

TAXATION OF
LIFE INSURANCE COMPANIES

SUGGESTED METHODS FOR PREVENTING
DOUBLE TAXATION OF TAX-EXEMPT INCOME

PREPARED FOR THE USE OF THE
SENATE COMMITTEE ON FINANCE

BY THE STAFFS OF THE
JOINT COMMITTEE ON INTERNAL REVENUE
TAXATION AND THE TREASURY DEPARTMENT



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SUGGESTED METHOD FOR PREVENTING DOUBLE DEDUCTION OF TAX-EXEMPT INCOME

1. STATEMENT OF PLAN

For purposes of taxation under the proposed legislation, and in order to prevent discrimination, a percentage of the earnings on each and every investment of a life insurance company (based on the 5-year earnings rule in phase 1) would be considered as being set aside in trust for the benefit of policyholders, and would be exempt from tax under this law. This amount would include the specified percentage of the total earnings, if any, from tax-exempt securities, from corporate stocks, corporation bonds, taxable Government obligations, mortgages, and from other investment sources.

From the percentage of the earnings remaining after the exemption on each and every investment, there would be deducted all the remaining earnings from tax-exempt securities and 85 percent of the earnings received as dividends from other corporations. The balance remaining in the portion of the earnings of each and every investment, after the above deductions, would be subject to the regular corporate income tax rates.

In addition, a provision should be added to the effect that if it is established in any case that the application of the definition of taxable investment income contained in the preceding sentences results in the imposition of tax on any interest which under section 103 is excluded from gross income, adjustment should be made to the extent necessary to prevent such imposition.

This approach could be similarly applied to phase 2. The procedure in phase 2 would be the same except that the percentage of the earnings on each investment considered to be held in trust for the benefit of policyholders and exempted from taxation would be based on the ratio of required interest (as figures by the company on its books) to investment earnings.

2. REVENUE EFFECT

This approach would have practically no effect on the revenues under H.R. 4245 under phase 1 or under phase 2.

3. STATUS OF TAX-EXEMPT INTEREST

In the opinion of the Treasury Department and the joint committee staff, this approach would not result in levying a tax on tax-exempt interest.

4. LOOPHOLE PROBLEM

Since the suggested approach does not allow a double deduction, it would not form a loophole.

5. ILLUSTRATIONS

The operation of the suggested approach, as compared with the method under H.R. 4245 in its present form, is illustrated by the following examples. Tax computations are shown under H.R. 4245 as amended to base the policy interest deduction on the 5-year average earned rate.

Basic assumptions

Assets.....	\$1,000
Capital and surplus.....	100
Reserves.....	900

	Percent
Assumed rate.....	3
Current earned rate.....	4
5-year average earned rate on taxables.....	3.8
5-year average earned rate on tax-exempts.....	2.8
5-year average earned rate on portfolio 90 percent in taxables and 10 percent in tax-exempts.....	3.7

Case 1.—\$1,000 invested in taxables at 4 percent:

Tax computation, phase 1

	H.R. 4245 in its present form		Under proposed amendment
Investment income.....	\$40.00	Investment income.....	\$40.00
Policy and other contract liability deduction.....	¹ 31.46	Exemption for policyholder interest (78.7 percent). ²	31.46
Adjustment for tax-exempt interest.....	None		
Total.....	31.46		
Tax base.....	8.54	Tax base.....	8.54

¹ Deduction rate 3.8 percent \times adjusted reserves \$828 (\$900 less 8 percent).

² $\frac{3.8 \text{ percent} \times 828}{40} = \frac{31.46}{40} = 78.7 \text{ percent.}$

Tax computation, phase 2

	H.R. 4245 in its present form		Under proposed amendment
Investment income.....	\$40.00	Investment income.....	\$40.00
Required interest.....	¹ 27.00	Exemption for policyholder interest (67.5 percent). ²	27.00
Taxable portion included in net operating gain.....	13.00	Taxable portion included in net operating gain.....	13.00

¹ Assumed rate 3 percent \times policy reserves \$900.

