TAXATION OF LIFE INSURANCE COMPANIES

ILLUSTRATIONS SHOWING WHY TREASURY PROPOSED AMENDMENT STILL RAISES CONSTITUTIONAL QUESTION

PREPARED FOR THE USE OF THE

SENATE COMMITTEE ON FINANCE

BY THE STAFF OF

THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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TAXATION OF LIFE INSURANCE COMPANIES

PART ONE—H.R. 4245

Schedule I. Tax Computation

A. Regular tax

1. Taxable investment income (step 1).
2. Plus one-half of underwriting gain or less *all* of the underwriting loss.
3. Plus withdrawals from policyholders' surplus account.
4. Life insurance company taxable income (1+2+3).
5. Tax, 30 percent of first $25,000 of amount shown on line 4 plus 52 percent of the balance.

B. Capital gains tax

1. Tax, 25 percent of any net long-term capital gains over any net short-term capital gains.

Schedule II. Computation of Tax Base Under the Three Steps

A. Step 1—Computation of taxable investment income

1. Gross investment income (interest, dividends, rents, royalties, and related income, short-term capital gain and noninsurance trade or business income).
2. Less investment expenses (including properly allocable real estate, depreciation and depletion expenses), tax-free and partially tax-free interest, 85 percent dividends received deduction, trade or business expenses (noncapital in nature and excluding those relating to running of insurance business and certain other deductions) and the small-business deduction.
3. Net investment income (1−2).
4. Less policy and other contract liability deduction which includes:
   (*a*) Deduction for investment income deemed allocable to life insurance reserves (see schedule III).
   (*b*) Deduction for investment income attributable to qualified pension plans.
   (*c*) Deduction for interest paid such as that arising from supplementary contracts and policyholder dividends left on account.
   (*d*) Above deductions are decreased for portion of deductions attributable to tax-exempt interest; the 85 percent of dividends received and the excluded portion of partially tax-exempt interest.
5. Taxable investment income (3−4).

B. Step 2—Computation of underwriting gain or loss

1. Gross receipts:
   (*a*) Premium receipts.
   (*b*) Investment and other income (including decreases in reserves).

2. Deductions:

(*a*) Operating and investment expenses generally.

(*b*) Claims paid to policyholders and beneficiaries.

(*c*) Additions to life insurance reserves.

*(*d*) 10 percent of additions to reserves attributable to life insurance business.

*(*e*) 2 percent of premiums attributable to group insurance (but to accumulate to no more than 50 percent of current premium receipts from these sources).

*(*f*) Dividends paid to policyholders.

(*g*) Above deductions are decreased for portion of deductions attributable to tax-exempt interest, the 85 percent of dividends received and the excluded portion of partially tax-exempt interest.

3. Gain or loss from operations (1—2).

4. Less taxable investment income (as determined under step 1).

5. Underwriting gain or loss (3—4).

Note.—Starred deductions are disallowed to the extent they would create an underwriting loss.

C. Step 3—Computation of amounts made available to shareholders which increase the tax base

All income for each year from 1959 on is entered in one of two surplus accounts: policyholders' surplus account or shareholders' surplus account. Distributions to shareholders are treated as coming first out of the shareholders' account and to this extent are not taxable. After this account is exhausted distributions are made from the policyholders' surplus account, withdrawals from which are taxable. The principal entries and withdrawals from these two accounts are as follows:

1. Shareholders' surplus account (withdrawals from which are not taxable):

(*a*) Entries:

(i) Taxable investment income (amount left after tax).

(ii) The one-half of underwriting gain which was taxed (amount left after tax).

(iii) Amounts not taxable (tax-exempt interest, 85 percent of dividends received, small business deduction, portion of partially tax-exempt interest).

(iv) Voluntary or compulsory withdrawals from shareholders surplus account.

(*b*) Withdrawals:

(i) Distributions to stockholders—deemed first made.

2. Policyholders surplus account (withdrawals from which are taxable):

(*a*) Entries:

(i) The one-half underwriting income which was not taxed.

(*b*) Withdrawals:

(i) Distributions to stockholders in excess of balance in shareholders surplus account.

(ii) Voluntary annual transfers to policyholders surplus account.

(iii) Compulsory transfers to shareholders surplus account to the extent balance in policyholders account exceeds 60 percent of net premiums for the taxable year or 25 percent of life insurance reserves, whichever is the greater.

(iv) Termination of the life insurance company.

(v) Tax payable with respect to withdrawals under (i), (ii), or (iii) above, plus the tax on the tax.

Schedule III. Computation of Investment Income Deemed Allocable to Life Insurance Reserves

A. Computation of "deduction rate"

1. Determine "investment yield rate" (earnings rate) by dividing investment yield (net investment income plus tax-exempt and partially tax-exempt interest, dividends received deduction and small business deduction) by the average of the taxpayer's assets for the year.

2. Determine the higher of—

(*a*) The average rate of interest assumed by the taxpayer in calculating his reserves, or

(*b*) The average rate of interest assumed by the life insurance industry (other than on pension plan reserves) in calculating reserves in the prior year.

