TAXATION OF LIFE-INSURANCE COMPANIES

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-FIRST CONGRESS

SECOND SESSION

ON

H. J. Res. 371

A JOINT RESOLUTION TO CORRECT THE FORMULA USED IN COMPUTING THE INCOME TAXES OF LIFE-INSURANCE COMPANIES FOR 1947, 1948, AND 1949

MARCH 16 AND 29, 1950

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TAXATION OF LIFE-INSURANCE COMPANIES

THURSDAY, MARCH 16, 1950

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met at 2:30 p. m., pursuant to call, in room 312, Senate Office Building, Senator Walter F. George, chairman, presiding.

Present: Senators George, Byrd, Hoey, Myers, Millikin, Taft, Butler, and Martin.

Present also: Elizabeth B. Springer, Chief Clerk.

The CHAIRMAN. The committee will come to order.

We will take up House Joint Resolution 371, a joint resolution to correct the formula used in computing the income taxes of life-insurance companies for 1947, 1948, and 1949.

(H. J. Res. 371 follows:)

[H. J. Res. 371, 81st Cong., 2d sess.]

JOINT RESOLUTION To correct the formula used in computing the income taxes of life insurance companies for 1947, 1948, and 1949

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the second sentence of section 202 (b) of the Internal Revenue Code is hereby amended to read as follows: "This figure shall be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary considers representative and shall be computed as follows:

"(1) IN GENERAL.—Except as provided in paragraph (2), the figure shall be computed in accordance with the following formula: The ratio which a numerator comprised of the aggregate of the sums of (A) 2 per centum of the reserves for deferred dividends, (B) interest paid, and (C) the product of (i) the mean of the adjusted reserves at the beginning and end of the taxable year and (ii) the reserve earnings rate bears to a denominator comprised of the aggregate of the excess of net incomes computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c).

"(2) SPECIAL RULE FOR 1947, 1948, AND 1949.—In the case of the taxes imposed for a taxable year beginning in 1947, 1948, or 1949, the figure to be used for such year shall be computed as provided in paragraph (1) except that—

"(A) in computing the product required under clause (C) of paragraph (1), there shall be used, in lieu of the reserve earnings rate, the average rate of interest assumed in computing life insurance reserves. Such average rate shall be calculated in the manner provided in the second sentence of section 201 (c) (4); and

"(B) if the Secretary, in computing the ratio, finds that the net effect of including the data with respect to any life insurance company is to increase the numerator more than it increases the denominator, he shall limit the net change in the numerator resulting from such inclusion to the net change in the denominator resulting therefrom."

(b) Section 203 (b) of the Internal Revenue Code is hereby amended by striking out "figure" and inserting in lieu thereof "applicable figure".

(c) The amendments made by this joint resolution shall be applicable to taxable years beginning after December 31, 1946. The Secretary of the Treasury shall, within sixty days after the date of the enactment of this joint resolution, determine and proclaim in accordance with the provisions of section 202 (b) of the Internal Revenue Code, as amended by this joint resolution, the figures to be used by life insurance companies in computing their reserve and other policy liability credits for taxable years beginning in 1947, 1948, and 1949.

SEC. 2. Every life insurance company subject to the taxes imposed by section 201 of the Internal Revenue Code shall, after the date of the Secretary's proclamation required by section 1 (c) of this joint resolution and on or before the 15th day of the third month following the close of the month in which this joint resolution is enacted, make returns for its taxable years beginning in 1947, 1948, and 1949 with respect to the taxes imposed by such section 201 (determined with the amendments made by the first section of this joint resolution). The return required by this section for any taxable year shall constitute the return for such taxable year for all purposes of the Internal Revenue Code; and no return for such taxable year, with respect to the taxes imposed by section 201 of such code, filed on or before the date of such proclamation shall be considered for any of such purposes as a return for such year. The taxes imposed by section 201 of such code (determined with the amendments made by the first section of this joint resolution) for each such taxable year shall be paid on the 15th day of the third month following the close of the month in which this joint resolution is enacted, in lieu of at the time prescribed in section 56 (a) of such code. All payments with respect to the taxes for each such taxable year imposed by section 201 of such code under the law in effect prior to the enactment of this joint resolution, to the extent that such payments have not been credited or refunded, shall be deemed to be payments made at the time of the filing of the return required by this section on account of the taxes for that year determined with the amendments made by the first section of this joint resolution.

