

REPORTS

to the

Joint Committee on Internal  
Revenue Taxation

Seventy-first Congress

Pursuant to

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Division of Investigation

Vol. 1—Part 6

Preliminary Report on Federal Taxation

of

Life Insurance Companies

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Printed for the examination and use of the Members of the Committee

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NOTE.—These reports have been submitted to the Committee and ordered printed for purposes of information, but no action has been taken by the Committee upon them



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## LETTER OF TRANSMITTAL

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CONGRESS OF THE UNITED STATES,  
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,  
*Washington, June 8, 1929.*

*To the members of the Joint Committee on Internal Revenue Taxation:*

There is transmitted herewith a report entitled "Preliminary Report on Federal Taxation of Life Insurance Companies," as prepared by our division of investigation.

The necessity of a report on this subject was suggested by the decision of the Supreme Court of the United States in the case of the National Life Insurance Co. While no criticism is, of course, made as to this decision, it modifies the plan of taxation which had been enacted by Congress in respect to life insurance companies in the revenue act of 1921 and subsequent years. It is requested that you give this report and the recommendations made therein your consideration. Your comments and suggestions on this subject will be appreciated.

Very truly yours,

WILLIS C. HAWLEY,  
*Chairman, Joint Committee on Internal Revenue Taxation.*

## LETTER OF SUBMITTAL

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CONGRESS OF THE UNITED STATES,  
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,  
*Washington, November 26, 1928.*

HON. WILLIS C. HAWLEY,  
*Chairman Joint Committee on Internal Revenue Taxation,  
Washington, D. C.*

MY DEAR CHAIRMAN: There is transmitted herewith a "Preliminary Report on Federal Taxation of Life Insurance Companies."

The provisions providing for the taxation of life-insurance companies were completely revised in 1921, and have undergone no substantial change since that date. It was recognized that life-insurance companies should receive a reasonable relief from the usual corporation tax on account of the mutual character of this business. In working out a fair tax the representatives of the Government made some concessions and the life-insurance companies made some. The principal concession made by the companies was in regard to the treatment of tax-exempt interest.

On June 4, 1928, the Supreme Court of the United States held the treatment of tax-exempt interest, provided for in the revenue acts, unconstitutional. This decision is in favor of the life-insurance companies and will occasion a refund with interest estimated at \$36,000,000.

Inasmuch, therefore, as the practical agreement entered into in 1921 between the Congress and the life-insurance companies has been overturned, it appears that prompt action is proper in correcting the present excessive relief from taxation enjoyed by these companies.

The report is designated as preliminary on account of the fact that some figures and facts are still being assembled. However, it is recommended the report be published for public examination and analysis without specific approval of the contents of same by the joint committee.

Very respectfully,

L. H. PARKER,  
*Chief, Division of Investigation.*

## PRELIMINARY REPORT

ON

# FEDERAL TAXATION OF LIFE-INSURANCE COMPANIES

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### FOREWORD

For the purposes of Federal taxation, insurance companies are divided into three groups:

First. Life-insurance companies, both stock and mutual.

Second. Mutual-insurance companies, other than mutual life companies.

Third. Insurance companies, other than life companies and mutual companies.

This report will deal only with Federal taxation of life-insurance companies. The taxation of insurance companies included in the second and third groups will be treated in separate reports. It should be noted that our system of taxing life-insurance companies makes no distinction between stock and mutual companies.

### SYNOPSIS

The facts and conclusions presented in this preliminary report may be summarized as follows:

1. The magnitude of the life-insurance business in the United States may be visualized from the fact that on December 31, 1927, there were 118,903,835 policies or certificates of insurance in force, which amounted to almost exactly one policy or certificate for every man, woman, and child making up our total population on that date. The total amount of insurance in force was more than \$97,000,000,000, or \$803 per capita.

2. Special provisions were written into our revenue act in 1921 to provide for the taxation of life-insurance companies because the provisions of the 1918 act were obscure and resulted in too small a tax. These provisions have remained practically unchanged from 1921 up to the present time.

3. An investigation of the effect of the special provisions of the 1921, 1924, 1926, and 1928 revenue acts shows as follows:

(a) The total tax payable by life-insurance companies under the acts as written for the years 1921 to 1928, inclusive, amounts to approximately \$112,066,000, or \$349,323,000 less than would have been assessed if the full theoretical tax had been specified.

(b) The treatment of tax-exempt interest in connection with a special deduction provided for in the revenue acts has been declared unconstitutional by the Supreme Court of the United States. This results in a final tax for the eight years, 1921 to 1928, of \$76,090,000, making a further tax reduction of \$35,976,000 (at least \$30,000,000 of the \$35,976,000 is refundable).

(c) The final tax on life-insurance companies for the eight years will be approximately \$19,017,000 less than would have been collected under the provisions of the 1918 act, in spite of the fact that the new provisions were designed for the purpose of getting more tax.

4. From an investigation of the theory of our present life-insurance provisions it appears as follows:

(a) It is theoretically sound to tax life-insurance companies on the basis of their investment income. Premium income can not logically be considered as taxable income to the company.

(b) It is not theoretically sound to exempt life-insurance companies from taxation on an amount equal to 4 per cent of the mean of their reserve funds held at the beginning and end of the year.

(c) It is not consistent to allow life-insurance companies to exclude capital gains and losses from the computation of their incomes, when every other corporation in the country must include such gains and losses.

5. In spite of theory, it appears that life-insurance companies should receive special treatment and not be subjected to the full theoretical tax for the following reasons:

(a) A tax levied on life-insurance companies will be borne, at least, largely by the policyholders. It is estimated that 65,000,000 different individuals hold insurance policies, and as we have less than 3,000,000 income-tax payers, it will follow that more than 62,000,000 individuals who should be exempt from taxation will be taxed indirectly by this tax collected at the source.

(b) The State taxes, licenses, and fees have become so heavy on life-insurance companies that a heavy Federal tax would be hard to bear and even might put our companies at a disadvantage in competing with foreign companies. The State and local taxes at present are about four times the Federal income tax.

(c) The insurance company must estimate Federal taxes for a long period in the future in making their life-insurance contracts. A sudden and large change in the tax on life-insurance companies would, therefore, affect the value of the contracts already in force.

(d) The public service rendered by the life-insurance business in reducing pauperism and encouraging thrift can not be overlooked, especially when it is remembered that these companies are nearly all on a mutual or profit-sharing basis and that other mutual organizations and even certain industries not on a mutual basis receive special relief under our revenue act.

6. In investigating the problem of what should be a fair tax on life-insurance companies, the following limits seem reasonable:

(a) *Maximum tax.*—It would be unfair to tax the net taxable investment income of life-insurance companies at a rate higher than the normal rate (5 per cent) on individuals, for to do so would be to tax practically every individual having a policy at a rate higher than he would pay if the income accrued to him direct. For 1927, the maximum tax is computed to be \$29,560,600 on the above principle.

(b) *Minimum tax.*—The tax on insurance companies should not be less than the tax that would be returned at the standard corporation rate on their increase in surplus and on their dividends to stockholders in the taxable year. This tax would certainly appear fair as the direct interest of the policyholders in the company is represented by the reserve and not by the surplus, and because the stockholders of an insurance company should not be treated differently than the stockholders of any other corporation. For 1927 the minimum tax is computed to be \$24,308,622 on the above principle.

7. It appears that under existing law life-insurance companies may be taxed in exceptionally bad years when they actually lose money on their total business. This would happen if conditions similar to those of 1918 should recur. This taxation in years of loss is believed inconsistent with the principles of our income tax.

8. After the investigation of several methods of taxing life-insurance companies which would result in a fair tax, the following method is presented for examination and analysis:

(a) The gross income of insurance companies to include all interest, dividends, and rents received in the taxable year, except interest from tax-exempt securities.

(b) The net income to be computed by deducting from gross income domestic dividends, investment expenses, real-estate expenses, depreciation, interest paid, and a specific exemption of \$3,000 in the case of companies having a net income of \$25,000 or less. The deductions mentioned above to be defined as in the case of the present law and subject to the same limitations. The special deduction of 4 per cent of the mean reserves and 2 per cent of the reserve for deferred dividends, provided for in the 1928 act, not to be allowed.

(c) The tax to be computed on the net income, determined as above specified, by applying thereto a rate equal to one-third the rate of tax levied on ordinary corporations for the same taxable year; or, at the option of the insurance company, the tax may be computed at the full standard corporation rate upon the net income computed on the cash receipts and disbursements basis under the same provisions as are prescribed in the case of the ordinary corporation.

9. The above method, while arbitrary, does not violate the principles set forth in this report. It would result for the year 1927 in a total tax upon life-insurance companies of approximately \$26,605,000. This tax meets the requirement of the fair tax already stated.

## DISCUSSION

## LIFE-INSURANCE COMPANIES, BOTH STOCK AND MUTUAL

*Remarks on the theory of life insurance.*—Before a discussion can be properly entered upon as to the propriety of our present system of taxation or as to suggested modifications thereof, the theory of life insurance must be briefly reviewed in order that we may at least distinguish income from capital for income-tax purposes. This review, however, will be made as brief and simple as possible and only the most common form of insurance will be considered which provides for the payment of a certain sum at death in return for the payment by the insured of a certain and uniform annual premium for life or for a fixed number of years.

Life insurance has been defined as “that social device for making accumulations to meet uncertain losses through premature death which is carried out through the transfer of the risks of many individuals to one person or a group of persons.” (Allen H. Willett, in *The Economic Theory of Risk and Insurance*.)

Our practical method of insurance does not attempt to measure by valuation the loss occurring through the death of the insured. The loss is fixed at an amount stated in the face of the policy, or, in other words, the amount payable, \$1,000, \$2,000, or the desired sum, is guaranteed by the insurer to the insured in event of death.

It is apparent from the definition of life insurance already given that we must have “the transfer of the risks of many individuals to one person or group of persons.” It would be impossible to have an insurance company which insured the life of only one person without the business being a gamble, pure and simple. When many risks are in the hands of one company, however, experience has shown that the number of deaths occurring yearly may be predicted with reasonable accuracy over a long period of years. These predictions are made possible by reason of the existence of mortality tables upon which such forecasts are based. The greater the number of risks in the hands of one insurer the more nearly will the deaths occur in conformity with the prediction.

In addition to the prediction as to the time of death, it is also known that the contributions of the insured will earn interest; therefore the insurance company is able to calculate the amount which, independent of the expenses of operation, will enable it to pay all the losses contracted to be paid under its policies. In any given case, the amount which must be set aside, annually or otherwise, in a reserve, to accumulate at interest and to provide for the payment of the death loss, is technically called the net premium.

Thus, for any given group, insured in a given year, the life insurance company is able to measure in advance the amounts to be paid yearly in death claims, and its premiums are so constructed that, if the yearly balances, after paying losses, are invested at the rate of interest assumed in calculating the net premium, the money to pay these losses will be in hand to the death of the last person insured.

To the net premium the company adds a sum called loading to cover the expenses of conducting the business and to provide against

unforeseen contingencies. The gross premium, which is the premium named in the policy, is the sum of the net premium and the loading.

Taking the income-tax viewpoint for the moment, it is seen, therefore, that the net premium constitutes capital invested by the insured with the insurer and can not properly be considered as income to the company. The loading, on the other hand, represents a payment for services rendered by the insurer to the insured, which payment, nevertheless, would not ordinarily come under the category of a deductible business expense to the individual as defined by our revenue acts. As far as the insurance company goes, the loading would theoretically represent income against which would be applied the actual expense of writing and maintaining the policy. If the actual loading necessary coincided with the computed loading, then the result would be no net income to the company from this source.

It might be noted, still on the same point, that the net premium is somewhat similar to the sum deposited with a savings bank, and, in our opinion, even more analogous to the investment by an individual in a corporation. The loading is an expense, although not deductible expense for income-tax purposes, to the insured as well as income to the insurance company. It should be observed, however, that in England premiums are given the effect of being an expense to the insured. In that country a taxpayer is entitled to an allowance or tax credit on the amount of his insurance at one-half the normal rate of tax. This amounts in the case of the small taxpayer to the allowance of one-half of the premium as an expense item.

It has already been stated that the net premium is set aside annually in a reserve and is assumed to accumulate up to the time of probable death at a specified rate of interest. This rate of interest is usually specified by the State insurance laws. It varies from 3 to 4 per cent, but  $3\frac{1}{2}$  per cent is probably the most common rate, at least in connection with the American Experience Table of Mortality. This rate of interest does not represent the actual rate of interest realized on reserve funds, which is nearer 5 per cent under present conditions.

From the above it may be concluded that the amount of interest which is set aside in accordance with the State laws at the legal rate represents income to the insured but not to the insurance company. From the income-tax standpoint, however, this income may be included in the taxable income of the company and the individual exempted from the normal tax thereon, in accordance with the theory of collection at the source.

Nearly all our life-insurance companies are mutual companies or operate on a profit-sharing principle. It results that the insured receives dividends from the insurance companies. In the analysis of this item trouble will be encountered. The moneys from which this dividend is paid may arise from savings from loading on the premium, from savings arising from mortality actually experienced being less than that shown by the table used in calculating the net premium, or from net profit on invested funds over and above the interest required to maintain the reserve. The question will arise, therefore, are dividends really a return of a portion of the premium (therefore, a return of capital) or do they represent a distribution

of profits to the insured?" It will not be necessary, now, to answer this question positively, as means will be found to eliminate our difficulties in this regard for tax purposes. However, it appears substantially correct to say that the dividend may be a return of capital or a payment of income to the insured, or both, according to the facts in the particular case.

