

TAXATION OF
LIFE INSURANCE COMPANIES

OTHER POSSIBLE METHODS FOR PREVENTING
DOUBLE TAXATION OF TAX-EXEMPT INCOME

PREPARED FOR THE USE OF THE
SENATE COMMITTEE ON FINANCE
BY THE STAFFS OF THE
TREASURY DEPARTMENT AND THE
JOINT COMMITTEE ON INTERNAL REVENUE
TAXATION



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TAXATION OF LIFE INSURANCE COMPANIES

1. *Providing for no double deduction*

(a) *Explanation of phase 2 proposal.*—Under the bill tax-exempt interest (and a portion of partially tax-exempt interest and 85 percent of dividends received) are first deducted in arriving at net investment income. The next step is to determine the policy and other contract liability deduction. Under the bill this deduction is cut back or reduced where there is tax-exempt interest, etc., under a specific formula provided by the bill. This formula for the cutback or reduction in the policy and other contract liability deduction is provided on the assumption that otherwise there would be a double deduction for tax-exempt interest, etc., once as a specific deduction and a second time as a part of the policy and other contract liability deduction.

The proposal made here would provide the same specific deduction for tax-exempt interest, etc., as the bill. However, instead of providing a cutback or reduction in the policy and other contract liability deduction for tax-exempt interest, etc., according to a specific formula, it merely provides that this deduction is not to be allowed to the extent it would provide a double deduction for tax-exempt interest, etc. Under this proposal the Treasury could take the same position as provided by the House bill but in any judicial determination of the issue, since this formula is not in the statute, this would not prejudice the decision. Moreover, the court issue would be on the question of whether there was a double deduction and would not need to involve the issue of the constitutionality of taxing State and municipal bond interest.

(b) *Explanation of phase 2 proposal.*—In phase 2 under the bill, first an exclusion is provided for tax-exempt interest (and a deduction for a portion of partially tax-exempt interest and 85 percent of intercorporate dividends received). Then the deductions otherwise generally allowable, including the deduction for additions to reserves, are reduced by a portion of the tax-exempt interest, etc. This proportion is the ratio of required interest (and the small-business deduction) to investment yield (net investment income plus tax-exempt interest, etc.). Required interest referred to in this case is the proportion of investment income which the company, under its own assumed rates of interest on its reserves, must add to the reserves in the current year. This is a part of the deduction allowed under the bill for additions to reserves. The other part of this deduction is the premium income added to reserves.

The proposal in this case, as in the case of phase 1, provides that a certain deduction is not to include any amount allowed as a deduction under subsection (d)(10) (namely, partially tax-exempt interest or the intercorporate dividends-received deduction) or excluded from gross income under section 103 (namely, tax-exempt interest). The deduction which is not to include any deduction for tax-exempt interest, etc., is the required interest deduction, which under the bill appears as a portion of the deduction for additions to reserves. Under the draft

this particular portion of the additions to reserves is separated out from other additions to reserves and it is this portion of the present deduction which is limited so as not to permit a deduction with respect to tax-exempt interest, partially tax-exempt interest, or intercorporate dividends received.

(c) *Revenue effect.*—This proposal will have no effect on revenues if the bill as passed by the House is held to do no more than eliminate double deductions. On the other hand, if the courts would determine that the House bill goes further than to eliminate a double deduction, part or all of the \$35 million would be lost under the proposal.

(d) *Long-range effect.*—Over the long run this proposal should not present any major reason for additional investments in tax-exempt securities by life insurance companies unless the courts should hold that no adjustments are needed to eliminate double deductions.

(e) *Constitutional problem.*—This proposal does not require any determination as to whether or not it is constitutional to tax State and municipal bond interest. Instead, the only issue to be resolved under this proposal is whether or not there would be a double deduction if under phase 1 the policy and other contract liability deduction were not reduced for a portion of tax-exempt interest, etc., and whether under phase 2 a similar reduction were not made in the deduction for required interest.

2. Provision for no tax on tax-exempt interest

(a) *Explanation of phase 1 proposal.*—Under phase 1, tax-exempt interest is first deducted and then the policy and other contract liability deduction which is allowed as a deduction after arriving at net investment income is reduced by a portion of the tax-exempt interest. This reduction, or cutback, in the policy and other contract liability deduction according to the House report is made in order not to allow a double deduction with respect to tax-exempt interest—once as a specific deduction and a second time as a part of the policy and other contract liability deduction. The House report states, however, that there was no attempt by making this cutback in the policy deduction to impose any tax on tax-exempt interest.

