TAXATION OF LIFE INSURANCE COMPANIES

SUMMARY OF SPECIAL PROBLEMS

FOR THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION

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SUMMARY OF SPECIAL PROBLEMS

1. Assessment companies

Assessment companies assess their members several times a year without regard to actual deaths. Under Texas law they must set aside 60 percent of each assessment in a reserve fund to pay death claims. Investment income is earned on the fund in the meantime. Without a special provision there would be no policy and other contract liability deduction, because, although these reserves are classed as life insurance reserves, there is no assumed rate of interest. They ask that these reserve funds be viewed as reserves with an assumed rate of 3 percent.

2. Swift & Co. Employees Benefit Association

This association is, in effect, a small mutual life insurance company except that it is organized under a trust and the policyholders are all employees, or former employees, of Swift & Co. In effect, each member has an ordinary level premium life insurance policy, paid up after 25 years. There are no cash surrender values, but any member can maintain his policy if he leaves Swift & Co. by paying the required premiums (to the end of the 25-year period). It has reserves based on mortality tables and assumed rates of interest, as with any life insurance company. However, the association is not regulated by the State insurance commissioner, nor are these reserves "required by law."

The association would be exempt under section 501(c)(9) except for the fact that less than 85 percent of its income consists of "collections from the members or contributions from the employer," since the investment income is about 35 percent of total receipts. Since it is not exempt, it is taxable as a life insurance company. One suggestion is that the 85 percent requirement be relaxed so the association will be exempt.

Under the bill the association would pay a large tax on its investment income, since there would be no deduction for required interest. One suggestion is, therefore, that its reserves be viewed as life insurance reserves. In that case there would be on taxable income under phase 1, since its required interest is greater than its investment income. It would still be subject to a tax of some $470,000 on its gain from operations, primarily because of a gain of over $2 million from lapsed policies. Since this gain results from decreases in reserves set up before 1958 one suggestion is that such a decrease, in whole or in part, not be viewed as an income item.

3. Austin Life Insurance Co.

Austin Life Insurance Co. reinsured the policies of two Texas assessment companies, agreeing to treat the policyholders as if they had bought ordinary level premium insurance for the face amounts of their policies. Austin agreed to accept the premiums payable under the old contracts, but those premiums were inadequate to equal the net premiums plus loading which would be charged for ordinary life insurance policies. The predecessor companies turned over to Austin their reserve funds, and Austin used these funds to cover deficiency reserves equaling the present value of the difference between the old premiums and the required premiums. These reserves will decrease, and, in general, a decrease in reserves results in taxable income under the bill, except that decreases in deficiency reserves do not result in taxable income. Although the reserves set up by Austin serve the purpose of true deficiency reserves they do not fit the definition of deficiency reserves in the bill because they cover loading (expense) elements as well as net premiums. Austin wants some provision that will prevent decreases in these reserves from being treated as taxable income.

4. American Life Insurance Co. of Birmingham (Mr. Hughes)

American Life reinsured (sold) its industrial life insurance business in 1958. The reserves on those policies amounted to $3,200,000. The purchasing company had to set up similar reserves, so American transferred securities with a value of $3,200,000 to that company. However, American had spent large amounts to get that business and in consideration of that the purchasing company paid American $3,400,000.

If American were an ordinary corporation the transaction would probably be viewed as the transfer of securities worth $3,200,000 and American's rights under the contracts with its policyholders for $3,400,000 and the assumption by the purchaser of American's obligations estimated at $3,200,000. Thus, assuming no basis for the insurance contracts, there would be a capital gain of about $3,400,000. If the expenses of writing these policies were capitalized, however, there would be a capital loss. A capital gain or loss for 1958 would not be recognized. However, the bill treats a decrease in reserves as taxable income. Here there was a decrease in reserves of $3,200,000. That income would be offset in many cases by a deduction for the consideration paid for the assumption by the purchasing company of the liabilities under the policies (sec. 809(d)(8)). Here there was no consideration, since the $3,200,000 paid by American was less than the $3,400,000 received. Or, if the $3,200,000 is viewed as a deductible consideration, offsetting the income from an equivalent decrease in reserves, the $3,400,000 received would be taxable as an item of gross income.

It might be argued that the $3,400,000 should be taxed as ordinary income, since it is a substitute for income of at least that amount which American would have received over the years from the policies if they had not been reinsured. However, American points out that there was an overall loss with respect to these policies, the premiums received plus the $3,400,000 being less than commissions, other expenses, death and surrender payments, etc. over the years. American contends that since the pre-1958 expenses were not deductible the offsetting $3,400,000 received in 1958 should not be taxable.