From the above brief review it will now be possible on a theoretical basis to set up for reference certain definitions for income-tax purposes of the insurance terms which must be dealt with in this report:

(a) The net premium is capital of the insured, held in trust by the insurance company.

(b) The loading is income to the insurance company, although it may not result in taxable net income, and if insufficient to meet expenses may even result in a loss.

(c) The interest set aside to maintain the legal reserve of an insurance company represents income to the insured but not to the company.

(d) The dividend to the policyholder may represent a return of capital to the insured or a payment of income; or a mixture of both; according to the circumstances of each particular case.

*The magnitude of the life-insurance business.*—It may be well to give a few general figures showing the present magnitude of the life-insurance business in the United States and its remarkable growth, for the United States leads the world in both number of policies and amount of same.

From the Insurance Year Book, published by the Spectator Co., figures can be obtained which are nearly complete. From this source the following figures are compiled showing the number of policies and amount of insurance in force on December 31, 1927:

*Life insurance in force December 31, 1927*

Kind of insurance	Number of companies	Number of policies	Amount
Legal reserve companies:			
Ordinary and group.....	} 319	27, 146, 035	\$71, 473, 615, 098
Industrial.....		82, 246, 402	15, 548, 488, 326
Assessment life association.....	85	1, 168, 915	826, 425, 279
Fraternal order.....	235	8, 342, 483	9, 726, 661, 968
Grand total.....		118, 903, 835	97, 575, 190, 671

These enormous figures represent almost exactly one policy or certificate of insurance for every man, woman, and child in the United States, for the estimated population in 1927 amounts to 119,000,000. The average amount of insurance carried by each of these 119,000,000 policies is \$803, or, in terms of our total population, it represents an insurance of \$803 per capita. Of course, some persons hold more than one policy, but it is conservatively estimated that there were not less than 65,000,000 different individuals holding insurance policies or certificates in 1927.

As of December 31, 1927, the Yearbook of the Spectator Co. shows the following important facts in relation to the 319 legal reserve life-insurance companies already mentioned:

*Statistics on 319 legal reserve life companies*

	As of Dec. 31, 1927	Increase in 10 years (1918-1927)	Per cent increase
Number of companies .....	319	75	31
Capital stock .....	\$132, 448, 985	\$73, 153, 289	123
Total premium income .....	2, 874, 452, 481	1, 880, 185, 870	189
Total investment and miscellaneous income .....	798, 698, 958	468, 378, 828	141
Grand total income .....	3, 673, 151, 439	2, 348, 564, 698	177
Losses paid (death, endowment, etc.) .....	1, 082, 036, 886	517, 051, 850	92
Dividends to policyholders .....	417, 861, 771	272, 645, 123	188
Dividends to stockholders .....	18, 258, 987	13, 238, 287	264
All other expenditures .....	776, 965, 638	493, 328, 145	174
Grand total expenditures .....	2, 295, 123, 282	1, 296, 263, 405	130
Excess of income over expenditures .....	1, 378, 025, 157	1, 052, 301, 293	323
Total admitted assets .....	14, 391, 850, 583	7, 916, 711, 081	122
Total reserve .....	12, 291, 049, 833	6, 883, 689, 997	127
Increase in reserve .....	1, 229, 590, 835	854, 987, 191	228
Total surplus funds .....	1, 525, 634, 795	800, 142, 314	110
Total ordinary and group insurance in force .....	71, 473, 615, 098	47, 306, 503, 196	196
Total industrial insurance in force .....	15, 548, 488, 326	9, 845, 290, 294	173

An examination of the above figures would appear to make it approximately correct to say that the life-insurance business of to-day has the same relation to the life-insurance business of 10 years ago as \$3 has to \$1. In other words, the life-insurance business has increased approximately 200 per cent in 10 years.

A further analysis of these figures will not be made here, but frequent mention will be made of the various items in connection with the discussion of the various points taken up later in this report.

*The present method of taxing life-insurance companies.*—The revenue act of 1928 provides in sections 201, 202, and 203 for the taxation of life-insurance companies. Provisions of the present act are practically the same as those of the revenue acts of 1921, 1924, and 1926, sections 242 to 245, inclusive.

A careful study of the method of taxing life-insurance companies was made prior to the passage of the revenue act of 1921, the situation at that time being summed up as follows in the House report on the 1921 bill:

The provisions of the present law applicable to life-insurance companies are imperfect and productive of constant litigation. Moreover, the taxes paid by life-insurance companies under the income tax are inadequate. It is accordingly proposed in lieu of all other taxes to tax life-insurance companies on the basis of their investment income from interest, dividends, and rents, with suitable deduction for expenses fairly chargeable against such investment income. The new tax would yield a larger revenue than the taxes which it is proposed to replace.

It will be noted from the above quotation that the laws prior to 1921 were condemned as imperfect and obscure, and further, that the taxes paid by the life insurance companies were inadequate under

these old acts. It is believed that it will serve no useful purpose to go into a description of the revenue acts relating to life insurance companies prior to 1921. In fact, inasmuch as the 1921 act is practically the same as the 1928 act, as above noted, it will be sufficient to confine ourselves to a discussion of the present provisions. Statistics on this subject which will be presented later will be representative of the effect of the provisions of the present act from the year 1921 to date. Statistics for the years prior to that time will, of course, not be representative of the present act, but only of the admittedly imperfect provisions of the prior act.

The first great difference that exists between the taxation of a life insurance company under our law and the ordinary corporation lies in the definition of what constitutes gross income for income-tax purposes. In the case of the ordinary corporation, practically all receipts, except interest on tax-exempt securities, must be included in gross income. In the case of life insurance companies, gross income includes only the receipts from interest, dividends, and rents. This automatically excludes from taxation in the case of life insurance companies any portion of the premiums paid by the policyholders to the company. This definition of income also excludes from taxation all gains from the sale or other disposition of property which are taxed in the case of all other corporations, including even insurance companies other than life insurance companies.

The second point of difference that exists between the taxation of a life insurance company and the ordinary corporation is in connection with the deductions from gross income allowable in arriving at net income. It will be necessary to discuss the deductions allowed insurance companies which are different from those allowed ordinary companies separately and in detail.

The most important deduction allowed, and one that is entirely different from any deduction allowed the ordinary corporation, is defined in the revenue act as follows:

An amount equal to the excess, if any, over the deduction specified in paragraph (1)<sup>1</sup> of this subsection, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life-insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the commissioner finds to be necessary for the protection of the holders of such policies only.

The laws of all the States now require life-insurance companies to maintain certain reserve funds, which may be designated legal reserves. The determination of the legal reserves at any date is made by computing the present value at a specified rate of interest of the future liabilities as represented by the insurance contracts in force with due adjustment on the basis of standard mortality tables. The specified rate of interest is not uniform in all States, but it is usually nearer 3½ per cent than the 4 per cent allowed by our revenue act.

In 1921, when the new insurance provisions were prepared, it appears that the deduction of 4 per cent of the mean reserves was taken as a basis rather than the actual amount of interest set aside to maintain the reserves for two reasons:

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<sup>1</sup> Paragraph (1) provides for the deduction of tax-exempt interest from gross income.

First, because it was believed a uniform arbitrary rate was simpler and possibly more equitable from the viewpoint of Federal taxation than the actual rate which might vary in the different States.

Second, because it was thought best in reality to tax any normally exempt interest making up part of the investment income of the insurance company by reducing by the amount of such tax-exempt interest the amount arrived at by taking 4 per cent of the mean reserves. The 4 per cent rate, which was on the average admittedly in excess of the legal rate, was given as an offset to this treatment of tax-exempt interest.

Explanatory of the effect of the treatment of tax-exempt interest, it should be stated that the tax-exempt interest is first allowed as a deduction from gross income, as in the ordinary case, and then the special deduction is allowed which consists of 4 per cent of the mean reserves less the tax-exempt interest. The result of this plan is to arrive at exactly the same tax regardless of the proportion of tax-exempt interest to ordinary investment income, except in the case where the tax-exempt interest exceeds 4 per cent of the mean reserves (a condition which we have never met with). This subterfuge by which tax-exempt interest is actually taxed has been now declared unconstitutional by the Supreme Court of the United States. A description of this decision will be given later.

The amount of dividends received from a domestic corporation is allowed as a deduction to the life-insurance company as in the case of an ordinary company.

A special deduction allowed life-insurance companies but not allowed ordinary corporations is provided for in the following terms:

*Reserve for dividends.*—An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract.

The practical result of this deduction is to allow the company to receive tax-free investment income on its reserve for deferred dividends up to 2 per cent of the amount of such reserve at the end of the year. The amount of the reserve, to which the 2 per cent rate is applicable, is limited to some extent by excluding dividends deferred for a period of less than five years from date of the policy contract. This deduction is now so small as to be practically negligible.

In the case of the ordinary corporation which reports its income from all sources, business expenses are allowed as a deduction. In the case of life-insurance companies, inasmuch as the income includes only investment income, the expenses allowable are limited to investment expenses. There is also an arbitrary limit put on these investment expenses in certain cases which it is not necessary to discuss now.

Real-estate expenses, depreciation, and interest paid are allowable deductions in the case of insurance companies as in the case of the ordinary corporations, although there are certain limitations to the two first named deductions in the case of real estate occupied in whole or in part by the insurance companies. The usual specific

exemption from net income of \$3,000 in the case of a company whose net income is \$25,000 or less is also allowed.

The rate of tax levied upon the net income of a life-insurance company is 12 per cent as in the case of the ordinary corporation.

The full text of the provisions of the revenue act of 1928 relating to life-insurance companies will be found in Appendix I of this report.

*The present method of taxing individuals in relation to their transactions with life-insurance companies.*—Before the present system of taxation on life-insurance companies can be commented on, it is necessary to describe how the individual is treated by the revenue act on his transactions with the life-insurance company.

In the first place, premiums paid by an individual to a life-insurance company are not deductible from income. On the other hand, amounts received from the insurance company by reason of the death of the insured are excluded from income.

It might be noted at this point in connection with life-insurance payments at death, that the value of the gross estate in case of the estate tax includes the amount receivable by the executor and the excess over \$40,000 of the amount receivable by all other beneficiaries. However, it should also be remembered that net estates less than \$100,000 are not subject to the estate tax.

Amounts received, not at death, but under endowment or annuity contracts are also excluded from taxable income, except as to the excess, if any, of the amount received over the aggregate of the premiums paid minus dividends received.

It is correct to say as far as the income tax is concerned that the return of the net premium to the insured is treated as return of capital. Also in the general case the interest accumulation on this capital is returned tax free. In certain special cases of endowments and annuities a portion of this interest may be taxable, but it must be obvious that the Government will receive little tax from this source. The checking up of an endowment policy over a period of 20 years to obtain the premiums and dividends paid is not a simple operation in the case of most individuals. Furthermore, on account of the life-protection feature of endowment policies the total sum received may be less than the amount paid in and is rarely very greatly in excess of the amount except in the case of persons who insure in their youth.

*Treatment of premiums, dividends, and interest for income tax purposes.*—From the foregoing description of our income tax laws relating to insurance, it now appears that we can make the following statements which will be correct in the great majority of cases (exceptions being possible in the case of annuity, endowment, and special contracts):

(a) The net premium is treated as the capital of the insured held in trust by the insurance company. The receipt of the premium is not considered as income to the company, neither is its payment considered as an expense to the insured, or income to him on its return.

(b) The loading is treated in the same way by our law. Theoretically, however, it has been shown that the loading is expense to the

insured, although not a business expense, and income to the company, although it may not result in taxable income to the company, for the loading is generally expended. It represents payment by the insured for service rendered by the company. If the loading is equal to the actual expense of the company in writing and maintaining the policy and does not include any investment expense then the non-inclusion of the loading in the income of the company is exactly offset by the nonallowance of the writing and maintaining expenses above noted.

(c) The interest set aside to maintain the legal reserve is not taxed to the insurance company nor is it taxed to the insured. Theoretically this is not sound. Our general rule in all cases is to tax interest from capital either to the individual or to collect the tax at the source from the company. Considerations which might justify the unusual treatment in regard to this interest will be discussed later.

(d) The dividend to the policyholder is treated as return of capital to the individual, whether the dividend is from excess loading or from investment income. Such dividends are not subject to surtax as in the case of dividends received from domestic corporations by an individual.

*Defects of the present system of taxation on a theoretical basis.*—While it will be shown later that there are excellent reasons why life-insurance companies should not be taxed on the same basis as ordinary corporations, yet it is proper to set forth how the insurance companies would be taxed if the same treatment was accorded them as in the case of ordinary companies:

(a) The net premium would not be taxed to the life insurance company, representing capital invested by the insured in the company.

(b) The loading would be included in the gross income of the insurance company.

(c) All business expenses would be deductible from the gross income of the insurance company instead of only the investment expenses.

(d) All investment income, except tax-exempt interest, would be included in the gross income of the insurance company.