The amendment which would be made by this proposal makes explicit in the statute the statement which already appears in the House committee report, namely, that there is no attempt by the adjustment made in the policy and other contract liability deduction to impose any tax with respect to tax-exempt interest. This is provided for by adding a proviso to the end of the phrase in the House bill which provides for the downward adjustment in the policy and other contract liability deduction for tax-exempt interest, etc. The proviso indicates that the extent to which this adjustment is to be made is to be governed by whether or not it is established in any case that a part of the adjustment results in the imposition of tax on tax-exempt income. If this is established, the adjustment to the extent of any such tax is not to be made.

(b) *Explanation of phase 2 proposal.*—Under the bill in phase 2 an adjustment similar to that made in phase 1 is also made with respect to tax-exempt interest. Here after excluding tax-exempt interest, the bill then provides that the deductions otherwise allowable are to be reduced by a proportion of any tax-exempt interest. The proportion is the ratio of required interest (and the small-business deduction) to investment yield (net investment income plus tax-

exempt interest, etc.). As in the case of phase 1, the House committee report indicates that this is not intended to impose any tax with respect to tax-exempt income.

The proposal, therefore, again makes explicit in the statute this expression of intent in the House committee report. It provides that the downward adjustment for tax-exempt interest to be made in the deductions otherwise allowable is not to be made to the extent that it is established that such an adjustment in any case results in the imposition of tax on tax-exempt interest.

(c) *Revenue effect.*—If the House report is correct that the bill as passed by the House imposes no tax on tax-exempt interest, there will not be any revenue loss from this proposal. On the other hand, if it is determined that the bill as passed by the House would impose a tax with respect to this tax-exempt interest, then to the extent of any such tax there would be a revenue reduction under this proposal. The maximum loss of revenue in such a case would be \$35 million.

(d) *Long-range effect.*—Over the long run, this proposal would not present any reason for additional investments in tax-exempt securities by life insurance companies (not already presented by the House bill) if the bill as passed by the House is determined not to impose any tax on tax-exempt interest. If, on the other hand, if it is determined that the bill as passed by the House does impose a tax on tax-exempt interest, then the reduction which then would be made in the adjustment otherwise made in both phases 1 and 2, presumably would increase municipal bond holdings by life insurance companies.

(e) *Constitutional problem.*—This proposal makes it clear that the determination to be made is whether or not the bill imposes a tax with respect to tax-exempt interest. Therefore, this amendment does not involve the likelihood of any ruling as to whether or not it is constitutional to tax State and municipal bond interest. Instead, attention would be focused on the single issue of whether the bill actually does impose a tax on tax-exempt interest. The bill provides that no such tax is to be imposed, whether or not such an imposition would be permitted by the Constitution.

3. *Percentage deduction in determining policy, etc., deduction*

(a) *Statement of plan.*—This approach would carry out the substance of the 5-year average earnings rule for determining the policy interest deduction under H.R. 4245, but would provide a percentage deduction based on the ratio of “adjusted” reserves to assets. Resulting changes in tax liability would be minor.

Tax-exempt earnings would be deducted from taxable income in the first instance. The deduction for policy interest would be computed as a prescribed percentage of taxable investment earnings. No further adjustment to prevent a double deduction would be necessary since the percentage deduction would make the adjustment automatically.

The percentage deduction would be determined as the ratio of “adjusted” reserves to total assets rather than as the ratio of required investment earnings on adjusted reserves to total investment earnings. “Adjusted” reserves for this purpose would be the reserve cut back by the reserve revaluation procedure prescribed by the bill plus an additional adjustment to take account of the spread between the earned rate and the deduction rate. An essential feature of the plan

is that it would use only the earned rate on taxable income-producing assets, excluding cash, for purposes of the reserve revaluation.¹

Similar procedures, with suitable modifications, would be applied in computing required interest in arriving at net operating gain in phase 2.

The specific objective of this approach is to meet the objection raised against the bill in its present form that it appears to increase the tax liabilities in certain assumed circumstances where a company shifts from cash into tax-exempt securities. The increase in tax arising under the bill where a company switches from cash into municipal securities is attributable primarily to the increase in its total earnings which constitute the denominator in the fraction which determines the policy interest deduction (expressed as a percentage of taxable earnings).

