

TAXATION OF
LIFE INSURANCE COMPANIES

SUGGESTIONS AND COMMENTS ON
MAJOR TOPICS

FOR THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION



APRIL 9, 1959

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1959

TAXATION OF LIFE INSURANCE COMPANIES

JOINT COMMITTEE STAFF SUGGESTIONS AND COMMENTS ON THE MAJOR TOPICS

1. Allowance of policyholder dividends as deductions where there is an underwriting loss

Various suggestions have been made as to the allowance of policyholder dividends as deductions where there is an underwriting loss as the result of the dividends. To the extent they are allowed as deductions in such cases they would reduce taxable investment income under phase 1. A suggestion frequently made is that these policyholder dividends be allowed as deductions to the extent of 50 percent where they either enlarge or create an underwriting loss. Objections have been raised to this, however, on the grounds that this would permit mutual insurance companies to pay tax on less than their full free investment income under phase 1, by paying part of this income out in the form of policyholder dividends. On the other hand, it is generally recognized that a small mutual company which is attempting to expand along with its stock competitors is likely to generate underwriting losses in the early period of this expansion. In such cases it is difficult to see why, if they are paying no more than normal policyholder dividends, they should be disallowed the deduction of these underwriting losses against their otherwise taxable investment income, when their stock competitors deduct such losses. To meet this more limited problem it is suggested that policyholder dividends be allowed as deductions where they either create or enlarge an underwriting loss up to the extent of something like \$250,000. This would meet the immediate, pressing problem of the small mutual while leaving in abeyance for future consideration the more basic problem of the deduction of policyholder dividends.

It is estimated that the allowance of policyholder dividends as deductions up to a limit of \$250,000 would reduce the revenue under the bill by about \$6 million. Allowance of these policyholder dividends as deductions up to a limit of \$500,000 would result in a revenue loss of approximately \$9 million, and allowance of policyholder dividends to the extent of 50 percent would result in a revenue reduction of about \$22 million.

2. Tax exempt interest

Under the bill, in both phases 1 and 2, tax exempt State and municipal bond interest and partially tax exempt Federal bond interest is either deducted or excluded from the two tax bases involved. However, in both cases the bill provides for the reduction of deductions otherwise allowable because of the presence of this tax exempt or partially tax exempt interest. Thus, under phase 1, for example, the policy and other contract liability deduction otherwise allowable is reduced in accordance with the proportion of the total net investment income (more correctly, investment yield)

represented by the tax exempt or partially tax exempt interest. A similar adjustment is made in phase 2. This treatment, which because of tax exempt interest reduces deductions otherwise allowable, raises a constitutional question and would undoubtedly result in litigation.

It is estimated that to remove the cutback in the deductions under phases 1 and 2 to the extent attributable to tax exempt interest of State and municipal bonds and partially tax exempt interest on Federal bonds will result in a revenue loss of approximately \$35 million.

3. The 10-percent and 2-percent deductions under phase 2

Under the bill a deduction equal to 10 percent of the additions to reserves attributable to nonparticipating policies is allowed under phase 2. Also allowed as a deduction under this phase is a deduction equal to 2 percent of the current year's premiums (subject to certain limitations) with respect to group insurance. Under the bill these two deductions may not increase an underwriting loss which is available to offset taxable investment income under phase 2. The staff suggests that if policyholder dividends are to be allowed to the extent of \$250,000 in the case of an underwriting loss that these 10-percent and 2-percent deductions also be included in this limited deduction. In addition, it believes that consideration might well be given to allowing the 2-percent deduction in the case of group insurance without limitation where there is an underwriting loss, since this deduction does not present a problem between stock and mutual companies and is wholly unrelated to the policyholder dividend deduction which is so limited.

The staff also suggests that these two deductions, the 10-percent and the 2-percent deductions, be treated for purposes of phase 3 in the same manner as the 50 percent of the underwriting gain not subject to tax under phase 2. This gain can only be paid out to stockholders after payment of tax. Since these two deductions are designed as special cushions to meet problems arising with respect to nonparticipating policies or with respect to group insurance it is suggested that if the amounts are paid out to stockholders and not held as a cushion there is no reason for not subjecting such amounts also to tax at that time.

The revenue effect of the suggestions made here is relatively minor and probably would result in a revenue loss of no more than \$2 million if the 10-percent deduction were allowed as a part of the \$250,000 limitation and the 2-percent deduction were allowed in such cases in full.

4. Small business deduction

Under the bill a deduction is allowed under phase 1 equal to 5 percent of the net investment income but not more than \$25,000. This is designed as an aid to small insurance companies because the interaction of the percentage and ceiling results in the maximum benefit to a company with a net investment income of \$500,000. Numerous suggestions have been made that this benefit be increased for the small companies. To accomplish this the staff suggests that the 5 percent be increased to 10 percent but that the \$25,000 ceiling be retained. As a result the maximum \$25,000 benefit under this suggestion would be available to a company with a net investment income of \$250,000.