SEC. 3. If any insurance company which was placed in receivership and its business operated by another insurance company as a separate fund under a management contract approved by the court having jurisdiction of the receivership, for the benefit of the policyholders of such company in receivership, and the management contract has, pursuant to its terms, terminated and final distribution and accounting made to the policyholders with the approval of the proper State supervisory officials, then the tax imposed by this joint resolution insofar as it applies to the business operations for the years 1947 and 1948 of any such separate fund so terminated, shall not apply.

Passed the House of Representatives January 26, 1950.

Attest:

RALPH R. ROBERTS, *Clerk.*

The CHAIRMAN. Chairman Doughton is here, and we are pleased to see him as well as several members of his committee.

Would you like to have something to say at this time, Mr. Chairman?

STATEMENT OF HON. ROBERT L. DOUGHTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Representative DOUGHTON. Mr. Chairman, I am here with other members of the Committee on Ways and Means to express our interest in the early and, we trust, the favorable consideration of House Joint Resolution 371, to correct the formula for computing the income tax of life-insurance companies. This formula was adopted in 1942.

The CHAIRMAN. You may sit down, if you will.

Representative DOUGHTON. Thank you, Mr. Chairman.

Under the formula life-insurance companies have paid no income tax on their invested income for the years 1947 and 1948, and probably will pay none for the years 1949 and 1950 unless the law is amended.

Under the formula adopted in 1942 they did pay taxes in that year of $27,427,000; in 1943, $34,482,000; in 1944, $34,462,000; in 1945, $24,725,000; and 1946, $21,825,000; and for 1947, 1948, and 1949, under the formula they will pay no income tax.

This matter was brought to my attention by the Secretary of the Treasury. As chairman of the Ways and Means Committee, I received a letter from Secretary Snyder in August of 1949. He said the Treasury staff and the staff of the Joint Committee on Revenue Taxation were conferring with the life-insurance companies, who themselves had signified that they thought they should pay some tax. And they were negotiating to see if they could reach an agreement by which this formula could be corrected, and under which they would pay the taxes contemplated in the 1942 act. But they did not reach an agreement; and so the Secretary of the Treasury wrote me on October 10 and sent a bill which I introduced on that date, October 10, 1949.

Then I called our committee together, and since we had just a short time until Congress would recess, at the direction of the Committee on Ways and Means I appointed a subcommittee to study the question and confer with the representatives of the life-insurance companies. The subcommittee was asked to see if they could work out some formula or reach some understanding by which this formula could be modified, and they could pay the taxes which many of them had indicated to me they thought they should pay and would like to pay.

A representative from the Jefferson Standard Life Insurance Co., one of the greatest life-insurance companies in the country, at Greensboro, N. C., came to see me, and wrote me subsequently, saying they should pay some taxes, that they were not paying because of the defect in existing law.

I appointed a subcommittee, with the distinguished gentleman from New York as chairman, and including Mr. Gregory of Kentucky, Mr. Camp of Georgia, Mr. Forand of Rhode Island, Mr. Reed of New York, Mr. Simpson of Pennsylvania, and Mr. Kean of New Jersey, a subcommittee that went into this very carefully, during the recess of Congress, and reached what they thought was an understanding with the majority of the life insurance companies whereby they would pay some tax for 1947, 1948, and 1949 taxable years.

Now, in order to avoid repetition and have the matter explained more fully than I could explain it, I would prefer for Representative Lynch and the other members of the subcommittee to speak on this subject. Mr. Lynch is here, with Mr. Camp and Mr. Simpson, members of the subcommittee. They are more familiar with the work that was done by the subcommittee and what is contemplated under the joint resolution than I am.

And so, with that statement, Mr. Chairman, I will ask Mr. Lynch, who is chairman of the subcommittee, to take over. And I will say that I have never known a subcommittee to do a more excellent job, and to go into any question more painstakingly and more thoroughly. I was greatly pleased with the work that they did.

I would be pleased to have Mr. Lynch explain more fully what was done by the subcommittee and the purposes of the bill.

The CHAIRMAN. The committee will be very glad to have you explain the work which culminated the work in this bill and its passage, so as to let us understand the bill, as you please.

You may be seated if you wish, Mr. Lynch.