Since the proposed alternative would in effect use total assets as the denominator and rely on an earned rate based on taxable investments only, it would eliminate the effect which has been cited as an objection to the present provisions of H.R. 4245.

(b) *Revenue effect.*—The proposal would increase tax liabilities under the bill by approximately \$10 million. This would reduce the decrease in revenue resulting from the adoption of the 5-year average earnings rule from about \$45 million to about \$35 million.

(c) *Status of tax-exempt interest.*—The proposal would avoid the effect which has been criticized under H.R. 4245 of appearing to raise a company's tax incident to the conversion of cash into tax-exempt securities.

(d) *Loophole problem.*—The proposal would not allow a double deduction and would thus prevent the formation of a loophole.

(e) *Illustrations.*—The following examples illustrate the suggested approach, as compared with the present treatment under H.R. 4245 (amended to use the 5-year average earned rate).

Basic assumptions

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

Assumed rate of 3 percent

	<i>Percent</i>
5-year average earned rate on taxables	3. 8
5-year average earned rate on tax-exempts	2. 8
5-year average earned rate on portfolio, 90 percent in taxables and 10 percent in tax-exempts	3. 7

¹ An alternative formulation of the percentage deduction which would be identical in tax effect but which might be more convenient for statutory drafting purposes is as follows:

$$\frac{\text{Adjusted reserves} \times \text{deduction rate} + \text{interest paid}}{\text{Total assets} \times \text{current earned rate on taxable investments (excluding cash)}}$$

* Five year average earned rate on taxable investments, excluding cash.

This formulation facilitates the treatment of interest paid, which is neglected in the text discussion to simplify the exposition. It also makes automatic provision for the further adjustment of the revalued reserves, to reflect the spread between the earned and the deduction rate.

CASE 1—\$1,000 INVESTED IN TAXABLES AT 4 PERCENT

Phase 1

	H. R. 4245	Under proposed amendment
Investment income.....	\$40.00	\$40.00
Policy and other contract liability deduction.....	¹ 31.46	² 31.46
Tax base.....	8.54	8.54

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

² Deduction equal to 78.7 percent of taxable investment income, computed as follows:

(1) Reserves \$900 less 8 percent = \$828 revalued reserves

(2) Revalued reserves \$828 less 5 percent = "adjusted" reserves \$787

$$\text{Where 5 percent} = \frac{\text{current earned rate 4 percent} - \text{deduction rate 3.8 percent}}{\text{Current earned rate 4 percent}}$$

(3) "Adjusted" reserves \$787
Total assets \$1,000 = 78.7 percent

Alternative method of computing percentage:

Revalued reserves \$828 \times deduction rate 3.8 percent = \$31.46

Total assets \$1,000 \times current earned rate 4 percent = \$40 = 78.7 percent

Phase 2

	H. R. 4245	Under proposed amendment
Investment income.....	\$40	\$40
Required interest.....	¹ 27	² 27
Taxable portion included in net operating gain.....	13	13

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

² Deduction equal to 67.5 percent of investment income, computed as follows:

(1) Reserves \$900 less 25 percent = \$675

$$\text{Where 25 percent} = \frac{\text{Current earned rate 4 percent} - \text{assumed rate 3 percent}}{\text{Current earned rate 4 percent}}$$

(2) "Adjusted" reserves \$675
Total assets \$1,000 = 67.5 percent

Alternative method of computing percentage:

Reserves \$900 \times assumed rate 3 percent = \$27 = 67.5 percent

Total assets \$1,000 \times current earned rate 4 percent = \$40

CASE 2.—\$900 INVESTED IN TAXABLES AT 4 PERCENT; \$100 INVESTED IN TAX-EXEMPTS AT 3 PERCENT

Phase 1

	H. R. 4245	Under proposed amendment
Investment income.....	\$39.00	\$39.00
Less tax-exempt interest.....	3.00	3.00
Taxable investment income.....	36.00	36.00
Policy and other contract liability deduction.....	¹ \$30.97	² 28.32
Less adjustment (79.4 percent \times 3).....	2.38	
Tax base.....	7.41	7.68

¹ Deduction rate 3.7 percent \times adjusted reserves \$837 (900 less 7 percent).