It is expected that this suggestion would reduce revenues by approximately \$1 million.

5. Alternative to 10-percent deduction for nonparticipating insurance

The 10-percent deduction for nonparticipating insurance is based upon additions to reserves. This assumes that the additional cushion needed with respect to nonparticipating policies is related directly to the size of the reserve. This relationship does, of course, exist with respect to the investment risk but not with respect to the mortality risk. To provide an alternative for nonparticipating insurance where the investment risk is minor, and the major risk is that involving mortality, it is believed that the committee might want to consider a deduction of 3 percent of the taxable years premium income attributable to policies of nonparticipating insurance for contracts for periods of 5 years or more. This proposal is an alternative to the 10-percent deduction based on additions to reserves, and the taxpayer would have to choose between the two. For most taxpayers the 10 percent would be the more generous since the 3 percent of net premiums in most cases would be less generous. Nevertheless it is believed that it would be beneficial to companies where reserves are a minor factor.

It is believed that a 3-percent deduction of the type described above would result in a revenue loss of \$1 to \$2 million, a 4-percent deduction of this type would result in a revenue loss of approximately \$3 million and a 5-percent deduction would involve a revenue loss of about \$6 million.

6. Loss carryforwards from before 1958

Under the bill no net operations loss from any year prior to 1958 may be carried forward to reduce income under phase 2 in 1958 and in subsequent years. It has been pointed out in the hearings that in some of the more recent years companies have incurred expenses (such as agents' commissions) to expand their businesses when underwriting gains were not subject to tax, and that now they may well be faced with the prospect of paying a tax on the underwriting gains attributable to these expenses incurred in earlier years. To compensate for this it is suggested that companies might be permitted to carry losses forward from 1955, 1956, and 1957, generally for 5 years. These losses would be available in 1958 and subsequent years in the same manner as already is provided in the bill for net operations losses. Therefore companies availing themselves of this provision would have to compute their phase 1 and phase 2 incomes under the bill for these prior years, since only any excess not offset against income in any of these prior years would be available to be offset against income in 1958 and subsequent years.

It is estimated that this provision will ultimately result in a revenue loss of approximately \$15 million. Perhaps something like \$5 million of this could be expected to affect the revenue otherwise derived with respect to the calendar year 1958.

7. Eight-year loss carryforward for small companies

Under the bill there is generally a 3-year carryback of a net operations loss and a 5-year carryforward of the remaining portion. Thus, for established companies there is a span of 8 years to which a loss may be carried. In the case of new companies, however, there is generally no income year to which a loss can be carried back. For that reason,

in effect, these companies derive a benefit only from the 5-year carry-forward. Since new insurance companies generally have a difficult time in getting started (because of losses incurred in expanding the insurance business) it is believed that for them there is a special case for an 8-year carryforward. For that reason it is suggested that consideration be given to providing insurance companies in the first 5 years of their existence with a loss carryforward of 8 years, instead of the usual 5-year loss carryforward.

This provision will have no immediate effect upon revenues.

8. *Application of phase 3 in the case of the termination of an insurance company*

The bill provides that underwriting gains which were not taxable under phase 2 generally are taxable at the time of distribution to stockholders, or at the time there is a voluntary transfer of these amounts to the shareholders surplus account. In addition, however, these amounts are taxable as of the end of the prior year whenever a company no longer qualifies as an insurance company. As a result this can trigger a sizable tax where a company by accident no longer qualifies as an insurance company. This can happen, for example, where a large group insurance policy is taken away from a company. To remove the sudden triggering of tax in such a case it is suggested that a tax be imposed under phase 3 only when for 2 consecutive years a company does not qualify as a life insurance company. However, if any funds were drawn out of the company during that interval, to prevent tax avoidance it would be necessary to impose a phase 3 tax in such a case.

It is anticipated that this suggestion would have only a negligible effect on revenues.

9. *Limitations on accumulations under phase 3*

Under the bill, when the amount in the policyholders surplus account reaches 25 percent of reserves or 60 percent of premiums for the taxable year any excess over this amount is transferred to the shareholders surplus account and becomes taxable at that time. It has been suggested that basing the limitation on 25 percent of reserves gives an advantage to a well-established company which already has built up large reserves. To remove this possible discrimination against new companies the committee might want to consider basing this limitation upon 25 percent of the cumulative additions to reserves since 1958. Then this limitation would work much in the same manner as the 10-percent deduction under phase 2. Alternatively, consideration might be given to reducing the 25 percent, as provided in the bill, to some lower figure such as 15 percent.

This provision will not affect revenues with respect to 1958 although it should result in some increase in revenues in future years.