(e) Dividends to policyholders paid out of investment income would be free from normal tax but subject to surtax to the insured, the income having been taxed at the source.

(f) Dividends to policyholder paid out of premium income would be tax free to the insured, being a return of capital.

(g) Gains on the sale of assets would be included in the income, and losses on the sale of assets would be deducted from the income of the company.

Now, if the assumption is made, which assumption appears approximately true, that the excess loading is either returned to

the taxpayer or expended by the company, the above propositions can be readily simplified as follows:

A. The gross premium would not be taxed to the company, representing capital invested by the insured.

B. All investment income except tax-exempt interest would be included in the gross income of the company.

C. Investment expenses and domestic dividends only would be allowed as a deduction from income.

D. Dividends to policyholders paid out of investment income would be free of normal tax, but subject to surtax.

E. Gains on the sale of assets would be included in the company's income, and losses on such sales deductible therefrom.

If the above simplified propositions be compared with the description of the present system of taxation, the following defects from a theoretical standpoint will be noted:

First, all net investment income (after deduction of investment expense) is not taxed, but only that portion in excess of 4 per cent of the mean of the reserve funds at the beginning and end of the year.

Second, dividends from investment income to policyholders are not subject to surtax.

Third, capital gains and losses are not considered in computing the net income of the company.

In view of the above theoretical defects, two questions arise:

(1) What is the total tax of the life-insurance companies on the present basis?

(2) What would be the total tax of the life-insurance companies, on a theoretical basis if they were taxed the same as other corporations?

It is obvious that before these questions can be taken up certain basic figures and facts must be developed.

*Basic figures.*—The figures which would be most valuable in connection with our study would be those giving the details of income, expenditures, assets and liabilities, net taxable income, Federal tax paid, etc., for all companies for a series of years. Complete figures for all companies on all these different items are not available and can not be obtained without a very great amount of work. Some complete figures on certain items are available.

By the selection of 10 large life-insurance companies it has been found on comparing the aggregate of certain known items of these 10 companies with the total aggregate of the same known items of the legal reserve companies in the United States, that for the year 1926 these 10 companies represent approximately 69 per cent of the insurance business of all legal reserve companies. This statement can be entirely confirmed by the table shown in Appendix II, which has been prepared from the Insurance Year Book of the Spectator Co. covering the calendar year 1926.

An examination of the table just mentioned shows that the aggregate of the various items in connection with the 10 large companies bears a very constant relation to the aggregate of the same items in connection with all legal reserve companies. This is especially true in regard to the most important items which it will be necessary to consider from an income-tax standpoint.

For instance, it is obvious that the two most important items are total income and total expenditures. The relation of these items in the case of the 10 companies to the same items in the case of all the companies is shown by the following percentages:

Total income of the 10 companies equals 67.57 per cent of the total income of all.

Total expenditures of the 10 companies equals 66.48 per cent of the total expenditures of all.

The percentages in the case of the other large items are as follows:

Total premium income (10 companies) equals 67.92 per cent of all.

Total investment income (10 companies) equals 66.29 per cent of all.

Total payments to policyholders (10 companies) equals 69.59 per cent of all.

Total expenses, etc. (10 companies) equals 60.53 per cent of all.

Total admitted assets (10 companies) equals 69.36 per cent of all.

Total liabilities (10 companies) equals 70.16 per cent of all.

Total insurance in force (10 companies) equals 65.86 per cent of all.

Having satisfied ourselves that the 10 large life-insurance companies are fairly representative of all legal reserve companies for statistical purposes, the next step has been to make a careful analysis of the income-tax returns filed for the years 1923 to 1927, inclusive, by the 10 representative companies selected. The result of this study will be found in Appendix III. An examination of this table will show that not only has the actual aggregate of the various items for the 10 companies been shown, but also the closely approximate aggregate of the same items for all legal reserve companies. This has been accomplished by applying to the actual figures obtained from the returns of the 10 companies, the actual percentages shown by a comparison of the Insurance Year Book totals for the 10 companies and for all companies.

It appears worth while to summarize the tax thus obtained for the years examined, together with a comparison with the figures shown in the Statistics of Income published by the Bureau of Internal Revenue:

Year	Tax paid by all legal reserve companies (closely approximate)	Tax paid by life-insurance companies (Statistics of Income)
1923.....	\$12,835,300	\$12,963,168
1924.....	14,116,300	13,872,056
1925.....	15,151,500	(1)
1926.....	17,000,660	15,998,502
1927.....	17,448,100	(1)

<sup>1</sup> Not available.

It seems apparent from the above that the two independent figures for tax are in very good agreement. It might be noted that in the Statistics of Income some companies which do a considerable life-insurance business have not been classified with this group but with a miscellaneous group because they also do a fire, accident, or casualty business, or because they file consolidated returns with such other insurance companies. For purposes of our study it seems that the figures arrived at by our computations are the most useful because they are broken down into the necessary separate items, and because on account of being somewhat higher, they give the benefit of any doubt to the insurance companies. In any event, it appears the differences are inconsequential in view of the proper adjustments which could be made to the Statistics of Income figures.

By the use of the figures based on actual returns shown in Appendix III, and the Insurance Year Book of the Spectator Co., a table is now constructed which will show those facts, or closely approximate facts, which will be necessary in discussing the taxation of life insurance companies. The table referred to, will be found in Appendix IV. A description of the method of constructing this appendix is thought unnecessary, as such method will be obvious to the mathematician and insurance actuary. It is important, however, to state the facts which Appendix IV develops, which are as follows:

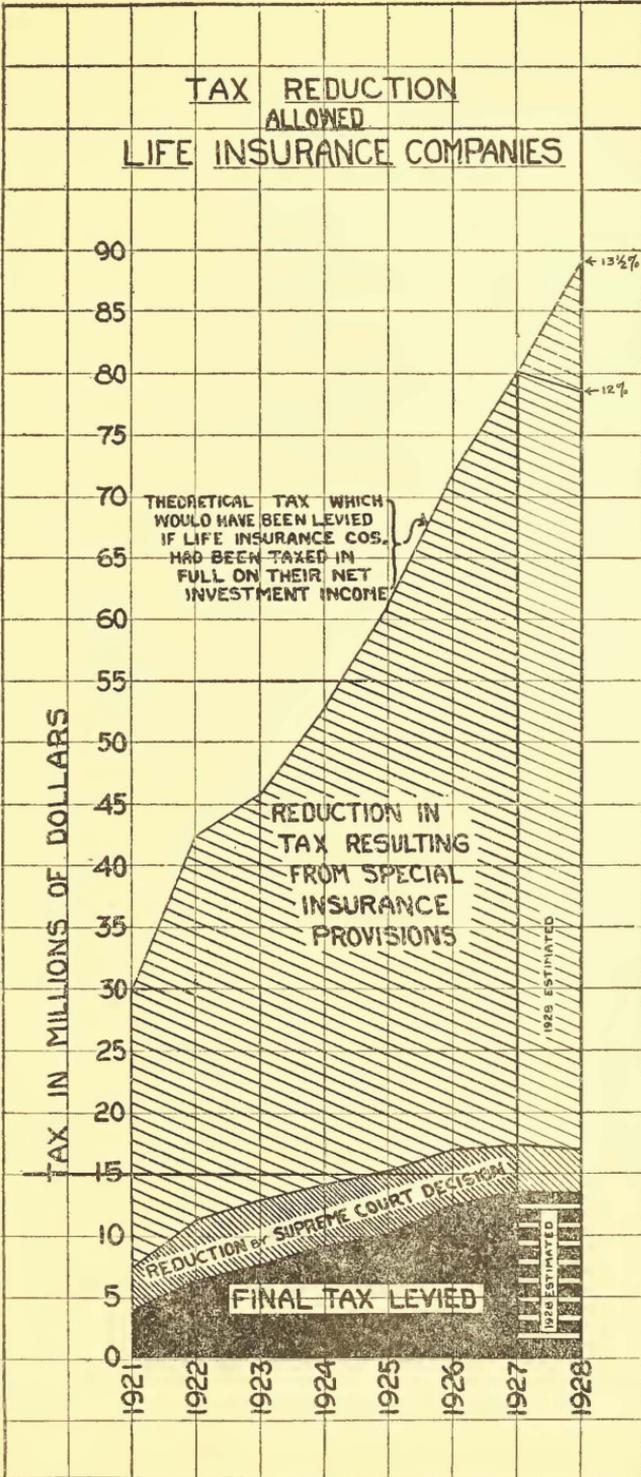
Part I shows income items, deduction items, and tax for all years from 1917 to 1928, inclusive, on the theory that the provisions of the 1926 revenue act were in force for all years. (Rate of tax  $12\frac{1}{2}$  per cent.) It also shows the tax in those years where the rate applicable to insurance companies was other than  $12\frac{1}{2}$  per cent. The figures for all years are closely approximate except for 1928 which are entirely estimated.

Part II is similar to Part I, except that it makes the modification required by the decision of the Supreme Court of the United States in the National Life Insurance Co. case.

Part III shows items similar to Part I, but is constructed so as to arrive at a theoretical tax for all years based on the principles of the 1926 act as applied to ordinary corporations.

Part IV shows an approximate computation of tax based on the theory that the revenue act of 1918 was in effect for all years.

*Reduction in tax allowed life insurance companies.*—The data is now at hand for answering the two questions previously raised as to the total tax on life insurance companies, and certain other questions involved therewith. To put these facts in a form where they may be visualized at a glance, recourse is had to a graphic representation. The graph follows:



The graph on the preceding page should now be briefly explained. The top curve shows the total tax in millions of dollars which would have been paid by all life-insurance companies if they were taxed in full on their net income like other corporations. The tax is shown for the years 1921 to 1928, inclusive, and the rate of tax used is the corporation tax rate in force for each year on the ordinary corporation. (It should be noted that in our theory of taxation as applied to insurance companies we have eliminated premiums paid from taxable income, on the basis that such premiums represent the investment of the policyholder in the company. It results that the tax is only computed on the investment income of the companies.)

The middle curve shows the total tax which was payable by all life-insurance companies under the revenue acts of 1921, 1924, 1926, and 1928 as written.

The bottom curve shows the total tax which is finally to be levied on all insurance companies for the years 1921 to 1928, inclusive, under the decision of the Supreme Court of the United States in the National Life Insurance Co. case.

The shaded area between the top curve and the middle curve represents the relief from taxation afforded by the special provisions of the revenue acts from 1921 to 1928.

The shaded area between the middle curve and the bottom curve represents the refunds which will be payable under the Supreme Court decision.

The area between the top curve and the bottom curve represents the total relief in taxation finally allowed life-insurance companies.

The black area between the bottom curve and the base line (O) represents the total tax finally levied on life-insurance companies.

While the preceding chart appears to give a fair idea of the practical tax situation in regard to life-insurance companies, it appears proper to add a few words on this subject.

The total tax and reductions under the three conditions named are shown in the following table:

Year	(1) Theoretical full tax	(2) Tax imposed by revenue act	(3) Relief to company (1) less (2)	(4) Final tax levied	(5) Reduction by Supreme Court (2) less (4)
1921-----	\$29,770,000	\$7,295,000	\$22,475,000	\$3,755,000	\$3,540,000
1922-----	42,296,000	11,245,000	31,051,000	6,320,000	4,925,000
1923-----	45,716,000	12,835,000	32,881,000	7,578,000	5,257,000
1924-----	52,795,000	14,116,000	38,679,000	9,177,000	4,939,000
1925-----	60,959,000	15,152,000	45,807,000	9,994,000	5,158,000
1926-----	71,655,000	17,001,000	54,654,000	12,429,000	4,572,000
1927-----	79,814,000	17,448,000	62,366,000	13,463,000	3,985,000
1928 (estimated)-----	78,384,000	16,974,000	61,410,000	13,374,000	3,600,000
Total-----	461,389,000	112,066,000	349,323,000	76,090,000	35,976,000

The above table can be summarized as follows:

Approximate relief given life-insurance companies, 1921 to 1928, inclusive, by revenue acts-----	\$349,323,000
Approximate relief given by decision of United States Supreme Court-----	35,976,000
Grand total relief in 8 years-----	385,799,000

It might be noted that the decision of the Supreme Court referred to above results in a refund of approximately \$32,376,000 in the years 1921 to 1927, inclusive, on taxes already paid, while for 1928 the original returns will undoubtedly reflect the relief of the \$3,600,000 noted for this year.

From Appendix IV it can also be computed that the probable tax for the years 1921 to 1928, inclusive, if the revenue act of 1918 had been left in force except as to corporation rates, would have been \$95,107,000. Now, the actual tax that will finally be collected for these years amounts to \$76,090,000; therefore, the Government will collect \$19,017,000 less tax than it would have if the principles of the 1918 act as applied to insurance companies had been left alone.

*Decision of the Supreme Court of the United States.*—The decision of the Supreme Court in the case of the National Life Insurance Co. v. the United States has often been referred to and it is proper to give a brief description of this decision, although its practical effect has already been indicated. A copy of the opinion of the court will be found in Appendix V.

The National Life Insurance Co. having relatively large investments in tax-exempt securities contended before the Supreme Court that it should be allowed the full 4 per cent of its mean reserves as a deduction from gross income in arriving at taxable income rather than only the amount by which 4 per cent of the mean reserves exceeded the tax-exempt interest as provided for in the statute.