² Deduction equal to 78.7 percent of taxable investment income, computed as follows:

(1) Reserves \$900 less 8 percent = revalued reserves \$828

(2) Revalued reserves less 5 percent = "adjusted" reserves \$787

$$\text{where 5 percent} = \frac{\text{current earned rate on taxables 4 percent} - \text{deduction rate 3.8 percent}}{\text{current earned rate on taxables 4 percent}}$$

(3) Adjusted reserves \$787 + total assets \$1,000 = 78.7 percent.

Alternative method of computing percentage:

Revalued reserves \$828 \times deduction rate 3.8 percent = \$31.46

total assets \$1,000 \times current earned rate on taxables 4 percent = \$40 = 78.7 percent.

CASE 2

Phase 2

	H.R. 4245	Under proposed amendment
Investment income.....	\$39.00	\$39.00
Less tax-exempt interest.....	3.00	3.00
Taxable investment income.....	36.00	36.00
Required interest.....	¹ \$27.00	
Less adjustment (69.2 percent×3).....	2.08	
	24.92	² 24.30
Taxable portion included in net operating gain.....	11.08	11.70

¹ Reserves \$900×assumed rate 3 percent.

² Deduction equal to 67.5 percent of taxable investment income, computed as follows:

(1) Reserves \$900 less 25 percent=adjusted reserves \$675 where 25 percent=
current earned rate on taxables 4 percent—assumed rate 3 percent
current earned rate on taxables 4 percent

(2) $\frac{\text{Adjusted reserves } \$675}{\text{Total assets } \$1,000} = 67.5 \text{ percent}$

Alternative method of computation of percentage:

$\frac{\text{Reserves } \$900 \times \text{assumed rate } 3 \text{ percent}}{\text{Total assets } \$1,000 \times \text{current earned rate on taxables } 4 \text{ percent}} = \frac{\$27}{\$40} = 67.5 \text{ percent}$

CASE 3—\$900 INVESTED IN TAXABLES AT 4 PERCENT; \$100 in CASH

Phase 1

	H.R. 4245	Under proposed amendment
Investment income.....	\$36.00	\$36.00
Reserve and other policy contract liability deduction.....	¹ 29.49	² 28.32
Tax base.....	6.51	7.68

¹ Deduction rate 3.42 percent × adjusted reserves \$862.20 (\$900 less 4.2 percent).

² Same as in case 2, phase 1, above.

Phase 2

	H.R. 4245	Under proposed amendment
Investment income.....	\$36.00	\$36.00
Required interest.....	¹ 27.00	¹ 24.30
Taxable portion included in net operating gain.....	9.00	11.70

¹ Same as in case 2, phase 2, above.

APPENDIX

DRAFTS OF POSSIBLE METHODS DESCRIBED IN REPORT

1. PROVIDING FOR NO DOUBLE DEDUCTION

Amendments to section 805

Amend section 805(e) to read as follows:

(e) **LIMITATION ON DEDUCTION.**—The deduction under this section shall not include any amount in respect of any item to the extent that such amount is allowed as a deduction by section 804(c).

Page 13, strike out the comma at the end of line 1 and insert a period, and strike out line 2.

Amendments to sections 809 and 810

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

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

On page 24, after line 16, insert:

(9) **REQUIRED INTEREST.**—The deduction for required interest (determined under subsection (f)).

On page 24, lines 17 and 25, strike out "(9)" and insert "(10)".

On page 27, beginning with line 8, strike out all through line 21, page 28, and insert:

(f) **DEDUCTION FOR REQUIRED INTEREST.**—

(1) **IN GENERAL.**—Except as provided in paragraph (2), the deduction for required interest is the sum of the products obtained by multiplying—

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

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

(2) **LIMITATION ON DEDUCTION.**—The required interest deduction shall not include any amount in respect of any item to the extent that such amount is allowed as a deduction by reason of subsection (d)(10) or is excluded from gross income under section 103.

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

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

(a) **ADJUSTMENT FOR DECREASE.**—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of the required interest for the taxable year determined under section 809(f)(1)), the excess shall be taken into account as a net decrease referred to in section 809(c)(2).

(b) **ADJUSTMENT FOR INCREASE.**—If the sum of the items described in subsection (c) as of the close of the taxable year (reduced by the amount of the required interest for the taxable year determined under section 809(f)(1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2).

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

2. PROVISIONS FOR NO TAX ON TAX-EXEMPT INTEREST

Amendment to section 805

Insert on page 13 at the end of line 2 before the period:

; except that if it is established in any case that a part of such adjustment results in the imposition of tax on interest which under section 103 is excluded from gross income, such adjustment shall not be made to the extent of such imposition.