3. The deduction rate is the average of the rates determined under 1 and 2 above (but never above the investment yield rate).

B. Computation of adjusted life insurance reserves

1. Determine the number of percentage points by which the deduction rate (A–3 above) exceeds (or is less than) the assumed rate of the taxpayer (A–2(*a*) above).

2. Multiply the difference in percentage points determined under 1 above by 10.

3. Decrease the company's life insurance reserves (excluding pension plan reserves) by the percentage determined under 2 above (or if the assumed rate was above the deduction rate, increase reserves by this percentage).

C. Computation of deduction allowed

Multiply deduction rate, determined under A, by adjusted life insurance reserves, determined under B.

PART TWO—1955 STOP GAP FORMULA

Schedule I. Tax Computation

A. Regular tax

1. Life insurance taxable (investment) income.
2. Nonlife insurance taxable (investment) income.[1]
3. Tax, sum of 1 and 2 with first $25,000 taxed at 30 percent and balance taxed at 52 percent.

B. Alternative tax—Applicable if greater than regular tax

1. The regular tax, computed as above, on life insurance taxable (investment) income *only*.
2. (*a*) A tax, at 1 percent, on the portion of gross investment income (less wholly tax-exempt interest) which nonlife insurance reserves are of (total) qualified reserves, plus

(*b*) A tax, at 1 percent, on the portion of net premiums on contracts other than life insurance, annuity, and noncancelable health and accident insurance contracts which is in excess of dividends to policyholders on these contracts.

3. Total tax (1+2).

Schedule II. Computation of Two Parts of Regular Tax Base

A. Computation of life insurance taxable (investment) income

1. Gross investment income (interest, dividends, rents, royalties, and related income and noninsurance trade or business income).
2. Less investment expenses (including properly allocable real estate, depreciation and depletion expenses), tax-free interest,[2] and trade or business expenses (subject to same exceptions as bill).[3]
3. Net investment income (1—2).
4. Less:

   (*a*) Net investment income allocable to nonlife insurance reserves (in ratio of nonlife insurance reserves to (total) qualified reserves),

   (*b*) The reserve and other policy liability deduction which (subject to certain limitations) is 87.5 on the first $1 million,[3] and 85 percent of any remaining net investment income allocable to life insurance reserves, and

   (*c*) A special interest deduction where in general the investment income received is less, or only slightly more than the interest required for reserves or to meet commitments.

5. Life insurance taxable (investment) income (1—2—4).

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[1] Nonlife insurance taxable income includes a pro rata portion of net capital gains (based on ratio of nonlife insurance reserves to (total) qualified reserves. An alternative capital gains tax computation also is available.

[2] Partially tax-free interest is elsewhere excluded from the normal tax base.

[3] A 2½ percent (rather than 5 percent) small business deduction is allowed in 4(*b*) rather than in 2. No 85-percent dividends-received deduction was allowed.

B. Computation of nonlife insurance taxable (investment) income

1. Net investment income (A–3 above) allocable to nonlife insurance reserves (allocation is made on basis of ratio of nonlife insurance reserves to (total) qualified reserves).
2. Plus net capital gain allocable to nonlife insurance business (same ratio as in 1 above).
3. Less 85-percent dividends-received deduction allocable to nonlife insurance reserves (same ratio as in 1 above).
4. Nonlife insurance taxable (investment) income (1+2−3).

PART THREE—1942 FORMULA

Schedule I. Tax Computation

A tax at the rate of 30 percent on the first $25,000 of life insurance taxable (investment) income and a tax at 52 percent of any such income remaining.

Schedule II. Computation of Life Insurance Company Taxable Income

1. Gross investment income (same as under 1955 stopgap formula).
2. Less same deductions as under 1955 stopgap formula.
3. Net investment income (1—2).
4. Less:

   (*a*) The reserve and other policy liability deduction as proclaimed each year by the Secretary of the Treasury based on prior year's data (see schedule III for computation), and

   (*b*) A special interest deduction where in general the investment income received is less, or only slightly more, than the interest required for reserves or to meet commitments (similar to 1955 stopgap deduction).
5. Plus an adjustment equal to 3¼ percent of the unearned premiums and unpaid losses on contracts not included in life insurance reserves (the unearned premiums not being less than 25 percent of the premiums written on these contracts during the year).
6. Life insurance company taxable income (1—2—4+5).

Schedule III. Method of Computation of Reserve and Other Policy Liability Deduction

A. Ratio proclaimed by Secretary of Treasury (based on experience of entire industry in prior year)

1. The numerator consists of—

   (*a*) 2 percent of the reserves held for dividends to policyholders,

   (*b*) interest paid, and

   (*c*) life insurance reserves (plus) percent of reserves (computed on a preliminary term basis) multiplied by the "reserve earnings rate" which is 65 percent of a rate at 3¼ percent and 35 percent the average rate of interest assumed by the industry, and
2. The denominator consists of the aggregate of the net investment incomes to the extent they exceed 3¼ percent of the unearned premiums and unpaid losses on contracts not included in life insurance reserves. (See 5 in schedule II.)

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