STATEMENT OF HON. WALTER A. LYNCH, A REPRESENTATIVE IN THE CONGRESS FROM THE STATE OF NEW YORK

Representative LYNCH. My name is Walter A. Lynch. I am a Member of the House of Representatives, representing the Twenty-third Congressional District of New York State.

Mr. Chairman and members of the committee, I appreciate very much the opportunity to appear in support of House Joint Resolution 371. Although the joint resolution was introduced by the distinguished chairman of the Committee on Ways and Means, he appointed a subcommittee consisting of Representatives Gregory, Camp, Forand, Reed, Simpson and Kean, with myself as chairman, to consider this problem. The subcommittee held several conferences with members of the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation, with members of the special joint tax committee of the American Life Convention and the Life Insurance Association of America, and with spokesmen of insurance companies not represented on the special joint tax committee of the industry. The resolution now before you represents the unanimous conclusion of the subcommittee and was favorably reported by the Committee on Ways and Means with only one dissenting vote. It was passed by the House of Representatives with but little opposition of January 26.

I might also say that it has met the approval as remedial stopgap legislation of the Treasury Department and has likewise been approved by the staff of the Joint Committee on Internal Revenue Taxation.

House Joint Resolution 371 would correct the formula used in computing the income taxes of life insurance companies for 1947, 1948, and 1949. Under existing law, no tax has been due from any company on its life insurance investment income for the years 1947 and 1948, and probably none will be due for 1949. The joint resolution would enable the statutory formula to operate in approximately the manner contemplated at the time it was enacted in 1942.

As the members of this committee well know, insurance companies are subject to the same tax rates as other domestic corporations. In determining the taxable income of an insurance company, however, allowances must be made for reserves for the payment of future claims. For tax purposes, gross income is limited to interest, dividends and rents, and deductions are limited to those allocable to such income. In addition, a special deduction is allowed against net investment income to take into account the commitments in the insurance contract made to policyholders that premiums collected in excess of current risks will be assumed to draw interest at a given rate.

Under the provision written into the Revenue Act of 1942, this special deduction—called the reserve and other policy liability credit—is computed, but with minor exceptions as follows: First, 65 percent of the contractual commitments of the companies to policyholders are assumed to be at the arbitrary rate of 3¼ percent. Second, the remaining 35 percent of the contractual commitments to policyholders are assumed to be at whatever rate is the actual average experience of all the life insurance companies.

At the time of enactment of the Revenue Act of 1942, it was not too unrealistic to assume that the companies needed 3¼ percent of their reserves to meet their policy-interest obligations. However, in recent years there has been a substantial decrease in the interest rates assumed by the companies on policy reserves. Consequently, although the life-insurance industry under the 1942 formula paid $27,500,000 in taxes in 1942 on net investment income slightly over $1,000,000,000 in 1947, 1948, and 1949, no taxes whatever are payable on annual net investment income of approximately 1.5 billion dollars, or 50 percent greater than that for 1942.

The effect of House Joint Resolution 371, as amended by the committee, is to correct the 1942 formula by eliminating entirely the arbitrary and unrealistically high 3¼ percent assumed rate of contractual commitments to policyholders. Instead, the credit ratio would be calculated entirely on the basis of the average experience of the industry in the preceding year for all outstanding contracts of insurance. A technical exception would omit the experience of any company whose contributions to policyholders' reserves exceed its net-investment income.

The suggestion has been made that the pending legislation should properly await the general tax-revision bill. However, the proposed solution is already being challenged as unconstitutional on grounds of retroactivity. Although the Committee on Ways and Means has carefully studied all relevant Supreme Court decisions, and is convinced that such charges are unfounded, the committee did agree that there should be no unwarranted delay in correcting the mistake in the Revenue Act of 1942.

The proposed legislation does not come as a surprise to the life-insurance companies. For more than 2 years the representatives of the life-insurance industry and the Treasury attempted to work out a formula to correct the defect in the existing law. And, in fairness, I should state that the proposed legislation is acceptable to 95 percent of the industry. The history of the discussions preparatory to consideration of this legislation by the Congress is set forth in detail in part II of the Report of the Committee on Ways and Means, House Report 1522, Eighty-first Congress, second session, which I ask permission to insert in the record at the conclusion of my testimony.

The CHAIRMAN. You have that privilege, Congressman.