The court sustained the company in its contention because it perceived that the taxpayer, through the device employed in limiting the special deduction, was taxed just as heavily as if all his income was from taxable interest. In other words, the statute really provided for taxing tax-exempt interest. Such taxation had already been held unconstitutional.

It may be interesting to show the original tax and the refunds and interest finally resulting from this decision in a typical and in an extreme case, respectively:

## CASE NO. 1

Year	Original tax	Final tax	Refunded or abated	Interest
1921.....	\$399,896.08	\$195,167.18	\$204,728.90	\$71,653.17
1922.....	661,589.07	288,943.57	372,645.50	109,528.37
1923.....	797,738.05	388,125.86	409,612.19	95,949.39
1924.....	914,830.89	536,853.80	377,977.09	68,004.65
1925.....	943,036.21	578,540.05	364,496.16	44,327.45
1926.....	970,393.88	645,582.18	324,811.70	18,061.11
1927.....	1,043,795.77	788,884.52	254,911.25	.....
Total.....	5,731,279.95	3,422,097.16	2,309,182.79	407,524.14

## CASE NO. 2

1922.....	\$136,607.65	None.	\$136,607.65	\$43,212.66
1923.....	142,515.72	None.	142,515.72	36,529.90
1924.....	139,819.56	None.	139,819.56	26,990.77
1925.....	143,075.96	None.	143,075.96	18,692.46
1926.....	127,352.47	None.	127,352.47	9,161.43
1927.....	129,164.79	\$4,267.43	124,897.36	999.26
Total.....	818,536.15	4,267.43	814,268.72	135,586.48

The total refunds and interest examined by this office and due to this decision in the three months period from August 27 to November 26, 1928, amount to \$12,346,084.16.

*Should life insurance companies receive special treatment?*—In view of the facts which have been stated, the question at once arises as to whether life insurance companies are entitled to special treatment for income tax purposes. This is certainly a serious question, when revenue of approximately \$385,000,000 has been lost by such special treatment in the last eight years, or approximately \$48,000,000 per year.

However, it appears that there are excellent reasons why special treatment should be given, although not necessarily the same special treatment that is now provided for.

The first reason is that a tax on the insurance companies will undoubtedly be borne by the policyholders and out of 65,000,000 policyholders, at least 62,000,000 are exempt from income tax as individuals. In other words, a Federal income tax on insurance companies amounts to collecting a tax at the source from 65,000,000 individuals, 62,000,000 of whom are tax exempt under our theory of taxation on individuals. Of course, this is not different from the result of taxing corporations at the source which may also affect individuals who should pay no income tax. Nevertheless, statistics prove that persons with very small incomes turn to insurance rather than to investment in the stock of domestic corporations. The taxation of profits from insurance investments at the source, is, therefore, a particularly inequitable case resulting from the defect in our income tax law, which does not permit of the refundment of taxes improperly collected at the source to the individual as provided for in Great Britain. (See *Income Tax in Great Britain*, printed for use of the joint committee, H. Doc. No. 332.)

It appears, therefore, that a tax of 12 per cent on the net investment earnings of an insurance company results in an indirect tax at this rate on the policyholder, who would pay no income tax in the great majority of cases. In view of the fact that our law, in many instances, takes cognizance of unusual situations, it would seem that the above is one reason for special treatment.

A second consideration to be kept in mind is the large amount of State and local taxes, licenses, and fees paid by the life-insurance companies. It is estimated that for the year 1927 such tax, including premium taxes and real-estate taxes, for all legal-reserve companies amounted to \$51,460,000. Now, the Federal tax finally levied for 1927 will amount to about \$13,460,000, so that it is evident that the State and local taxes are nearly four times the Federal tax.

In the third place, it should be remembered that the insurance business may be said to consist of the making of long-term contracts with the policyholder. In the making of such contracts it is necessary to estimate the Federal taxes over a long period in the future. A sudden and large change in the tax on the life insurance companies would, therefore, affect the value of the contracts already in force. If the tax was increased too greatly it might even affect the stability of the life insurance companies.

Finally, looking at the life insurance business as a whole, it must be admitted that it has performed an enormous service to the

country. It can not well be denied that life insurance has reduced pauperism and encouraged thrift. When it is considered that our income tax law exempts entirely from tax certain charitable and cooperative institutions, and gives special relief to the mining industry and to the income from building and loan associations, it seems certain that reasonable relief should be given to life insurance companies which now are nearly all either mutual or on a mutualized basis.

*What constitutes a reasonable tax on life insurance companies.*— If it is decided to continue giving life-insurance companies special treatment for the future as in the past, which, for the reasons given, seems proper, the next question that arises is, What constitutes a reasonable tax on life insurance companies?

In 1921, as has been pointed out, the insurance provisions were rewritten for two reasons; first, because they were obscure, and second, because the taxes which had been collected were deemed inadequate.

The tax resulting from the 1921 act and subsequent acts, as written, did return somewhat more revenue than would have been returned from the 1918 act, but now under the decision of the Supreme Court in the National Life Insurance Co. case, it is found that less tax will be collected than would have been received under the provisions of the 1918 act, with rates modified to conform to the standard corporation rates.

Therefore, the second purpose of the revenue act of 1921 has been defeated, for, if the taxes were inadequate under the 1918 act, they are still more inadequate now.

It is obvious that the determination of a reasonable tax for insurance companies to pay is a matter of judgment, as long as the regular statutory tax is not to be levied.

In spite of the difficulty of such a determination, computations for such a reasonable tax will be made as follows for the year 1927:

*Maximum determination*

Gross income interest, dividends and rents.....	\$657, 755, 000
Capital gains (add).....	8, 523, 000
Tax-exempt interest and domestic dividends (subtract).....	33, 730, 000
<hr/>	
Total taxable income.....	632, 548, 000
Investment and real estate expenses.....	41, 336, 000
<hr/>	
Net taxable income.....	591, 212, 000
Tax at 5 per cent rate (the normal tax on individuals instead of corporate rate).....	29, 560, 000

*Minimum determination*

Increase in surplus funds.....	\$161, 804, 878
Dividends to stockholders.....	18, 258, 987
<hr/>	
Tax at 13½ per cent (corporate rate).....	180, 063, 865
	24, 308, 622

The basis for the maximum determination is as follows: It would be unfair to tax the net taxable investment income of life insurance companies at a rate greater than 5 per cent which is the normal rate on individuals, for to do so would be to tax practically every indi-

vidual having a policy at a rate higher than he would pay if the income accrued to him direct. It will be noted full relief is given for dividends and tax-exempt interest in arriving at taxable income but that capital gains and losses are included in the computation.

The basis for the minimum computation is as follows:

The increase in surplus indicates the profits made and not allocated to the benefit of the policyholder. The reserve indicates the interest of the policyholder in the company. If the increase in reserve for all reasons, including the addition of the legal interest earned on such reserve is entirely exempted from taxation, it would certainly seem fair to tax the annual increase in surplus plus the dividends to stockholders at the full corporate rate (13½ per cent). This tax would not fall on the policyholders at all.

Now, there may be good reasons why neither of the above methods should be directly applied by law, but it is considered reasonable in view of the above computations that a proper tax on insurance companies for the year 1927 would be between \$29,600,000 and \$24,300,000. It is now proper to consider methods which would arrive at a fair tax on insurance companies.

#### METHOD NO. 1

A tax on the net taxable income of life-insurance companies at one-third the standard corporate rate, as computed under the maximum determination given above, would yield \$26,605,000 under 1927 conditions, or about the average between the maximum and minimum shown.

For reasons already given or to be given hereafter, and in the interest of simplification, it is believed that a tax on the net taxable investment income of life-insurance companies at one-third the standard rate would be a fair tax. The net taxable investment income of insurance companies mentioned should be arrived at by taking the total income from interest, dividends, and rents less tax-exempt interest, domestic dividends, and investment and real-estate expenses properly assignable thereto, plus or minus the capital net gain or capital net loss, as the case may be. (For investigation of capital gains and losses of insurance companies see Appendix VI.)

It seems proper to compare the results of this new method, applied to all years from 1921 to 1928, with the results of the acts in force and the results of the acts as modified by the United States Supreme Court.

Year	Tax under revenue acts as written	Final tax levied as required by Supreme Court	Proposed method No 1, tax at one-third standard rate
1921.....	\$7,295,000	\$3,755,000	\$9,923,000
1922.....	11,245,000	6,320,000	14,099,000
1923.....	12,835,000	7,578,000	15,239,000
1924.....	14,116,000	9,177,000	17,598,000
1925.....	15,152,000	9,994,000	20,320,000
1926.....	17,001,000	12,429,000	23,885,000
1927.....	17,448,000	13,163,000	26,605,000
1928.....	16,974,000	13,374,000	26,128,000
Total.....	112,066,000	76,090,000	153,797,000

This new method may result in a tax on life-insurance companies in years in which they really take a loss. However, this same thing was true of all acts which have been passed from 1921 to date, inasmuch as the tax is based on investment income without regard to premium income, death losses, etc. In view of the somewhat larger tax proposed under Method No. 1, it would appear proper, if such a method was adopted, to allow a life-insurance company to either be taxed under Method No. 1 or to be taxed under the regular statutory provisions provided for all ordinary corporations. (On the cash receipts and disbursements basis.) This would exempt life-insurance companies from taxation in unusual years like 1918 when there was a combination of war and epidemic. Of course, in a great majority of years there is no question but that Method No. 1 would be chosen. It might be noted that Great Britain taxes insurance companies under either one of two methods, one based on investment income and one based on total profits. The Crown selects the method returning the larger tax.

The advantages of Method No. 1 would appear to be as follows:

1. The method is very simple and easy of computation.

2. It does away with the present discrimination between companies on account of the 4 per cent rate on the mean of the legal reserves. Under the present system, if a company computes its reserve at a 3 per cent rate, its reserve is much higher for the same amount of insurance in force than if the reserve was computed at a 4 per cent rate; therefore the special deduction of 4 per cent of such reserves is much greater in the case of companies computing the reserves at rates lower than 4 per cent than is the case with the companies, which are generally smaller companies, which compute their reserves at a 4 per cent rate.

3. It gives a tax which is about one-half way between the maximum and minimum tax which should be imposed.

4. By making the method optional, the life-insurance companies can be relieved of taxes in unusual years of loss which it is believed should be the case.

5. Capital gains and losses are taken into account, which removes the present discrimination, as life-insurance companies are now the only corporations which do not report these gains and losses.

6. The method conforms to the theory of life-insurance taxation already briefly stated, but results in such practical reduction of tax as seems proper for the reasons already set forth.

Several objections can be raised to the new method. In the first place, objections may be made on account of applying this tax to the net investment income. However, as this same basis is used in our present revenue act, it is not felt that such objections need to be detailed here, especially in view of the fact that it has already been recommended that this new method be made optional and therefore that life-insurance companies will be protected from taxation in years in which they have a statutory loss. Objection as to the amount of tax, which has already been stated to be a matter of judgment, will also be disregarded here. Probably the first objection that will arise in most minds will be the taxation of these companies at one-third of the standard rate, which, under the revenue act of 1928, will amount

to a tax of 4 per cent. It will undoubtedly be considered that this advantage is a plain discrimination in favor of life-insurance companies. It appears, however, that as long as we do actually discriminate in favor of life-insurance companies, and properly so, there is no real object to keep this fact from the public. It might be noted that under the 1924 and 1926 acts, insurance companies were taxed at a rate lower than the standard rate.

## METHOD NO. 2

A second method which might be considered as partially remedying the present situation may be described as follows: The tax levied on life insurance companies might be prescribed in a manner similar to that provided in sections 201 to 203, inclusive, of the revenue act of 1928, with the following amendments: The special deduction allowable under section 203 (a) (2) should provide as follows: That the deduction should be the same proportion of the actual amount of interest necessary to maintain the reserves for the taxable year as the difference between the mean of the total reserve funds held at the beginning and end of the taxable year and the mean of the tax-exempt securities included in such reserve funds at the beginning and end of the taxable year bears to the mean of such total reserve funds.

The above rather involved statement can be made clear by a hypothetical example, as follows:

Suppose the "X" Life Insurance Co. has a reserve of \$635,800,000 at the beginning of the year and a reserve of \$680,200,000 at the end of the year. The first reserve includes \$57,700,000 in tax exempts, while the second includes \$45,300,000 in tax exempts.

The actual interest necessary to maintain the reserve for this year was \$20,800,000. With these facts the deduction allowable would be computed as follows under method No. 2:

Reserve on Jan. 1.....	\$635,800,000
Reserve on Dec. 31.....	680,200,000
Mean reserve.....	<u>658,000,000</u>
Tax-exempt securities on Jan. 1.....	57,700,000
Tax-exempt securities on Dec. 31.....	45,300,000
Mean tax-exempts.....	<u>51,500,000</u>
Tax-exempt interest.....	2,317,500
Mean reserve less mean tax-exempts.....	<u><u>606,500,000</u></u>

Ratio \$606,500,000 divided by \$658,000,000 equals 92.17 per cent.