² $\frac{3 \text{ percent} \times 900}{40} = \frac{27}{40} = 67.5 \text{ percent.}$

Case 2.—\$900 invested in taxables at 4 percent, \$100 invested in tax-exempts at 3 percent:

Tax computation, phase 1

	H.R. 4245 in its pres- ent form		Under proposed amendment	
			Taxable	Tax-exempt
Investment income.....	\$39.00	Investment income.....	\$36.00	\$3.00
Less tax-exempt interest.....	3.00	Exemption for policyholder in- terest (79.4 percent). ¹	28.59	2.38
Taxable investment in- come.	36.00	Remainder.....	7.41	.62
Policy and other contract liabil- ity deduction.	² 30.97	Deduction for remaining tax- exempt interest.	-----	.62
Adjustment for tax-exempt inter- est (79.4 percent×3).	2.38			
Total.....	28.59			
Tax base.....	7.41	Tax base.....	7.41	-----

¹ \$30.97÷total investment earnings, \$39.

² Deduction rate 3.7 percent×adjusted reserves, \$837 (\$900 less 7 percent).

Tax computation, phase 2

	H.R. 4245 in its pres- ent form		Under proposed amendment	
			Taxable	Tax-exempt
Investment income.....	\$39.00	Investment income.....	\$36.00	\$3.00
Less tax-exempt interest.....	3.00	Exemption for policyholder in- terest (69.2 percent). ¹	24.92	2.08
Taxable investment in- come.	36.00	Remainder.....	11.08	.92
Required interest.....	² 27.00	Deduction for remaining tax- exempt interest.	-----	.92
Adjusted for tax-exempt interest (69.2 percent×3).	2.08			
Net deduction.....	24.92			
Taxable portion included in net operating gain.	11.08	Taxable portion included in net operating gain.	11.08	-----

¹ \$27÷total investment earnings \$39.

² Assumed rate 3 percent×policy reserves \$900.

6. SUGGESTED DRAFT

Amendments to sections 804, 805, and 806

Amend subpart B (beginning on page 7, line 7) to read as follows:

“Subpart B—Investment Income

“Sec. 804. Taxable investment income.

“Sec. 805. Policy and other contract liability requirements.

“Sec. 806. Certain changes in reserves and assets.

“SEC. 804. TAXABLE INVESTMENT INCOME.

“(a) IN GENERAL.—

“(1) EXEMPTION OF POLICYHOLDERS’ SHARE OF INVESTMENT YIELD.—The policyholders’ share of each and every item of investment yield (including wholly-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders’ share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield.

“(2) TAXABLE INVESTMENT INCOME DEFINED.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the life insurance company’s share of the sum of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

“(A) the life insurance company’s share of the sum of—

“(i) the amount of interest which under section 103 is excluded from gross income,

“(ii) the deduction for partially tax-exempt interest provided by paragraph (3), and

“(iii) the deductions allowed by sections 243, 244, and 245 (relating to dividends received); and

“(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company’s share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent. If it is established in any case that the application of the definition of taxable investment income contained in the preceding sentences results in the imposition of tax on any interest which under section 103 is excluded from gross income, adjustment shall be made to the extent necessary to prevent such imposition.

“(3) PARTIALLY TAX-EXEMPT INTEREST.—The deduction referred to in paragraph (2)(A)(ii) is an amount which bears the same ratio to the amount allowable as a deduction under section 242 (relating to deduction for partially tax-exempt interest) as—

“(A) the normal tax rate for the taxable year prescribed by section 11, bears to

“(B) the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

“(4) SMALL BUSINESS DEDUCTION.—The deduction referred to in paragraph (2)(B) is an amount equal to 10 percent of the in-

vestment yield for the taxable year. The deduction under this paragraph shall not exceed \$25,000.

“(b) GROSS INVESTMENT INCOME.—For purposes of this part, the term ‘gross investment income’ means the sum of the following:

“(1) INTEREST, ETC.—The gross amount of income from—

“(A) interest, dividends, rents, and royalties,

“(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

“(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

“(2) SHORT-TERM CAPITAL GAIN.—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

“(3) TRADE OR BUSINESS INCOME.—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

“(c) INVESTMENT YIELD DEFINED.—For purposes of this part, the term ‘investment yield’ means the gross investment income less the following deductions—

“(1) INVESTMENT EXPENSES.—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

“(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(3)) held at the beginning and end of the taxable year,

“(B) the amount of the mortgage service fees for the taxable year, plus

“(C) whichever of the following is the greater:

“(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds $3\frac{3}{4}$ percent of the mean of the assets (as defined in section 805(b)(3)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

“(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

“(2) REAL ESTATE EXPENSES.—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent

improvements or betterments made to increase the value of any property.