In brief, this background reveals that the Treasury Department submitted recommendations when it became apparent that it would be impracticable to work out a permanent solution to the problem of the taxation of life-insurance companies before the adjournment of the last session of Congress.

Senator TAFT. May I ask why? I mean if we are going into this thing from the bottom, can we not fix it now, the whole business? Why a temporary bill? Your committee has been working for 3 or 4 months. Is it not just as easy to do it now, as any time?

Representative LYNCH. Senator, I do not think so.

Senator TAFT. What is the reason? What unknown element is there now?

Representative LYNCH. I think that the problem is so great, to determine the kind of a formula to work out, whether or not we should have the average rate which we are submitting now as stopgap legisla-

tion, which is really an amendment to the present law, or whether, as some of the members of the insurance industry feel, we should take the individual experience of the company, or whether in addition to the question of what constitutes a net-investment income we should include some of those suggestions made by the Secretary of the Treasury with respect to underwriting profits, so called. At the particular time that we had the proposition under consideration we felt that the best way to do it would be to bring the then existing law into, let us say, activity again by an amendment which would acomplish what it was intended to accomplish in 1942.

Senator TAFT. I mean, we have to go to the bottom of a very complicated question anyway. While we are going to the bottom of this very complicated question, why not settle it right, permanently.

Representative LYNCH. If it could be done I think it would be desirable, but I do not think you can do it in the time you are going to be able to give to this subject. And meanwhile these companies are going along without taxes. And, frankly, the longer they go the more difficult becomes the proposition of whether we are acting in an arbitrary and capricious manner in insisting that they pay taxes for the years in which the formula did not originally work.

Senator TAFT. I still do not see, though. How can the problem be so complicated? There are no unknown factors in it, we know that. So there is only one reconciling difference there. It has been discussed for 3 years. Why not get down to business and adopt a permanent plan?

Representative LYNCH. If it could be adopted, it would certainly be agreeable to the subcommittee that had charge of it; but whether or not you can do it without extensive hearings is very problematical. And from the experience of our subcommittee I believe we are almost in unanimous accord that it would take considerable study.

Senator TAFT. Frankly, I do not understand it at all yet. But before I am willing to pass this bill I want to understand it completely. By that time it seems to me we ought to be ready to adopt a permanent method. That is the only suggestion I have.

Representative LYNCH. I hope we will be able to convince you before that time comes, sir. I will continue my statement.

In brief, this background reveals that the Treasury Department submitted recommendations when it became apparent that it would be impracticable to work out a permanent solution to the problem of the taxation of life-insurance companies before the adjournment of the last session of Congress, and the chairman of the Committee on Ways and Means introduced House Joint Resolution 371 on the same date that he received the recommendations of the Treasury Department. Two days later, the subcommittee of which I was chairman was appoitned to study the problem, and our unanimous report was filed on the opening day of the current session.

No Federal income tax has ever been held invalid on the ground that the tax was retroactively imposed. Taxpayers have, on a number of occasions, contended before the Supreme Court that the retroactive application of an income tax constituted a deprivation of property without due process of law and therefore was prohibited by the fifth amendment. In every case the Supreme Court held that the retro-

activity involved did not offend the due process clause of the fifth amendment.

I have prepared a memorandum summarizing the decisions on retroactive income taxes which I ask consent to insert at this point in the record, Mr. Chairman.

The CHAIRMAN. Yes, it will be inserted.

(The memorandum referred to follows:)

MEMORANDUM ON CONSTITUTIONALITY OF RETROACTIVE INCOME TAXES

Nearly all of the acts of Congress imposing an income tax have had some degree of retroactivity. The practice started nearly 90 years ago when the act of August 5, 1861, taxed income received during the entire calendar year 1861. The joint resolution of July 4, 1863, imposed an additional tax on incomes received during the calendar year 1863. This additional tax was imposed after the taxes for 1863 had already been paid at the rates established by an earlier act. In *Stockdale* v. *Insurance Companies* (20 Wallace 323), the Supreme Court said with respect to the validity of the retroactive tax imposed by the joint resolution of July 4, 1864:

"The right of Congress to have imposed this tax by a new statute, although the measure of it was governeed by the income of the past year, cannot be doubted * * * no one doubted the validity of the tax or attempted to resist it."