Total amount interest required to maintain reserve.....	20,800,000
Deduction allowable equals 92.17 per cent of \$20,800,000, or.....	19,171,360

It should be noted that the deduction allowable under the present law as written in the above case is \$24,002,500 and under the present law as modified by the Supreme Court, \$26,320,000.

If 4 per cent of the mean reserves was used instead of the actual amount of interest necessary to maintain the reserve in Method No. 2, the result obtained by the new way of handling tax-exempt interest would amount to a deduction of approximately \$24,260,000.

This method of treating tax-exempt interest does not appear to interfere with the principle involved in the National Life Insurance Co. case, because it will be found that the special deduction will not be the same for companies having tax exempts and companies having no tax exempts even if their total investment income is the same. The principle applied is that, as long as tax-exempt interest is not included in income, the reserves upon which the special deduction is computed should not include the value of tax-exempt securities. There is no attempt made by the method to tax tax-exempt interest.

Capital gain and losses should be included in the computation of net income under this method.

Method No. 2, above described, which contemplates the treatment of tax-exempt interest in a way which appears constitutional and which allows a special deduction of the actual amount of interest required to maintain the reserve instead of the present arbitrary 4 per cent of the mean reserves, may be objected to on account of the different requirements for the legal reserves in the different States. While some inequality will result in the Federal tax imposed, it is believed this inequality will be less than in the present method.

This method seems to have the advantage of disturbing the existing law as little as possible and still of arriving at a tax approximating that which could be considered fair.

#### METHOD NO. 3

Method No. 3 which might be used in providing for the tax on life-insurance companies is the same as Method No. 2 except that instead of basing the special deduction on the actual amount of interest required to maintain the reserve for the taxable year, 4 per cent of the mean of the reserve funds held at the beginning and end of the year is used as a basis as in the present law. Tax-exempt securities and capital gains and losses, however, are treated as in Method No. 2.

#### COMPARISON OF THE THREE METHODS

In making a comparison of the above methods it seems proper to first set forth the taxes which it is believed would result from the application of these three methods to the taxable year 1927, including also, for comparative purposes, the taxes which have finally resulted under the Supreme Court decision and the taxes which were imposed by the revenue act of 1926, as written.

The table follows:

#### *Tax under 1927 conditions*

Total tax under revenue act of 1926 as written.....	\$17, 448, 100
Total tax under revenue act of 1926, as modified by Supreme Court.....	13, 463, 400
Total tax under Method No. 1.....	26, 605, 000
Total tax under Method No. 2.....	25, 130, 000
Total tax under Method No. 3.....	18, 070, 000

It will be seen from the above figures for the year 1927 that Methods Nos. 1 and 2 both give results which meet the requirement

of a fair tax upon life-insurance companies. It will be remembered that the fair maximum tax was estimated to be approximately \$29,500,000 and the fair minimum tax \$24,300,000.

It will also be observed that Method No. 3 is considerably below what was considered to be a fair minimum tax. The reason for this is that Method No. 3 allows an arbitrary 4 per cent of the mean reserves to be allowed as a deduction. This amounts, in 1927, to about \$60,000,000 more than the actual amount of interest required to be added to the reserve funds. It results that the tax under this method is reduced about \$7,500,000 on account of the arbitrary allowance being greater than the actual allowance which should theoretically be permitted.

When this arbitrary 4 per cent allowance was given in place of the actual amount of interest necessary to maintain the reserve, it was really done as a trade. On account of this excess deduction, the insurance companies agreed to the method which really brought about a tax on tax-exempt interest. The Supreme Court, however, having upset this arrangement, it seems distinctly proper to return to an actual instead of an arbitrary basis, if such a method as is now included in our revenue act is still to be employed.

It is concluded, then, as Method No. 3 can not properly be used, the choice will lie between Methods Nos. 1 and 2. It will be observed that the tax found under these two methods varies only about 5 per cent. It is the opinion of the writer, therefore, in view of the much greater simplicity of Method No. 1, that this latter method should be used.

*British tax system on life-insurance companies.*—An investigation has been made as to the method employed by Great Britain in taxing life-insurance companies. A summary of this investigation will be found in Appendix VII, attached.

It does not appear that the methods employed in Great Britain can be advantageously used by this country, and therefore we shall not go into a further discussion of this system here. It is of interest to point out that for the year 1924 the percentage of income tax to investment income in Great Britain was 14 per cent, while in the United States the percentage of income tax to investment income was less than 2 per cent. If the State and local taxes are added to the Federal tax, it will be found the total tax in the United States is about 10 per cent of the investment income.

## CONCLUSION

In concluding this report, it will not be out of place to review the principal facts and arguments already presented.

First, as regards our present system of taxation of life-insurance companies, it is believed that this system, as now applied under the interpretation of the Supreme Court of the United States, gives us a tax which is entirely inadequate. It has already been shown that this tax is less than the tax which would be paid even if the principles of the revenue act of 1918 were now in force, and it was generally admitted that the provisions of the 1918 act did not return a fair tax from the insurance companies. Moreover, while there may be justification for a special deduction on account of the interest which is

legally set aside each year in the reserve fund for the benefit of the policyholder, there appears to be no reason why this special deduction should be allowed at an arbitrary rate of 4 per cent, which gives the companies a reduction of at least \$60,000,000 from taxable income more than they actually set aside for the policyholders. It is also believed that to allow a deduction on the basis of the total amount of the reserves, which reserves include large amounts of tax-exempt securities, is not equitable as between the different insurance companies. It might be noted that in the computation of invested capital in some of our former revenue acts investments in tax-exempt securities were specifically eliminated from the computation of invested capital for a reason similar to that just outlined.

Second, it appears that in no case should the tax on life-insurance companies be less than the amount resulting from the application of the regular corporation rate to the annual increase in surplus and to the dividends to stockholders. It can easily be seen that the surplus of the companies is not directly, at least, set up for the benefit of the policy holders, for their interests are represented by the regular legal reserve. If we take the point of view that all the earnings of the life-insurance companies which go directly to the benefit of the policyholder should be entirely exempted from tax in order to encourage this form of saving and protection among our citizens, it must be admitted that any earnings remaining after the exemption of such an enormous amount should be taxed in full. Under 1927 conditions, we have found this minimum tax to be \$24,300,000.

Third, there appears to be no good reason why insurance companies should not be treated the same as other companies in regard to capital gains and losses. On account of the great majority of insurance investments being in bonds and mortgages and not in the stock of corporations it results that capital gains and losses are relatively small in comparison to the size of the capital invested. The only effective argument which has been made against the inclusion of capital gains and losses in the computation of the taxable income of insurance companies is that such companies will be able to take losses and delay taking gains, thus really effecting a reduction in tax. It does not appear that this argument has great weight. It is true that some tax evasion might occur from this cause in a given taxable year, yet it is well known that through the taking of losses the basis of the property sold will be reduced and it does not appear that in the long run any benefit would accrue. Most of our insurance companies are in too sound a financial position to manipulate their investments for the purpose of taxes when they realize that over a series of years there will be no beneficial result.

Fourth, it is believed for the reasons stated in detail in this report that insurance companies should be taxed on their net investment income, made up of interest, dividends, and rents, plus capital gains and minus capital losses as the case may be, at a rate equal to one-third the standard rate in force on ordinary corporations for the same taxable year. It also appears, inasmuch as this method might produce a tax on an insurance company which suffered a loss in relation to its whole business in a year of war or epidemic, that life-insurance companies should be allowed the option of reporting on the

cash receipts and disbursements basis as in the case of an ordinary corporation. This would relieve life-insurance companies from tax in especially bad or unusual years, and it is believed that this relief is proper under our income-tax theory of taxing when the taxpayer is able to pay. This method, although open to the objection of being arbitrary, is extremely simple and would seem sufficiently liberal as it returns a tax only slightly greater than the minimum tax already noted.

Finally, it may be said that a tax upon the increase in surplus plus dividends to stockholders at the regular corporation rate would have been recommended except for the fact that it seems difficult to properly define surplus in such a way as to avoid controversy. If it can be shown that surplus can be properly defined there would seem to be no objection to taxing life-insurance companies on this basis which would practically exempt all policyholders from any tax being collected at the source on their account from the insurance company. In view of the fact that 65,000,000 of the inhabitants of the United States are affected to some extent, although it may be small, on account of the taxation of life-insurance companies, the careful examination and analysis of this report is requested.

Respectfully submitted.

L. H. PARKER.

NOVEMBER 26, 1928.

## APPENDIX I

### SUPPLEMENT G—INSURANCE COMPANIES

(Revenue act of 1928)

#### SEC. 201. TAX ON LIFE-INSURANCE COMPANIES.

(a) *Definition.*—When used in this title the term “life-insurance company” means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per cent of its total reserve funds.

(b) *Rate of tax.*—In lieu of the tax imposed by section 13, there shall be levied, collected, and paid for each taxable year upon the net income of every life-insurance company a tax as follows:

(1) In the case of a domestic life-insurance company, 12 per cent of its net income:

(2) In the case of a foreign life-insurance company, 12 per cent of its net income from sources within the United States.

#### SEC. 202. GROSS INCOME OF LIFE-INSURANCE COMPANIES.

(a) In the case of a life insurance company the term “gross income” means the gross amount of income received during the taxable year from interest, dividends, and rents.

(b) The term “reserve funds required by law” includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

#### SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General rule.*—In the case of a life insurance company the term “net income” means the gross income less—

(1) *Tax-free interest.*—The amount of interest received during the taxable year which under section 22 (b) is exempt from taxation under this title:

(2) *Reserve funds.*—An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subsection, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of

the taxable year, as the commissioner finds to be necessary for the protection of the holders of such policies only;

(3) *Dividends*.—The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 251, and other than a corporation organized under the China trade act, 1922, or (B) from any foreign corporation when it is shown to the satisfaction of the commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 119:

(4) *Reserve for dividends*.—An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;

(5) *Investment expenses*.—Investment expenses paid during the taxable year: *Provided*, That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

(6) *Real-estate expenses*.—Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed and not including any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder of a company upon his interest as shareholder, which are paid by the company without reimbursement from the shareholder, but in such case no deduction shall be allowed the shareholder for the amount of such taxes;

(7) *Depreciation*.—A reasonable allowance for the exhaustion, wear, and tear of property, including a reasonable allowance for obsolescence;

(8) *Interest*.—All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer), the interest upon which is wholly exempt from taxation under the title; and

(9) *Specific exemption*.—In the case of a domestic life-insurance company, the net income of which (computed without the benefit of this paragraph) is \$25,000 or less, the sum of \$3,000; but if the net income is more than \$25,000 the tax im-

posed by section 201 shall not exceed the tax which would be payable if the \$3,000 credit were allowed, plus the amount of the net income in excess of \$25,000.

(b) *Rental value of real estate.*—No deduction shall be made under subsection (a) (6) and (7) of this section on account of any real estate owned and occupied in whole or in part by a life-insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which, in addition to any rents received from other tenants, shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied.

(c) *Foreign life-insurance companies.*—In the case of a foreign life-insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.

## APPENDIX II

*Comparison of aggregate financial statement of 10 large life-insurance companies with aggregate financial statement of 322 legal reserve life-insurance companies*

[Basis, Insurance Year Book of the Spectator Co.]

As of Dec. 31, 1926	Aggregate of 10 companies	Aggregate of 322 companies	Per cent aggregate 10 com- panies to total aggregate
Capital stock.....	\$17,000,000	\$128,050,064	13.27605
INCOME			
New premiums.....	204,219,464	347,245,161	58.81132
Renewal premiums.....	1,547,086,284	2,229,653,709	69.38685
Received for annuities.....	30,840,851	47,115,098	65.45853
Total premium income.....	1,782,146,599	2,624,013,968	67.91681
Dividends, interest, etc.....	401,624,233	582,848,685	68.90711
Received for rents.....	12,804,786	24,228,397	52.85032
All other receipts.....	53,761,546	99,267,019	54.19127
Total interest and other income.....	468,190,565	706,284,101	66.28926
Total income.....	2,250,337,164	3,330,298,069	67.57104
EXPENDITURES			
Paid for death losses.....	382,146,237	569,077,143	67.15192
Paid for matured endowments.....	68,981,432	98,868,875	69.77062
Annuities paid, disability and double indemnity.....	58,155,501	66,488,244	87.46734
Paid for surrendered, lapsed, and purchased policies.....	173,922,681	269,327,254	64.57671
Dividends to policyholders.....	272,463,917	359,439,828	75.80237
Total payments to policyholders.....	955,669,768	1,373,201,344	69.59425

*Comparison of aggregate financial statement of 10 large life-insurance companies with aggregate financial statement of 322 legal reserve life-insurance companies—Continued*