“(3) **DEPRECIATION.**—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

“(4) **DEPLETION.**—The deduction allowed by section 611 (relating to depletion).

“(5) **TRADE OR BUSINESS DEDUCTIONS.**—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

“(A) There shall be excluded losses—

“(i) from (or considered as from) sales or exchanges of capital assets,

“(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

“(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

“(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

“(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

“SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

“(a) **IN GENERAL.**—For purposes of this part, the term ‘policy and other contract liability requirements’ means, for any taxable year, the sum of—

“(1) the adjusted life insurance reserves, multiplied by the average earnings rate,

“(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

“(3) the interest paid.

“(b) **EARNINGS RATES.**—

“(1) **CURRENT EARNINGS RATE.**—For purposes of this part, the current earnings rate for the taxable year is the amount determined by dividing—

“(A) the taxpayer’s investment yield for such taxable year, by

“(B) the mean of the taxpayer’s assets at the beginning and end of the taxable year.

“(2) AVERAGE EARNINGS RATE.—

“(A) IN GENERAL.—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

“(B) SPECIAL RULES.—For purposes of subparagraph (A)—

“(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) applied to such taxable year, and

“(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

“(3) ASSETS.—For purposes of this part, the term ‘assets’ means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

“(A) real property and stock shall be the fair market value thereof, and

“(B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition.

“(c) ADJUSTED LIFE INSURANCE RESERVES.—

“(1) ADJUSTED LIFE INSURANCE RESERVES DEFINED.—For purposes of this part, the term ‘adjusted life insurance reserves’ means—

“(A) the mean of the life insurance reserves (as defined in section 801 (b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

“(B) that percentage which equals 100 percent—

“(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

“(ii) reduced by that percentage which is 10 times the average earnings rate.

“(2) AVERAGE INTEREST RATE ASSUMED.—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

“(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

“(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

“(d) PENSION PLAN RESERVES.—

“(1) PENSION PLAN RESERVES DEFINED.—For purposes of this part, the term ‘pension plan reserves’ means that portion of the life insurance reserves which is allocable to contracts—

“(A) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be (i) trusts described in section 401(a) and exempt from tax under section 501(a), or (ii) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

“(B) purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans meeting the requirements of section 401 (a) (3), (4), (5), and (6), or the requirements of section 165 (a) (3), (4), (5), and (6) of the Internal Revenue Code of 1939; or

“(C) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of section 401 (a) (3), (4), (5), and (6).

“(2) SPECIAL TRANSITIONAL RULE.—For purposes of this part, the amount taken into account as pension plan reserves shall be—

“(A) in the case of a taxable year beginning after December 31, 1957, and before January 1, 1959, zero;

“(B) in the case of a taxable year beginning after December 31, 1958, and before January 1, 1960, 33½ percent of the amount thereof (determined without regard to this paragraph);

“(C) in the case of a taxable year beginning after December 31, 1959, and before January 1, 1961, 66½ percent of the amount thereof (determined without regard to this paragraph); and

“(D) in the case of a taxable year beginning after December 31, 1960, 100 percent of the amount thereof (determined without regard to this paragraph).

“(e) INTEREST PAID.—For purposes of this part, the interest paid for any taxable year is the sum of—

“(1) INTEREST ON INDEBTEDNESS.—All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

“(2) AMOUNTS IN THE NATURE OF INTEREST.—All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.

“(3) DISCOUNT ON PREPAID PREMIUMS.—All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

“SEC. 806. CERTAIN CHANGES IN RESERVES AND ASSETS.

“(a) ADJUSTMENTS TO MEANS FOR CERTAIN TRANSFERS OF LIABILITIES.—For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between

the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the means of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfers. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

“(b) **CHANGE OF BASIS IN COMPUTING RESERVES.**—If the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of this subpart the amount of such item—

“(1) as of the close of the taxable year shall be computed on the old basis, and

“(2) as of the beginning of the next taxable year shall be computed on the new basis.

Amendments to sections 809 and 810

Strike out subsections (a) and (b) of section 809 and insert:

“(a) **GAIN AND LOSS FROM OPERATIONS DEFINED.**—

“(1) **GAIN FROM OPERATIONS.**—For purposes of this part, the term ‘gain from operation’ means the amount by which—

“(A) the life insurance company’s share of the investment yield plus the sum of the items referred to in subsection (c), exceeds

“(B) the deductions provided by subsection (d).