The act of October 3, 1913, applied to income received after March 1, 1913. The retroactivity of the tax was held valid in *Brushaber* v. *Union Pacific Railroad* (240 U. S. 1). The Revenue Act of 1918, which was enacted into law on February 24, 1919, applied to income received during 1918. Many other examples of similar retroactivity of the revenue acts could be cited.

An important exercise by the Congress of its power to impose retroactive income taxes can be found in the Revenue Act of 1936 which was enacted on June 22, 1936. On January 6, 1936, the Supreme Court in *United States* v. *Butler* (297 U. S. 1), held that the processing taxes levied by the Agricultural Adjustment Act were invalid. Many processors had been unjustly enriched in that, not having paid the processing taxes, they had nevertheless passed the taxes on to their purchasers. The Revenue Act of 1936 imposed the so-called windfall tax on such unjust enrichment and the tax was retroactively made applicable to taxable years ending in 1935. Thus, the 1936 act reached back and taxed, in the case of a taxpayer having a fiscal year beginning February 1, 1934, and ending on January 31, 1935, the income resulting from unjust enrcihment for a taxable year which began more than 28 months prior to the date of the enactment of the Revenue Act of 1936. The retroactive imposition of the windfall tax was held valid in the case of *White Packing Co.* v. *Robertson* (89 Fed. 2d 775).

The most recent important case of the Supreme Court on the validity of a retroactive income tax is *Welch* v. *Henry* ((1938) 305 U. S. 134). The case involved an act passed in 1935 by the Legislature of the State of Wisconsin, imposing a tax on corporate dividends reecived in 1933. Under the Wisconsin income tax existing during 1933, certain corporate dividends were exempted from tax. The 1935 act imposed an income tax, at graduated rates, on the dividends received in 1933 which were not taxed in 1933. The taxpayer received some $12,000 of the exempt type of dividends in 1933. He filed his income-tax return for the year 1933 during 1934, at which time he had no intimation that he would later be called upon for a tax upon the dividends. He contended that the tax imposed in 1935 was inavlid on the ground, among others, that the retroactive tax violated the due-process clause of the fourteenth amendment. The Supreme Court of Wisconsin held the act valid and the decision was affirmed by the Supreme Court of the Untied States. Justice Stone, speaking for the Court, said in part:

"The objection chiefly urged to the taxing statute is that it is a denial of due process of law because in 1935 it imposed a tax on income received in 1933. But a tax is not necessarily unconstitutional because retroactive. * * * Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of Government among those who in some measure are privileged to enjoy its benefits and

must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process, and to challenge the present tax it is not enough to point out that the taxable event, the receipt of income, antedated the statute.

"* * * In each case it is necessary to consider the nature of the tax and the circumtances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.

"* * * We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one. The objection to the present tax is of a different character and is addressed only to the particular inconvenience of the taxpayer in being called upon, after the customary time for levy and payment of the tax has passed, to bear a governmental burden of which it is said he had no warning and which he did not anticipate.

"Assuming that a tax may attempt to reach events so far in the past as to render that objection valid, we think that no such case is presented here. * * *

"The equitable distribution of the costs of Government through the medium of an income tax is delicate and difficult task. In its performance experience has shown the importance of reasonable opportunity for the legislative body, in the revision of tax laws, to distribute increased costs of Government among its taxpayers in the light of present need for revenue and with knowledge of the sources and amounts of the various classes of taxable income during the taxable period preceding revision. Without that opportunity accommodation of the legislative purpose to the need may be seriously obstructed if not defeated."

The Supreme Court has never attempted to define a boundary line beyond which Congress cannot retroactively impose an income tax. The boundary line, wherever it may be, must necessarily be vague. Each case must be judged, as the courts have done in the past, on its own merits, rather than by a fixed rule of metes and bounds. A particular income tax imposed under one set of circumstances may be held valid when applied retroactively *x* number of years, while another income tax, under different circumstances, might very well be held arbitrary and capricious when applied retroactively the same number of years. The problem resolves itself simply to an answer to this question: Has the Congress in retroactively imposing a particular tax under the circumstances in which it is laid acted unfairly and in an arbitrary and capricious manner?