Amendment to section 809

Insert on page 27, line 16, before the comma:

(except that, if it is established in any case that the application of this clause results in the imposition of tax on any such interest, this clause shall not apply to the extent of such imposition)

3. PERCENTAGE DEDUCTION IN DETERMINING POLICY, ETC. DEDUCTION

Amend sections 805 and 806 to read as follows:

SEC. 805. POLICY AND OTHER CONTRACT LIABILITY DEDUCTION.

(a) IN GENERAL.—For purposes of this part, the term “policy and other contract liability deduction” means, for any taxable year, the amount determined by multiplying the net investment income (computed without the deduction provided by section 804(c)(9)) by the ratio—

(1) the numerator of which is the sum of—

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

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

(C) the interest paid; and

(2) the denominator of which is the mean of the assets at the beginning and end of the taxable year, multiplied by the current earnings rate.

(b) EARNINGS RATES.—

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

(A) the net investment income for such taxable year computed without—

(i) the deduction for partially tax-exempt interest provided by section 804(c)(6),

(ii) the deduction for dividends received provided by section 804(c)(7), and

(iii) the small business deduction provided by section 804(c)(9), by

(B) the admissible assets for the taxable year.

(2) AVERAGE EARNINGS RATE.—

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

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

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

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

(c) ADJUSTED LIFE INSURANCE RESERVES.—

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

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

(B) that percentage which equals 100 percent—

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

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

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

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

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

(d) PENSION PLAN RESERVES.—

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

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

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

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

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

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

(B) in the case of a taxable year beginning after December 31, 1958, and before January 1, 1960, 33 $\frac{1}{3}$ percent of the amount thereof (determined without regard to this paragraph);

(C) in the case of a taxable year beginning after December 31, 1959, and before January 1, 1961, 66 $\frac{2}{3}$ percent of the amount thereof (determined without regard to this paragraph); and

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

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

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

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

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

(f) ASSETS.—

(1) DEFINITIONS.—For purposes of this part—

(A) ASSETS.—The term “assets” means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business.

(B) INADMISSIBLE ASSETS.—The term “inadmissible assets” means money and obligations the interest on which under section 103 is excluded from gross income.

(C) AVERAGE INADMISSIBLE ASSETS.—The term “average inadmissible assets” means the amount determined (i) by ascertaining the amount attributable thereto for each day of the taxable year, (ii) by adding such daily amounts, and (iii) by dividing the total of the daily amounts by the number of days in such taxable year.

(D) ADMISSIBLE ASSETS FOR THE TAXABLE YEAR.—The term “admissible assets for the taxable year” means the amount by which—

(i) the mean of the taxpayer’s assets at the beginning and end of the taxable year, exceeds

(ii) the average inadmissible assets for the taxable year.

(2) AMOUNT OF ASSET.—For purposes of paragraph (1), the amount attributable to—

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

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

SEC. 806. CERTAIN CHANGES IN RESERVES AND ASSETS.

(a) ADJUSTMENTS TO MEANS FOR CERTAIN TRANSFERS OF LIABILITIES.—For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

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

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

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

Amendments to sections 809 and 810

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

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

On page 24, after line 16, insert:

(9) REQUIRED INTEREST.—The deduction for required interest (determined under subsection (f)).

On page 24, lines 17 and 25, strike out “(9)” and insert “(10)”.

On page 25, strike out lines 1 through 4, and insert:

(1) INTEREST.—Section 163 (relating to deduction for interest) shall not apply.

On page 27, beginning with line 8, strike out all through line 21, page 28, and insert:

(f) DEDUCTION FOR REQUIRED INTEREST.—

(1) AMOUNT.—For purposes of this part, the deduction for required interest for any taxable year is the amount determined by multiplying the net investment income (computed without the deduction provided by section 804(c)(9)) by the ratio—

(A) the numerator of which is the required interest, and

(B) the denominator of which is the mean of the assets at the beginning and end of the taxable year, multiplied by the current earnings rate (computed under section 805(b)(1)).

(2) REQUIRED INTEREST.—For purposes of this part, the term “required interest” means the sum of—

(A) the total of the products obtained by multiplying—

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

(ii) the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, plus
(B) to the extent not taken into account under subparagraph (A), the interest paid (as defined in section 805(e)).

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

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

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

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

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