“(2) **LOSS FROM OPERATIONS.**—For purposes of this part, the term ‘loss from operations’ means the amount by which—

“(A) the sum of the deductions provided by subsection (d) exceeds

“(B) the life insurance company’s share of the investment yield plus the sum of the items referred to in subsection (c).

“(3) **EXCEPTION.**—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on any interest which under section 103 is excluded from gross income, adjustment shall be made to the extent necessary to prevent such imposition.

“(b) **INVESTMENT YIELD.**—

“(1) **POLICYHOLDER’S SHARE.**—For purposes of this subpart, a portion of the investment yield of any life insurance company equal to the required interest shall be considered as received for the benefit of the policyholders and shall not be included in gain or loss from operations.

“(2) **LIFE INSURANCE COMPANY’S SHARE.**—For purposes of this subpart, the life insurance company’s share of the investment yield is an amount equal to the investment yield (as defined in section 804(c)) minus the required interest.

“(3) **REQUIRED INTEREST.**—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

“(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

"(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

On page 22, lines 7 and 8, strike out "Each item of" and insert "Each".

On page 22, strike out lines 11, 12, 13, 14, and insert:

"(4) OTHER AMOUNT.—All amounts, not included in computing investment yield and not included under paragraph (1), (2), or (3), which under this subtitle are includible in gross income.

On page 23, lines 4 and 5, strike out "Each item of" and insert "The".

On page 23, line 15, strike out "804(c)(9)" and insert "804(b)(4)".

On page 24, after line 16, insert:

"(9) TAX-EXEMPT INTEREST, ETC.—The deduction for tax-exempt interest, partially tax-exempt interest, and dividends received provided by subsection (f).

"(10) INVESTMENT EXPENSES.—Investment expenses to the extent not allowed as a deduction in computing investment yield."

On page 24, lines 17 and 25, strike out "(9)" and insert "(11)".

On page 26, beginning with line 8, strike out all through line 7 on page 27 (paragraphs (6) and (7) of section 809(e)).

On page 27, beginning with line 8, strike out all through line 21, page 28 (subsection (f) of section 809), and insert:

"(f) LIFE INSURANCE COMPANY'S SHARE OF TAX-EXEMPT INTEREST, ETC.—

"(1) DEDUCTIONS ALLOWED.—For purposes of this subpart, there shall be allowed as a deduction the sum of the life insurance company's share of the following items:

"(A) the interest which under section 103 is excluded from gross income,

"(B) the deduction for partially tax-exempt interest (determined under paragraph (3)), and

"(C) the deduction for dividends received provided by sections 243, 244, and 245.

"(2) LIFE INSURANCE COMPANY'S SHARE.—The life insurance company's share of each item described in paragraph (1) is an amount equal to the amount of such item multiplied by the ratio—

"(A) the numerator of which is the life insurance company's share of the investment yield, and

"(B) the denominator of which is the investment yield.

"(3) PARTIALLY TAX-EXEMPT INTEREST.—The deduction referred to in paragraph (1)(B) is an amount which bears the same ratio to the amount allowable as a deduction under section 242 (relating to deduction for partially tax-exempt interest) as—

"(A) the normal tax rate for the taxable year prescribed by section 11, bears to

"(B) the sum of the normal tax rate and surtax rate for the taxable year prescribed by section 11.

"(4) LIMITATION ON DIVIDENDS RECEIVED.—In applying section 246(b) (relating to limitation on aggregate amount of deductions)—

“(A) the limit on the aggregate amount of the deductions allowed by sections 243(a), 244, and 245 shall be 85 percent of the gain from operations computed without regard to—

“(i) the deductions provided by paragraphs (3), (6), and (7) of subsection (d),

“(ii) the operations loss deduction, and

“(iii) the deductions allowed by sections 243(a), 244, and 245, but

“(B) such limit shall not apply for any taxable year for which there is a loss from operations.

On page 29, line 1, strike out “(after the application of subsection (f))”.

On page 29, beginning with line 15, strike out all through line 3 on page 30, and insert:

“(a) ADJUSTMENT FOR DECREASE.—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of the required interest for the taxable year), the excess shall be taken into account as a net decrease referred to in section 809(c)(2).

“(b) ADJUSTMENT FOR INCREASE.—If the sum of the items described in subsection (c) as of the close of the taxable year (reduced by the amount of the required interest for the taxable year) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2).

On page 34, line 3, strike out “an item of” and insert “a”.