As of Dec. 31, 1926	Aggregate of 10 companies	Aggregate of 322 companies	Per cent aggregate 10 com- panies to total aggregate
EXPENDITURES—continued			
Dividends to stockholders.....	\$1,900,000	\$13,204,727	14.38878
Commissions, salaries, and travel expenses of agents.....	269,862,653	427,675,148	63.09991
Medical fees, salaries, and other charges to employees.....	55,870,062	104,980,859	53.21928
All other expenditures.....	128,623,043	204,709,962	62.83184
Total expenses, etc.....	454,355,758	750,570,696	60.53470
Total expenditures.....	1,411,925,526	2,123,772,040	66.48197
Excess of income over expenditures.....	838,411,638	1,206,526,029	69.48972
ASSETS			
Real estate owned.....	123,570,395	303,417,616	40.72617
Real estate mortgages.....	3,712,356,574	5,564,257,488	66.71791
Bonds owned.....	3,631,403,694	4,592,911,802	79.06552
Stocks owned.....	33,062,541	89,395,494	36.98457
Collateral loans.....	6,326,118	25,514,071	24.79462
Premium notes and loans.....	1,003,705,031	1,599,389,667	62.75555
Cash in office and banks.....	50,123,236	116,682,897	42.95679
Net deferred and unpaid premiums.....	181,772,423	283,992,819	64.00599
All other assets.....	232,132,307	364,244,955	63.72972
Total admitted assets.....	8,974,458,319	12,939,806,809	69.35542
Items not admitted.....	68,747,179	114,296,817	60.14793
LIABILITIES			
Reserve.....	7,766,405,655	11,061,458,998	70.21140
Losses and claims not paid.....	54,493,505	75,213,187	72.45206
Claims resisted.....	3,824,704	6,730,296	56.82816
Dividends unpaid and to accumulate.....	90,744,023	159,230,859	56.98896
Surplus apportioned.....	464,724,468	601,385,739	77.27565
All other liabilities.....	163,513,621	273,343,552	59.81982
Total liabilities.....	8,543,705,976	12,177,362,631	70.16056
Surplus unapportioned including capital.....	430,752,343	762,482,866	56.49338
Total surplus funds.....	895,476,811	1,363,868,605	65.65711
Increase in reserve for year.....	799,033,060	1,134,943,512	70.40289
Increase in total surplus for year.....	89,407,695	129,935,585	68.80924
Percentage dividends to stockholders to capital stocks.....	11.18	10.31	-----
POLICY ACCOUNTS			
New business written and paid for:			
Ordinary.....	5,946,026,756	11,014,741,923	53.982
Group.....	931,502,611	1,367,879,181	68.098
Total.....	6,877,529,367	12,382,621,104	55.541
Industrial.....	2,764,449,540	3,953,972,274	69.915
Total.....	9,641,978,907	16,336,593,378	59.020
Insurance in force:			
Ordinary—			
Whole life.....	27,284,668,147	40,269,513,970	67.755
Endowment.....	5,518,221,844	10,512,312,616	52.492
All other.....	2,654,045,605	8,249,508,112	34.836
Reversionary additions.....	219,788,171		
Total.....	35,676,723,767	59,031,334,698	60.436
Group.....	3,895,031,549	5,425,987,646	71.784
Total.....	39,571,755,316	64,457,322,344	61.392
Industrial.....	12,123,821,597	14,034,819,943	86.383
Total.....	51,695,576,913	78,491,142,287	65.861

### APPENDIX III

*Analysis of actual returns of 10 large life insurance companies, with computation of estimated totals for all legal reserve companies based on estimate factors from Insurance Yearbook of the Spectator Co.*

Item	On basis of actual income tax returns			Estimate factors based on Yearbook data		
	1	2	3	4	5	6
	1923					
1	Interest and dividends.....	\$301,063,653	Estimated totals for all legal reserve companies.....	\$302,494,203	Aggregate for all legal reserve companies.....	Percent, Col. 4 Col. 5
2	Rents.....	6,900,437		11,230,757	\$436,308,680 19,777,154	69.33031 56.78651
3	Total income for tax purposes.....	307,964,090	446,398,000			
4	Interest exempt from taxation.....	29,158,053	42,057,000			
5	Excess of 4 per cent of the mean reserve, over tax-exempt interest.....	192,828,525	272,626,000			
6	2 per cent of the reserve for deferred dividends.....	1,147,554	70,730	Reserve.....	8,129,711,473	70.72961
7	Dividends deductible.....	1,558,402	69,330			
8	Investment and real estate expenses, taxes, depreciation, and interest.....	15,880,238	63,109	Miscellaneous expenses.....	133,637,609	63.10861
9	Total deductions.....	240,572,772	343,716,000			
10	Net income (item 3 less item 9).....	67,391,318	102,682,000			
11	Income tax at 12½ per cent.....	8,423,914	12,835,300			
	1924					
1	Interest and dividends.....	328,542,583	475,887,000	Interest and dividends.....	476,539,949	69.03778
2	Rents.....	7,328,908	13,254,000	Rents.....	11,351,759	55.26351
3	Total income for tax purposes.....	335,871,491	489,141,000			
4	Interest exempt from taxation.....	27,277,457	39,511,000			
5	Excess of 4 per cent of the mean reserve over tax-exempt interest.....	214,298,194	305,020,000	Reserve.....	8,938,652,988	70.25700

Analysis of actual returns of 10 large life insurance companies, with computation of estimated totals for all legal reserve companies based on estimate factors from Insurance Yearbook of the Spectator Co.—Continued

Item	On basis of actual income tax returns			Estimate factors based on Yearbook data		
	1 Aggregate for 10 companies	2 Estimated per cent 10 companies to all companies	3 Estimated totals for all legal reserve companies	4 Aggregate for 10 companies	5 Aggregate for all legal reserve companies	6 Per cent, Col. 4 Col. 5
	1924					
6	\$669, 102	70.257	\$952, 000			
7	1, 466, 153	69.038	2, 124, 000			
8	17, 818, 257	62.292	28, 604, 000	\$92, 979, 299	\$149, 263, 941	62.29186
9	261, 529, 163		376, 211, 000			
10	74, 342, 328		112, 930, 000			
11	9, 292, 791		14, 116, 300			
	1925					
1	361, 143, 181	68.565	526, 717, 000	361, 734, 183	527, 577, 319	68.56515
2	7, 086, 293	54.042	13, 113, 000	12, 496, 955	23, 124, 723	54.04153
	Total income for tax purposes					
4	308, 229, 474		539, 830, 000			
5	28, 230, 775	68.565	41, 291, 000			
6	239, 068, 533	70.190	340, 602, 000			
7	364, 188	70.190	519, 000			
8	1, 498, 387	68.565	2, 185, 000			
9	20, 758, 352	60.962	34, 031, 000			
	Total deductions					
10	289, 980, 235		418, 618, 000			
11	78, 249, 239		121, 212, 000			
	9, 781, 153		15, 151, 500			
				Interest and dividends		
				Rents		
				Reserve	6, 967, 372, 695	70.18961
				Miscellaneous expenses	107, 915, 970	60.96228

1926		1927	
1	Interest and dividends	400,701,071	68,907
2	Rents	7,160,511	52,850
3	Total income for tax purposes	407,861,582	595,059,000
4	Interest exempt from taxation	25,204,106	30,577,000
5	Excess of 4 per cent of the mean reserve over tax-exempt interest	271,558,934	386,775,000
6	2 per cent of the reserve for deferred dividends	469,584	669,000
7	Dividends deductible	1,334,170	1,936,000
8	Investment and real-estate expenses, taxes, depreciation and interest	20,368,106	33,097,000
9	Total deductions	318,934,900	459,054,000
10	Net income (item 3 less item 9)	88,926,682	136,005,000
11	Income tax at 12½ per cent	11,115,835	17,000,600
1927			
1	Interest and dividends	441,000,399	68,913
2	Rents	9,247,691	51,903
3	Total income for tax purposes	450,248,090	657,755,000
4	Interest exempt from taxation	21,967,794	31,878,000
5	Excess of 4 per cent of the mean reserve over tax-exempt interest	310,362,110	442,382,000
6	2 per cent of the reserve for deferred dividends	506,064	722,000
7	Dividends deductible	1,270,190	1,852,000
8	Investment and real-estate expenses, taxes, depreciation, and interest	24,839,287	41,336,000
9	Total deductions	358,952,045	513,170,000
10	Net income (item 3 less item 9)	91,296,045	139,585,000
11	Income tax at 12½ per cent	11,412,006	17,448,100

Interest and dividends	401,624,233	582,848,685	68,90711
Rents	12,804,786	24,228,397	52,85032
Reserve	7,766,395,665	11,064,458,998	70,21131
Miscellaneous expenses	121,777,036	197,881,955	61,54024
Interest and dividends	442,099,084	641,531,864	68,91303
Rents	14,140,008	27,243,128	51,90302
Reserve	8,623,083,459	12,291,019,833	70,15701
Miscellaneous expenses	130,242,740	216,743,715	60,03066

## APPENDIX IV

Table of basic data relating to income, deductions, and actual and theoretical Federal tax for all legal reserve life-insurance companies in the United States (figures are actual or closely approximate)

PART I.—DATA FOR ALL YEARS, BASED ON THE THEORY THAT THE 1928 REVENUE ACT, AS WRITTEN, WAS IN EFFECT FOR ALL YEARS

Item	1928 (estimated)	1927	1926	1925	1924	1923
ACTUAL OR CONSTRUCTED						
Income:						
1	\$701,000,000	\$639,938,000	\$581,510,000	\$526,717,000	\$475,887,000	\$434,247,000
2	18,000,000	17,817,000	13,549,000	13,113,000	13,254,000	12,151,000
3	719,000,000	657,755,000	595,059,000	539,830,000	489,141,000	446,398,000
Deductions:						
4	30,000,000	31,878,000	36,577,000	41,261,000	39,511,000	42,057,000
5	1,800,000	1,852,000	1,936,000	2,185,000	2,124,000	2,248,000
6	44,000,000	41,336,000	33,097,000	34,051,000	28,604,000	25,163,000
7	501,000,000	442,382,000	386,775,000	340,602,000	305,020,000	272,626,000
8	750,000	722,000	669,000	519,000	952,000	1,622,000
9	577,550,000	518,170,000	459,054,000	418,618,000	376,211,000	343,716,000
10	141,450,000	139,585,000	136,005,000	121,212,000	112,930,000	102,682,000
11	117,651,300	17,448,100	17,000,600	15,151,500	14,116,300	12,835,300
Estimate factors:						
a	\$641,531,864	\$582,848,685	\$527,577,319	\$476,539,949	\$436,308,080	
b	99,752	99,770	99,837	99,863	99,527	
c	\$27,243,128	\$24,228,397	\$24,228,397	\$23,124,723	\$21,434,264	\$19,777,154
d	65,400	55,923	56,705	61,836	61,440	
e	4,289	6,290	7,834	8,303	8,303	9,685
f	0,289	0,333	0,415	0,446	0,446	0,518
g	\$435,172,177	\$383,182,490	\$336,042,359	\$301,856,289	\$269,522,208	
h	101,657	100,938	101,357	101,357	101,048	101,152
i	\$216,743,715	\$197,881,955	\$177,020,872	\$149,263,941	\$133,657,069	
j	19,071	16,726	19,236	19,163	19,163	18,826
k	0,163	0,173	0,152	0,152	0,312	0,595
l	2,500	2,807	2,876	2,876	2,886	2,875

Item	1922	1921	1920	1919	1918	1917
ACTUAL OR CONSTRUCTED						
Income:						
1	\$394,017,000	\$555,984,000	\$323,559,000	\$300,059,000	\$278,406,000	\$258,954,000
2	13,032,000	10,718,000	9,830,000	8,892,000	8,504,000	7,559,000
3	407,049,000	364,702,000	353,389,000	308,951,000	286,910,000	266,513,000
Deductions:						
4	39,402,000	35,398,000	32,356,000	30,006,000	25,057,000	20,717,000
5	1,970,000	1,770,000	1,618,000	1,500,000	1,392,000	1,295,000
6	23,511,000	20,937,000	20,275,000	16,601,000	14,335,000	12,373,000
7	250,697,000	232,251,000	213,601,000	197,139,000	186,005,000	175,993,000
8	1,504,000	1,394,000	1,282,000	1,183,000	1,116,000	1,053,000
9	317,084,000	291,750,000	269,135,000	246,429,000	228,105,000	211,437,000
10	89,965,000	72,952,000	64,254,000	62,522,000	58,805,000	55,076,000
11	11,245,600	9,119,000	8,031,800	7,815,300	7,350,000	6,884,500
Estimate factors:						
a	\$395,004,228	\$354,871,020	\$324,369,685	\$300,810,527	\$279,103,334	\$259,603,260
b			799,75			
c			\$16,312,272	\$14,756,727	\$14,111,813	\$12,543,213
d	\$21,026,780	\$17,786,493	760,26			
e		10,0	10,0	10,0	9,0	8,0
f		0,5	0,5	0,5	0,5	0,5
g	\$247,650,553	\$229,428,978	\$211,005,837	\$194,743,630	\$183,745,321	\$173,857,415
h		7,101,23				
i		\$112,540,023	\$108,996,015	\$89,231,736	\$78,127,566	\$66,506,214
j	\$126,377,744		718,604			
k						
l	0,6	0,6	0,6	0,6	0,6	0,6

7 5-year average.

4 \$7,056,600 at 12 per cent.

3 6,125,400 at 10 per cent.

1 \$16,974,000 at 12 per cent.

6 \$3,304,600 at 6 per cent.

4 \$6,252,200 at 10 per cent.

2 \$7,295,200 at 10 per cent.