Tested by the standard just stated, there is no doubt that House Joint Resolution 371 does not offend the fifth amendment. It purposes to tax the life-insurance companies for the years 1947, 1948, and 1949 on income which escaped taxation during those years; income which Congress had every intention of taxing, when it enacted the Revenue Act of 1942. Certainly the dire need at this time of the Government for revenue is sufficient justification for the Congress to now impose on the life-insurance companies the tax on income for 1947, 1948, and 1949 which quite fortuitously escaped taxation due to the operation of the defective formula. It could hardly be contended by the life-insurance companies that a retroactive correction by the Congress of the formula is harsh, oppressive, or unjust. It can fairly be stated, I am sure, that the life-insurance companies have been embarrassed by the fact that the 1942 formula produced no revenue for the Government from the insurance companies for the years 1947, 1948, and 1949, years in which other taxpayers were paying heavy taxes resulting from the costs of World War II and its aftermath. I am confident that the life-insurance industry, almost unanimously, and the Supreme Court, if the question is ever presented to it, will agree that the retroactive correction of the formula in the manner proposed by House Joint Resolution 371 is consonant with justice and will impose no hardship upon the life-insurance industry.

Representative LYNCH. I submit that the enactment of this legislation would not be a precedent for the passage of retroactive taxes on individuals and corporations in view of the special circumstances that I have outlined.

Mr. Chairman, in my opinion House Joint Resolution 371 provides a constitutional, equitable and practical stopgap solution of a serious error in the present formula for the taxation of life-insurance companies.

Now, Mr. Chairman, I would just like to state that Mr. Reed, the ranking minority member on the committee, indicated when he took the floor in connection with this bill in support of it, and he ended his statement by saying, "Mr. Chairman, I hope the resolution will be passed without serious opposition."

And if permissible, I would like Mr. Camp, also of the committee, and Mr. Simpson, just to express an opinion in 1 or 2 minutes.

Senator MILLIKIN. Mr. Chairman, may I ask one or two questions?

The CHAIRMAN. Yes.

Senator MILLIKIN. I believe you said either 90 percent or 95 percent of the insurance companies are in favor. Is that in terms of money size or in terms of what? What is the point of reference?

Representative LYNCH. The point of reference was the number of them; and very largely the extent and money size as well. There are one or two large companies that have been opposed to this situation—one in New York, and I think one in Ohio, and one, I think, in Minnesota, the Northwestern, I think it is. But the vast majority of them are in favor of this legislation.

Some of those who are opposed to it are not altogether opposed to it on the retroactivity side. They are opposed to it in the same way as Acacia, for instance, who is opposed to the formula; and, as I understand it, was opposed to it back in 1942. But we did not go into the question of the change of the formula at the time we had it under consideration, as we felt that the important thing to have the stopgap legislation, and to that extent we sought to keep as closely as we could to the present law, to make it workable.

Senator MILLIKIN. May I ask one more question, Mr. Chairman? Have all the companies set up reserves to meet this liability?

Representative LYNCH. As far as I know all companies have set up the reserve to meet the liability. As far as I know, all companies were notified as far back as 1947 of the probability of such a situation. As far as I know, there is no company that would be seriously affected by the payment of these taxes, and, as far as I know, pretty near every company today is willing to pay the taxes so that they will carry on their fair cost to the Government.

Senator MILLIKIN. Is there a difference of opinion between paying it this way and paying it in futuro?

Representative LYNCH. Some suggestion was made, Senator, to have it all payable in 1950 and that did not meet very great approval either among the insurance companies or among the subcommittee of the Committee on Ways and Means. I personally felt that it would be better if there were stopgap legislation to cover the 3-year intervening period, rather than to freeze into the law something apparently for 1950 which might stick in there until some other change might come, 10 or 15 years hence.

Senator MILLIKIN. Do any of the insurance companies plead surprise?

Representative LYNCH. None that I know of.

Senator MILLIKIN. Thank you.

The CHAIRMAN. Any further questions?

Thank you, Congressman Lynch.

(The report of the House Ways and Means Committee follows:)

[H. Rept. No. 1522, 81st Cong., 2d sess.]

TAXATION OF LIFE INSURANCE COMPANIES

The Committee on Ways and Means, to whom was referred the joint resolution (H. J. Res. 371) relating to the income taxes of life-insurance companies for 1948 and 1949, having considered the same, report favorably thereon with amendments and recommend that the joint resolution as amended do pass.

