on total net income, and it is only inci-

dentally related to investments. A natural separation may exist between Phases 1 and 2 if a company desires to charge part to investment and part to insurance.

Some persons feel that the federal income tax should no longer be allocated on page 5 by line. The suggestion has been made that the tax instead be charged in the surplus account on page 4. This would place us in a similar position to most other industries. One very practical result is that the need to allocate the tax in the limited time available at the year end would be avoided. The internal allocations could be done at a more convenient time. This is a matter which may eventually concern the blanks committees of our industry organizations, although considerable study will be required before a recommendation can be made.

Without question, Mr. Lewis said, there will be no unanimity of opinion on some of these allocation problems. Perhaps his comments would help stimulate companies to study both their tax and surplus allocation procedures and to give other members of the Society the benefit of their thinking.

In response to the question from the floor, "Does the new law make pension fields more attractive to a company?" MR. GUEST answered, "Yes." To the inquiry, "Has the question of tax-exempts been resolved by the courts; what prospect is there of an early ruling?" Mr. Guest answered, "No" to the first part, and "We don't know" to the second part. To the question, "What is the estimated tax revenue to the Treasury of the 1959 Act?" Mr. Guest answered, "Somewhere around \$560 million."

In response to the question, "In the two percent group deduction, what is the chance of calling franchise insurance group insurance if the state law provides?" MR. ROOD said that, if franchise insurance is issued as group insurance under the definition of the federal tax law, he would think that the two percent deduction was in order. If it is issued through individual policies, even though there may be some statutory provision for setting up a special contingency reserve, he didn't believe it would qualify as group insurance under the federal law and therefore he doubted that a company would be entitled to the two percent deduction.

Answering the question, "In the allocation of taxes by major line of business, why not determine what the tax would be if each line of business were the only line of business and then allocate the total tax in proportion?" Mr. Rood said he had tried to cover that in his presentation under the "Company by Company approach."

An inquiry was made whether companies with incremental tax rates under 25% were considering taking short-term rather than long-term gains. MR. MATZ could state only the attitude of his own Company

which is, under current conditions, to offset all capital gains with capital losses.

In answer to a question about using average cost for determining capital gains, Mr. Matz said he felt this was really a problem for a tax attorney. He said that after examination of the situation in his own Company, the conclusion was reached that each purchase and sale had to be related to a specific piece of paper, except for the instances of multiple purchases or sales in a brief period such as one day.

In response to the question, "If a company pays and reserves on the basis of immediate payment of claims, is there an approximate method which can be used to arrive at the reserve which would be economical in use?" MR. DELANEY stated that there were methods in use which enabled companies to approximate the reserve for immediate payment of claims, but any such method would need to be approved by the insurance department of the state of domicile. Whether setting up such additional reserves would be worth while would depend upon individual company considerations, but it would seem that nearly every company with a Phase 2 problem would benefit by establishing such additional reserve. Since this could hardly be a change in company practice, establishing these additional reserves would be reserve strengthening and would be deductible over the ten-year period following such strengthening.

MR. J. STANLEY HILL opined that one reason for the confusion about incremental tax rates may be the large number of possible incremental rates which may exist among various companies. Although such rates may vary gradually as a consequence of having a little more or a little less income or a little more or a little less reserves, they may vary sharply between companies from other causes. Among these causes are included six different phase situations in which a company might find itself, two five-year average situations, and two different interpretations of the exception clauses. Taken in combination these produced twenty-four distinctly different concepts of an incremental tax rate. If a company is looking for ways to attract new money to invest, the incremental rate on the income from this new money will be higher than the rate on additional income derived from existing assets, thus producing twenty-four more distinct incremental rates, or a total of forty-eight.

The chairman thanked the panel members for their presentations and the audience for its attention.