Table of basic data relating to income, deductions, and actual and theoretical Federal tax for all legal reserve life-insurance companies in the United States (figures are actual or closely approximate)—Continued

PART II.—DATA FOR ALL YEARS, BASED ON THE THEORY THAT THE 1926 ACT, AS MODIFIED BY UNITED STATES SUPREME COURT, WAS IN EFFECT FOR ALL YEARS

Item	1928 (estimated)	1927	1926	1925	1924	1923
ACTUAL OR CONSTRUCTED						
1	Gross income from interest, dividends, and rents (returns).....	\$719,000,000	\$657,755,000	\$595,059,000	\$539,830,000	\$489,141,000
2	Tax-exempt interest (subtract).....	30,000,000	31,878,000	36,577,000	41,261,000	39,511,000
3	Gross income for income-tax purposes.....	689,000,000	625,877,000	558,482,000	498,569,000	449,630,000
4	Deductions:					
5	Domestic dividends.....	1,800,000	1,852,000	1,936,000	2,185,000	2,248,000
6	Investment and real estate expenses.....	44,000,000	41,336,000	33,007,000	34,051,000	28,604,000
7	4 per cent of mean reserves.....	531,000,000	474,260,000	423,352,000	381,863,000	314,883,000
8	2 per cent of reserves for deferred dividends.....	750,000	722,000	664,000	519,000	952,000
9	Total deductions.....	577,550,000	518,170,000	453,054,000	418,618,000	376,211,000
10	Net income.....	111,450,000	107,707,000	99,428,000	79,951,000	60,625,000
11	Federal tax at 12½ per cent.....	\$13,931,300	13,463,400	12,428,500	9,993,900	7,378,100
ACTUAL OR CONSTRUCTED						
1	Gross income from interest, dividends, and rents (returns).....	\$407,049,000	\$364,702,000	\$333,389,000	\$308,951,000	\$286,910,000
2	Tax-exempt interest (subtract).....	39,402,000	35,398,000	32,356,000	30,006,000	20,717,000
3	Gross income for income-tax purposes.....	367,647,000	329,304,000	301,033,000	278,945,000	261,853,000
4	Deductions:					
5	Domestic dividends.....	1,970,000	1,770,000	1,618,000	1,500,000	1,295,000
6	Investment and real estate expenses.....	23,511,000	20,937,000	20,278,000	16,601,000	12,873,000
7	4 per cent of mean reserves.....	290,099,000	267,649,000	245,957,000	227,145,000	211,062,000
8	2 per cent of reserves for deferred dividends.....	1,904,000	1,894,000	1,282,000	1,183,000	1,116,000
9	Total deductions.....	317,084,000	291,750,000	269,135,000	246,429,000	228,105,000
10	Net income.....	50,563,000	37,554,000	31,898,000	32,516,000	34,359,000
11	Federal tax at 12½ per cent.....	6,320,400	4,694,300	3,987,300	4,064,500	4,294,900

PART III. THEORETICAL TAX FOR ALL YEARS, BASED ON THE PRINCIPLES OF THE 1926 REVENUE ACT AS APPLIED IN GENERAL.

Item	1923 (estimated)	1927	1926	1925	1924	1923
ACTUAL OR CONSTRUCTED						
1	\$719,000,000	\$657,755,000	\$595,059,000	\$539,830,000	\$489,141,000	\$446,308,000
2	10,000,000	8,523,000	7,326,000	6,379,000	5,455,000	4,700,000
3	31,800,000	33,736,000	38,513,000	43,146,000	41,655,000	44,305,000
4	697,200,000	632,548,000	563,872,000	502,963,000	450,991,000	390,893,000
5	44,000,000	41,336,000	33,697,000	34,051,000	28,604,000	25,163,000
6	653,200,000	591,212,000	530,775,000	468,912,000	422,357,000	365,730,000
7	\$88,182,000	\$79,814,000	\$71,655,000	\$63,303,000	\$57,018,000	\$49,374,000
8	12	13½	13½	13	12½	12½
9	\$78,384,000	\$79,814,000	\$71,655,000	\$60,959,000	\$52,795,000	\$45,716,000
ACTUAL OR CONSTRUCTED						
1	\$407,049,000	\$364,702,000	\$333,389,000	\$308,951,000	\$286,910,000	\$266,513,000
2	3,800,000	3,900,000	3,974,000	2,003,000	1,500,000	1,000,000
3	41,872,000	37,168,000	33,970,000	31,556,000	26,419,000	22,012,000
4	361,877,000	318,634,000	294,415,000	275,445,000	261,961,000	245,501,000
5	23,511,000	20,937,000	20,278,000	16,601,000	14,535,000	12,373,000
6	338,366,000	297,687,000	274,137,000	258,844,000	247,426,000	233,128,000
7	\$45,579,000	\$40,189,000	\$37,008,000	\$34,944,000	\$33,403,000	\$31,472,000
8	12½	10+	10+	10+	12+	0+
9	\$42,296,000	\$29,770,000	\$27,414,000	\$25,884,000	\$29,691,000	\$13,988,000

8 \$13,374,000, at 12 per cent.  
 9 \$3,755,400, at 10 per cent.

10 \$3,180,800, at 10 per cent.  
 11 \$3,251,600, at 10 per cent.

12 \$4,049,800, at 12 per cent.  
 13 \$2,061,540, at 6 per cent.

Table of basic data relating to income, deductions, and actual and theoretical Federal tax for all legal reserve life-insurance companies in the United States (figures are actual or closely approximate)—Continued

PART IV. DATA FOR ALL YEARS, BASED ON THE THEORY THAT THE REVENUE ACT OF 1928 WAS IN EFFECT FOR ALL YEARS

Item	1928 (estimated)											1923
	ACTUAL OR CONSTRUCTED											
	1927	1926	1925	1924	1923	1922	1921	1920	1919	1918	1917	
1	\$1,570,000,000	\$1,378,028,000	\$1,081,379,000	\$889,385,000	\$761,266,000	\$655,222,000	\$662,385,000	\$565,846,000	\$453,843,000	\$325,727,000	\$403,720,000	
2	19,000,000	18,259,000	14,500,000	11,748,000	12,294,000	10,735,000	6,025,000	5,308,000	4,203,000	5,021,000	3,752,000	
3	17,448,000	17,001,000	14,116,000	12,835,000	11,246,000	7,295,000	2,212,000	312,000	1,621,000	3,000,000	1,143,000	
4	1,606,448,000	1,413,288,000	1,109,995,000	913,968,000	784,776,000	673,252,000	670,622,000	571,466,000	459,667,000	333,748,000	408,617,000	
5	31,800,000	33,730,000	43,446,000	41,635,000	44,305,000	41,372,000	37,168,000	33,974,000	31,505,000	26,449,000	22,012,000	
6	1,380,000,000	1,229,591,000	987,862,000	808,942,000	680,463,000	545,870,000	565,403,000	507,849,000	422,762,000	374,604,000	336,792,000	
7	1,411,800,000	1,263,321,000	1,031,308,000	850,577,000	724,768,000	673,252,000	602,577,000	541,823,000	454,268,000	401,053,000	358,804,000	
8	194,648,000	149,957,000	78,687,000	63,391,000	60,008,000	86,010,000	68,045,000	29,643,000	5,399,000	14,67,305,000	49,813,000	
9	\$24,331,000	\$18,746,000	\$9,836,000	\$7,924,000	\$7,501,000	\$10,751,000	\$8,506,000	\$3,705,000	\$675,000	None.	\$6,227,000	
10	12	13½	13	12½	12½	12½	10	10	10	12	6	
11	\$23,358,000	\$20,246,000	\$10,229,000	\$7,924,000	\$7,501,000	\$10,751,000	\$6,805,000	\$2,944,000	\$540,000	None.	\$2,989,000	
Item	ACTUAL OR CONSTRUCTED											
1	Excess of income over expenditures (Yearbook)											
2	Add dividends to stockholders											
3	Add Federal tax for prior year											
4	Total											
5	Subtract tax-exempt interest and domestic dividend											
6	Subtract addition to reserve											
7	Deductions											
8	Net income											
9	Federal tax (at 12½ per cent)											
10	Standard corporation rate, in force											
11	Federal tax at standard rate											

<sup>14</sup> Deficit.

NOTE.—The revenue acts of 1926, 1924, and 1921 were practically identical in regard to life insurance companies (except the rate in 1921 was 10 per cent); hence above figures are actual for 1922 to 1927, and theoretical from 1917 to 1921. The data are from tax returns for 5 years 1923 to 1927, and have been reduced to tax return basis for 1917 to 1922 by use of estimate factors, shown below. The revenue act of 1928 is the same for life insurance companies as the 1926 act except as to the rate, which is 12 per cent. The figures for 1928 are entirely estimated.

## APPENDIX V

SUPREME COURT OF THE UNITED STATES. No. 228. October term, 1927. National Life Insurance Co., petitioner, *v.* The United States. On writ of certiorari to the Court of Claims. (June 4, 1928.)

Mr. Justice McReynolds delivered the opinion of the court.

In 1921, departing from previous plans, Congress laid a tax on life-insurance companies based upon the sum of all interest and dividends and rents received, less certain specified deductions—(1) interest derived from tax-exempt securities, if any; (2) a sum equal to 4 per cent of the company's legal reserve diminished by the amount of the interest described in paragraph (1); (3) other miscellaneous items—seven—not presently important.

Petitioner maintains that, acting under this plan, the collector illegally required it to pay taxes, for the year 1921, on Federal, State, and municipal bonds; and it seeks to recover the amount so exacted. The Court of Claims gave judgment for the United States.

The revenue act of 1921, approved November 23, 1921, (ch. 136, Title II, Income Tax (42 Stat. 237, 238, 252, 261)) provides:

SEC. 213. That for the purposes of this title (except as otherwise provided in sec. 233) (the exceptions not here important) the term "gross income"—

(a) Includes gains, profits, and income \* \* \*

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) (2) and (3) (not here important).

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal farm loan act of July 17, 1916; or (c) the obligations of the United States or its possessions; \* \* \*

SEC. 230. That, in lieu of the tax imposed by section 230 of the revenue act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

SEC. 243. That in lieu of the taxes imposed by sections 230 (general corporation tax) and 1000 (special taxes on capital stock) and by Title III (war profits and excess profits taxes) there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life-insurance company a tax as follows:

(1) In the case of a domestic life-insurance company, the same percentage of its net income as is imposed upon other corporations by section 230 (ten per cent for 1921, twelve and one-half thereafter);

(2) In the case of a foreign life-insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

SEC. 244. (a) That in the case of a life-insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

(b) The term "reserve funds required by law" includes \* \* \*

SEC. 245. (a) That in the case of a life-insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title; (interest on tax-exempt securities).

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (certain other sums not here important) \* \* \*

(3), (4), (5), (6), (7), (8), and (9) grant other exemptions not now important.

The mean of petitioner's reserve funds for 1921 was \$67,381,877.92. Four per cent of this is \$2,695,279.12.

During 1921 interest derived from all sources amounted to \$3,-811,132.78; from dividends, nothing; from rents \$13,460. Total, \$3,824,592.78; \$1,125,788.26 of this interest came from tax-exempt securities, \$873,075.66 from State and municipal obligations, and \$252,712.60 from those of the United States.

The collector treated interest plus dividends plus rents, \$3,824,-592.78, as gross income, and allowed deductions amounting to \$2,-899,690.79, made up of the following items: \$1,125,788.26, interest from tax-exempt securities; \$1,569,490.86, the difference between 4 per cent of the reserve fund (\$2,695,279.12) and (\$1,125,788.26) interest received from exempt securities; miscellaneous items, not contested and negligible here, \$204,411.67. After deducting these from total receipts (\$3,824,592.78 - \$2,899,690.79), there remained a balance of \$924,901.99. This he regarded as net income and upon it exacted 10 per cent, \$92,490.20.

If all interest received by the company had come from taxable securities, then, following the statute there would have been deducted from the gross of \$3,824,592.78—4 per cent of the reserve, \$2,695,-279.12, plus the miscellaneous items \$204,411.67—\$2,899,690.79, and upon the balance of \$924,901.99 the tax would have been \$92,490.20. Thus it becomes apparent that petitioner was accorded no advantage by reason of ownership of tax-exempt securities.

Petitioner maintains that the result of the collector's action was unlawfully to discriminate against it and really to exact payment on account of its exempt securities, contrary to the Constitution and laws of the United States. Also that diminution of the ordinary deduction of 4 per cent of the reserves because of interest received from tax-exempt securities, in effect, defeated the exemption guaranteed to their owners.

The portion of petitioner's income from the three specified sources which Congress had power to tax—its taxable income—was the sum of these items less the interest derived from tax-exempt securities. Because of the receipt of interest from such securities, and to its full extent, pursuing the plan of the statute, the collector diminished the 4 per cent deduction allowable to those holding no such securities. Thus, he required petitioner to pay more upon its taxable income than could have been demanded had this been derived solely from taxable securities. If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted.

The suggestion that as Congress may or may not grant deductions from gross income at pleasure, it can deny to one and give to another is specious, but unsound. The burden from which Federal and State obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowances is the thing really taxed.