The amendments are as follows:

The amendment to the text strikes out all after the resolving clause and inserts in lieu thereof a substitute which appears in the reported joint resolution in italic type.

The other amendment amends the title of the joint resolution to make it conform to the changes made by the committee amendment.

Part I—General Statement

INTRODUCTION

Under existing law no tax has been due from any company on its life-insurance-investment income for the years 1947 and 1948, and it appears that no tax will be due for 1949. This situation results from the use of a formula for determining taxable income adopted in 1942 and still in effect, which concededly no longer applies in the manner contemplated at the time of the enactment of the formula. There is a pressing need for the correction of this situation.

House Joint Resolution 371 as introduced on October 10, 1949, by the chairman of your committee would have have determined a tax for each of the years 1948 and 1949 by fixing the reserve and other policy liability credit ratio for these years at 0.92. It was estimated that the enactment of the resolution, as introduced, would produce a total revenue of $90,000,000 for the 2-year period. As amended, the joint resolution would determine the income tax of life-insurance companies for 1947, 1948, and 1949 by revising the present statutory formula to reflect the average rates of interest assumed by the industry in maintaining its policy reserves, thus eliminating the fixed element of 3¼ percent now used in the formula. In applying the formula, no account would be taken of the excess of the policy liabilities of individual companies above their net investment incomes. It is estimated that the enactment of the resolution, as reported, would produce a total tax for the 3-year period of 1947, 1948, and 1949 of about $93,000,000. This is approximately equal to the tax which would have resulted from the enactment of the resolution as originally introduced, which applied only to the years 1948 and 1949.

THE SITUATION UNDER EXISTING LAW

Under existing law life-insurance companies are required to pay a tax on investment income only. Investment income consists of interest, dividends, and rents. Investment expenses are allowed as a deduction, and against the resulting net investment income there is allowed a special deduction, called the reserve and other policy liability credit, equal to a specified percentage of such income, designed to represent the amount required to meet contractual commitments to policyholders. This percentage is determined from year to year by the Secretary of the Treasury, in accordance with a statutory formula, on the basis of representative industry-wide data for the preceding year. The percentage is the same for each company in the industry. The income left after applying this special deduction is subject to the same rates of tax as are applicable to ordinary corporations, including the reduced rates for small companies.

The significant element in the percentage figure, determined under the present formula, used to calculate the reserve and other policy liability credit is the relationship between the reserve earnings allowance of the industry as a whole and the net investment income of the industry as a whole. The reserve earnings allowance is computed by applying a statutory average rate to the industry's reserves. This statutory rate consists of an average of two elements, a fixed 3¼-percent element, weighted 65 percent, and the average of the industry's assumed rates, weighted 35 percent. Thus, in effect, the importance of the 3¼-percent rate is about twice that of the average of the industry's assumed rates.

The reserve and other policy liability credit ratios announced by the Secretary of the Treasury and the combined income tax liabilities of all the life insurance companies for the years 1942 to 1948, inclusive, are shown in the following table:

	Reserve and other liability credit ratio	Amount of tax liability (in thousands of dollars)
1942	0.93	27,427
1943	.9198	34,482
1944	.9261	34,462
1945	.9539	24,725
1946	.9595	21,825
1947	1.0066	
1948	1.0243	

It will be noted that the credit ratio was somewhat lower and the tax liability larger in 1943 than in 1942, but thereafter, despite a continued rise in the volume of investment income, the credit ratio increased and the tax liability declined steadily. In 1947 the credit ratio exceeded 100 percent. This meant that the deductions from net investment income were larger than the income itself, so that the tax base vanished and the tax liability of life-insurance income was reduced to zero. The credit ratio for 1948 was also over 100 percent, and it appears that it will again be over 100 percent for 1949.

The fact that the credit ratio exceded 100 percent is due primarily to the fixed element in the formula used under existing law to determine the reserve-earnings rate. While at the time of the 1942 legislation the 3¼ percent approximated the average experience of the industry, the companies subsequently tended to assume a lower rate of interest in issuing new policies in line with a decline in the yield on their current investments. If the 3¼-percent fixed element had not been used in the 1942 formula, the percentage of net investment income offset by the reserve and other policy liability credit would have tended to increase but the tax base would not have been wiped out entirely.