5. Taxpaid income for 1958 as shareholders surplus

Monumental Life Insurance Co. of Baltimore and others point out that they will pay tax on a large amount of income for 1958 but did not pay out all that income (after tax) in dividends to stockholders in 1958. They believe they should be permitted to pay out the taxed 1958 income (less 1958 dividends) as dividends to stockholders in 1959 or 1960 without running the risk of being taxed on policyholders surplus. Under the bill dividends to stockholders in 1959 and subsequently will be viewed as coming first from *post-1958* shareholders surplus, then from post-1958 policyholders surplus, and only then from pre-1959 surplus, which would include income taxed in 1958.

6. Special distributions

A. Two companies mutualized some time before 1958, under agreements to pay the stockholders, in installments over a period of years, not only the capital and surplus at the time of mutualization but a part of the income to be earned, since the stock company had incurred large expenses in writing the policies issued before mutualization. They contend that, because of these pre-1958 obligations, payments to the stockholders out of income should be deductible in computing gain from operations under phase 2. It appears that these payments are part of the purchase price for the business, which the policyholders are paying to the stockholders. Under general tax law payments for property, or payments of a debt, must be made out of taxed income, and are not deductible in determining taxable income.

B. Some companies issued callable preferred stock prior to 1958. Although it is not certain, it appears that this stock was issued to meet some special temporary need of the company, and was intended to be redeemed when the need had passed. It is argued that payments in redemption of such stock should not (if in excess of shareholders surplus) trigger a tax on policyholders surplus. The principle of phase 3 is, however, that any money paid by the company to its stockholders comes out of the latest earnings, first from the shareholders surplus and then from the policyholders surplus, and that, by paying money to stockholders, the company demonstrates that the policyholder surplus is to that extent not needed for policy obligations.

C. It is argued that any repayment to stockholders of capital or surplus paid in by them, whether before or after December 31, 1958, should not trigger the tax on policyholder surplus. The principle of phas 3 is, however, that by paying any money to stockholders the company has shown that it does not need untaxed income to meet policy obligations.

7. Preliminary term reserves

The bill provides that any company having preliminary term reserves may, for tax purposes, revalue them as if they were net level premium reserves. There may be an exact conversion of each block of reserves, or a net adjustment in accordance with a formula given in the bill. Section 818(c) provides that if the taxpayer elects to convert its preliminary term reserves "the basis adopted shall be adhered to" in making computations for subsequent years unless a change is approved by the Secretary or his delegate.

A. Acacia, and others, want to make the approximate adjustment for 1958 and exact conversions for 1959 and subsequent years.

B. A company which issues noncancelable accident and health policies wants to make an approximate adjustment not based on each "$1,000 of insurance in force," as provided in section 818(c), since there is no fixed amount of insurance under an accident and health policy.

8. Life insurance departments of mutual savings banks

Some mutual savings banks in Massachusetts and New York have life insurance departments. Section 594 provides for a tax under the ordinary rules on the ordinary income of the bank plus a tax computed under subchapter L on the income from the life insurance department.

A. These banks want a clarification of section 594 to make sure that the life insurance department is treated as if it were a life insurance company, with all the provisions of this bill made applicable.

B. Section 811(b) of this bill provides that dividends to policyholders declared before March 16 shall be viewed as accrued at the end of the preceding year. The mutual savings banks believe it is necessary for them to have a little more time to determine the amount of policyholder dividends, and ask that the date be changed to April 16.

9. Special reinsurance arrangements

Some reinsurance contracts involve the receipt of all the income on the policies, and the payment of the tax on the entire income, by the ceding company; and their payment of part of the income to the reinsuring company and payment by the reinsuring company of part of the tax to the ceding company. The result is a double taxation of part of the income (the income being taxable to the ceding company as investment income and to the reinsuring company as premium income), and the pyramiding of the tax, since payment of the ceding company's tax by the reinsuring company generates taxable income to the ceding company, and thus additional tax to be refunded to the ceding company. Any reasonable solution of these difficulties is requested.

10. Distributions by Canadian companies

For purposes of phase 3 it is necessary to determine what part of the dividends paid by a foreign life insurance company to its stockholders relates to its U.S. business and the shareholders surplus and policyholders surplus attributable to the U.S. business. Under the bill this portion is determined by the ratio of U.S. surplus (as defined in the bill) to overall surplus. Since determination of world surplus requires valuation of world assets it is suggested that the appropriate portion be determined as the ratio of U.S. liabilities to world liabilities.

The bill does not provide an apportionment rule where a foreign stock life insurance company becomes a mutual company. Such an apportionment rule should be provided.

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