*United States v. Ritchie* (1872) (Fed. Cases 16, 168): *Ritchie* was the State's attorney for Frederick County, Md. The Federal statute

allowed an exemption of \$1,000. The collector claimed that if Ritchie's salary was held free from taxation, \$1,000 of it should be applied to the exemption clause. Giles, J., held:

The United States could not apply the compensation of a State officer to the satisfaction of the exemption alone, because that would, indirectly, make his income from such source liable to the taxation from which it is exempt; that to exhaust the exemption clause by taking the amount out of his official income, would be to make it, in effect, subject to the revenue law, and to deny to a State's officer the advantage of the State's exemption, and that therefore the official income of defendant was not to be taken into consideration in the assessment of the tax.

*People, etc. v. Commissioners, etc.* (1870) (41 How. Prac. Reports, 459): Held, that in determining the amount of personal property of an individual, by assessors or commissioners of taxes, for the purposes of taxation, stocks and bonds of the United States are to form no part of the estimate. They can not be excluded or deducted from the amount of his assets, liable to taxation, for it is error to include them in such assets.

*Packard Motor Car Co. v. City of Detroit* (1925) (232 Mich. 245): Held, that tax exempt credits may not be taxed, directly or indirectly, and in levying a tax on property they must be treated as nonexistent. The provision of Act No. 297, Public Acts 1921, providing that if the person to be taxed "shall be the owner of credits that are exempt from taxation such proportion only of his indebtedness shall be deducted from debts due or to become due as is represented by the ratio between taxable credits and total credits owned, whether taxable or not," is void as an interference with the power of the United States Government to raise money by issuance of tax-exempt obligations and is in conflict with the Constitution of the United States. (See also *City of Waco v. Amicable Life Ins. Co.* (1923) Texas —: 248 S. W. 332.)

*Miller, et al., Executors, v. Milwaukee* (272 U. S. 713): Held, that where income from bonds of the United States which by act of Congress is exempt from State taxation is reached purposely, in the case of corporation-owned bonds, by exempting the income therefrom in the hands of the corporations, and taxing only so much of the stockholder's dividends as corresponds to the corporate income not assessed, the tax is invalid.

It is settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves. (*Northwestern Mutual Life Ins. Co. v. Wisconsin*, 275 U. S. — (Nov. 21, 1927).) Also that the United States may not tax State or municipal obligations.

*Metcalf & Eddy v. Mitchell, Admx.* (269 U. S. 514, 521): How far the United States might repudiate their agreement not to tax we need not stop to consider. Counsel do not claim that here State obligations should have more favorable treatment than is accorded to those of the Federal Government. The revenue act of 1921 (sec. 213) expressly disavows any purpose to tax interest upon the latter's obligations.

Section 1403 provides that if any provision of this act, or the application thereof to any person or circumstances, is held invalid, the remainder of the act, and the application of such provision to other persons or circumstances, shall not be affected thereby.

Congress had no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others. It had no purpose to subject obligations of the United States to burdens which could not be imposed upon those of a State.

Considering what has been said, together with the saving clause just quoted and the manifest general purpose of the statute, we think that provision of the act which undertook to abate the 4 per cent deduction by the amount of interest received from tax-exempt securities can not be given effect as against petitioner under the circumstances here disclosed. It was unlawfully required to pay \$92,490.20, and is entitled to recover.

The judgment of the Court of Claims must be reversed. If within 10 days counsel can agree upon a decree for entry here, it may be presented. Otherwise the cause will be remanded to the Court of Claims for further proceedings in conformity with this opinion.

A true copy.

Test:

\_\_\_\_\_  
*Clerk, Supreme Court, United States.*

## APPENDIX VI

NOVEMBER 26, 1928.

Re Taxation of life-insurance companies—capital gains and losses.

MR. L. H. PARKER,

*Chief, Division of Investigation,*

*Joint Committee on Internal Revenue Taxation,*

*Washington, D. C.*

DEAR MR. PARKER: Under the revenue acts prior to that of 1921 capital gains and losses were included in the computation of the taxable income of insurance companies of all classes. The revenue act of 1921, instituting a new system of taxing life companies, both stock and mutual, and stock companies of other classes than life, made no provision for taxing their capital gains or deducting their capital losses. This is likewise true of the revenue acts of 1924 and 1926. The revenue act of 1928 provided for such taxation and deduction in the case of stock companies of other classes than life.

In other words, capital gains and losses have been included in the computation of the taxable income of mutual companies of other classes than life under all the revenue acts; of stock companies other than life, under the revenue act of 1928; and of life companies, both stock and mutual, under the acts prior to the 1921 act. It may be added that life-insurance companies constitute the only class of taxpayers whose capital gains and losses are now disregarded for income-tax purposes.

The policy of including capital gains and losses being subject to this single exception, inquiry naturally suggests itself as to the reason for it. As a matter of taxation policy, it must be conceded

that no reason exists; as a matter of expediency, no reasons have been advanced that appear adequate. It seems proper at the outset to dismiss arguments that are applicable also to other corporations, that is, arguments against the general policy, of which the principal is based on the theory that the taxpayer can in any taxable period select and dispose of such capital assets as will show losses.

As for expediency, it is stated that the inclusion of capital gains in taxable income and of capital losses in deductions would be the preliminary step in a return to the system of taxation in force under the revenue act of 1918 and prior acts. Admitting the undesirability of this, it may well be doubted whether such a step could be so interpreted. On the contrary, the inclusion of capital gains and losses would appear calculated rather to perfect the present system of taxing life companies, the basis of which is the limitation of taxable income to investment income and of deductions to investment deductions. Realized appreciation and depreciation of the principal sum invested are obviously closely related to investment income and deductions. For these reasons, it seems that the burden may fairly be placed upon the advocates of exclusion and that their case is not established.

It remains to consider the effect of inclusion upon the revenue. It may reasonably be expected that both the capital gains and losses of life companies would be small, compared with the capital invested. Life-insurance funds are loaned on tangible security and are not subject to the usual business risks. Conservation of the funds is the primary consideration; yield, secondary; appreciation, remote.

The revenue, therefore, would not be materially affected over a long period, though under present conditions it would be increased. The table below shows the estimated net capital gain or loss for all legal-reserve life companies in the United States for the years 1921 to 1927, inclusive:

*Estimated net capital gain or loss*

1927-----	\$8, 523, 000
1926-----	7, 326, 000
1925-----	6, 579, 000
1924-----	3, 455, 000
1923-----	<sup>1</sup> 11, 200, 000
1922-----	<sup>1</sup> 3, 800, 000
1921-----	<sup>1</sup> 8, 900, 000
Total net gain (7 years)-----	
	1, 983, 000

In conclusion, it should be noted that in the event, which seems not unlikely, that life companies will be permitted to invest in stocks—to assume business risks—to an increasing extent in the future, the question at issue will become of increasing importance, in consideration both of the tax payable for periods of preponderating gains and of the deduction allowable when the situation is reversed.

Yours respectfully,

L. L. STRATTON.

<sup>1</sup> Loss.

## APPENDIX VII

NOVEMBER 26, 1928.

Mr. L. H. PARKER,  
*Chief Division of Investigation,  
Joint Committee on Internal Revenue Taxation,  
Washington, D. C.*

DEAR MR. PARKER: Under your direction there is here presented a review of the procedure of the taxation of life-insurance companies in Great Britain for consideration in connection with the study of the taxation of life-insurance companies in the United States.

It must be remembered that the British do not impose a separate tax on corporations, as is done in the United States, but that the same income tax applies to all "persons" whether real or artificial.

Corporations or companies in general in Great Britain are taxed on their profits for the preceding year, but any business dealing in investments is subject to the optional charge by the Crown of a tax on the interest received from investments. The buying and selling of investments is a necessity of insurance business, and this option on the part of the Crown is therefore held to be applicable to the taxing of insurance companies. Naturally the Crown exercises the option yielding the greater tax which, in the case of purely life-insurance companies, almost invariably is the tax on interest received from investment. Until as late as 1915 the effect of this option was that companies doing a general insurance business (including life insurance) were taxed on profits, while companies engaged in life-insurance business only were taxed on interest receipts, invariably a greater sum. Amendment to the law in 1915 required the companies to report and be taxed on the business of their life-insurance branch independently of the business of their other branches. This provision had the effect of overruling the *Last v. London Assurance* decision of 1885 and was intended to remove the anomaly between life offices and composite offices.

The act of 1918 authorized the deduction of expenses from interest earnings—the Crown, of course, still retaining the option of taxing on profits should such tax be greater—but provided that the amounts of any fines, fees, or profits from reversions should be deducted from the expenses of management, and that losses arising from reversions from any previous year might be deducted from profits.

The expense of conducting industrial insurance business is so much greater than that of ordinary life insurance that it is quite usual for such management expenses to exceed the investment income. Companies having any considerable amount of industrial insurance business, therefore, paid little tax because the tax which would have been payable on their ordinary life business was reduced by the excessive expenses of their industrial department. Accordingly, in 1923, the law was further amended so that separate returns are now made and separate taxes are computed and paid for ordinary life and industrial life insurance even when conducted by the same company.

The net effect is that almost invariably ordinary life insurance branches of a company are taxed on their investment income, less expenses of management, while industrial life branches are usually taxed on their total net profits.

An insurance company in Great Britain conducting a general insurance business would, therefore, file three returns, one on its industrial life-insurance business, one on its ordinary life-insurance business, including annuity, and one on its other lines of insurance, and the Crown, through the board of inland revenue, would assess income tax on each return quite independent of the others, with the option that this tax might be assessed either on the total net profits of that branch of the business or on the receipts from interest, dividends, and rents, less expense, whichever is the greater. However, should an insurance company suffer a loss in its life-insurance business it may set off the loss against the profit from its other business, just as any other person or company conducting more than one business.

For the year 1924 the 89 life-insurance companies of Great Britain, including industrial branches, paid an income tax of approximately \$21,542,645, according to the Annual Reports of Insurance Companies under the assurance companies act of 1909. Of this, ordinary life branches contributed \$19,869,205 and industrial \$1,673,440. The returns from interest, dividends, and rents by ordinary life branches showed \$137,029,000, so that the percentage of income tax to interest, dividends, and rents is 14½, a percentage considerably higher than that in the United States. This is, however, offset, in part, by the taxation of insurance companies by State and local subdivisions in the United States.

The 297 life-insurance companies in the United States for the year 1924, with a capital stock of \$95,381,749, and assets of \$10,394,034,380, wrote \$13,162,445,852 in insurance. The 89 life-insurance companies in Great Britain for the same year, with a capital stock of \$147,158,165 and assets of \$1,406,399,425, wrote \$1,240,515,960 in insurance. It is, therefore, apparent that the volume of life-insurance business in the United States is much greater than that of Great Britain. Notwithstanding this, life-insurance companies in Great Britain paid \$21,542,645 in income tax in 1924 while in the United States for that year the amount of income tax was but \$9,177,000. It is, therefore, quite evident that the rate of tax applicable to insurance companies in Great Britain is considerably higher than in the United States.

It would not seem, however, that the British system of optional taxation by the Crown on total net profits or on investment income, with assessment of separate and independent tax upon the several branches of life insurance and without any further deductions, allowances, or credits, could be adapted to the United States without a complete rearrangement of our system of taxing general corporations in a different manner and at a different rate from individuals.

There are appended hereto certain statistics bearing on the insurance business in Great Britain.

Respectfully submitted.

G. R. SIMCOX.

*Interest, dividends, and rents, and amount of income tax paid on ordinary life insurance for the year 1924 by 25 insurance companies in Great Britain*

Name of company	Interest, dividends, and rents	Income tax paid
Alliance Assurance Co.....	\$4,964,990	\$956,650
Commercial Union Insurance Co.....	2,951,935	396,095
Eagle, Star & British Dominions Insurance Co.....	3,947,155	690,575
Equity Law & Life Assurance Society.....	1,226,950	212,295
Friends Provident & Century Life Office.....	1,582,265	317,820
Guardian Assurance Co.....	1,291,020	231,625
Legal & General Assurance Society.....	3,583,055	591,820
Liverpool & London & Globe Insurance Co.....	1,543,325	279,490
London Life Association.....	2,221,410	367,130
National Provident Institution.....	2,270,190	394,585
North British & Mercantile Insurance Co.....	5,749,720	702,800
Norwich Union Life Insurance Society.....	5,853,380	525,180
Pearl Assurance Co.....	3,885,305	479,530
Phoenix Assurance Co.....	3,331,945	590,205
Prudential Assurance Co.....	18,861,530	2,420,095
Refuge Assurance Co.....	5,309,445	769,500
Royal Exchange Assurance.....	1,807,870	265,100
Royal Insurance Co.....	4,048,815	674,020
Scottish Amicable Life Assurance Society.....	2,167,840	249,700
Scottish Equitable Life Assurance Society.....	1,883,480	343,875
Scottish Provident Institution Mutual Life Association.....	4,639,410	740,635
Scottish Widows Fund & Life Assurance Society.....	6,294,110	972,160
Standard Life Assurance Co.....	3,919,000	392,730
Sun Life Assurance Society.....	3,764,085	348,290
United Kingdom Temperance & General Provident Institution.....	3,268,105	540,765
Total for 25 companies.....	100,366,335	14,552,670
Total for all (89) companies.....	137,029,000	19,869,205
Per cent of tax to investment income.....		14.50
Total for all companies, including industrial insurance.....	\$169,540,255	\$21,542,645