LEGISLATIVE CONSIDERATION

In connection with the proclamation of the reserve and other policy liability credit ratio for 1947, which was the first of the ratios to exceed 100 percent, the Secretary of the Treasury stated that the fact that the life-insurance business was not subject to tax called for the immediate attention of Congress and others concerned. The Secretary reported that the representatives of the life-insurance industry at their request had already conferred with the Treasury on the development of a more satisfactory method of taxing life-insurance companies. The conferences referred to started in the autumn of 1947 and continued over an extended period. A detailed account of these discussions appears in part II of this report.

Despite these lengthy discussions it proved impracticable to develop a satisfactory long-range basis for taxing life-insurance companies. Therefore, in order to avoid further delay in securing a tax from the life-insurance companies the Treasury and the staff of the Joint Committee on Internal Revenue Taxation suggested stopgap legislation.

A letter dated August 16, 1949, from the Secretary of the Treasury to the chairman of your committee proposed that the reserve and other policy liability credit ratio be 0.92 for each of the years 1948 and 1949. On the basis of the discussions between the representatives of the industry associations and the Treasury staff, the Secretary believed that the industry would not interpose objections to this plan, thus eliminating the need for lengthy legislative consideration. However, action was delayed again by the receipt of protests from a number of the constituent members of the life-insurance company associations who did not agree with their representatives. After further discussions the Secretary reaffirmed his recommendation for stopgap legislation in a letter dated October 10, 1949. On the same date House Joint Resolution 371 embodying the recommendation was introduced by the chairman of your committee. It was estimated that the adoption of the resolution, as introduced, would produce a tax liability of $90,000,000 for the 2 years 1948 and 1949. On October 12, 1949,

your committee authorized the appointment of a subcommittee to consider the life-insurance company tax problem.

This subcommittee considered objections on the part of the company representatives to the alleged arbitrary nature of the 0.92 credit ratio used under House Joint Resolution 371, as well as to the application of the tax to 1948. It was the opinion of this subcommittee, an opinion concurred in by your committee, that the objection made to the retroactive application of the tax is untenable. It seems intolerable that so large an industry should pay no tax, due to the failure of a formula to accomplish the purpose for which it was designed, at a time when others were bearing an unusually heavy burden, a consideration which applies to 1947 as well as to 1948 and 1949. Furthermore, correction of the law had been the subject of discussion between the Treasury and representatives of the industry since the autumn of 1947. There appeared, however, to be considerable merit in the claim that the use of a credit ratio of 0.92 was to some extent arbitrary.

Under the resolution as amended the credit ratio would be calculated on the basis of the average experience of the industry in the preceding year, but, as suggested by the industry, any excess of contributions to policyholders' reserves over the net investment income of particular companies would be left out of account. Taxes would be assessed under this approach for each of the 3 years 1947, 1948, and 1949. It is estimated that the total tax liability under the resolution as amended for this 3-year period would approximate the estimated $90,000,000 liability arising under House Joint Resolution 371 as originally introduced, which would have applied only to 1948 and 1949.

Representatives of the industry have expressed a strong preference for the resolution as amended. This preference appears to be based in part upon the fact that under the amendment a tax liability would be established for each of the years in which no liability accrued under existing law. In part the industry's preference for this approach reflected approval of the principle of relating the reserve and other policy liability credit ratio to the actual experience of the industry in the preceding year.

The calculation of the credit ratio under the resolution as amended would differ from the one used under existing law in the computation of the "reserve earnings rate." The arbitrary element of 3¼ percent would be eliminated, so that the credit ratio would be based exclusively on the average experience of the industry in the preceding year, excluding the excess, if any, of policy liabilities of individual companies over their investment income. As under existing law, the credit ratio for all companies would be the same, and in each case the net investment income in excess of the reserve and other policy liability credit would be subject to the regular corporation income-tax rates.

The committee is not willing, at this time, to recommend permanent legislation. Substantial objection has been made to the principle of basing the tax on the average experience of the industry rather than on the experience of the individual company. The restriction of the tax to net investment income (leaving underwriting income out of account) has also been criticized. The committee does not believe that it is possible to resolve these fundamental questions of principle on the basis of the necessarily brief study which it has been possible to make at this time. Therefore, the committee plans to give the problem of defining the appropriate tax base for life-insurance companies further study, with a view to the enactment of permanent legislation during this session of Congress. In the event that no action is taken on permanent legislation during 1950, this stop-gap legislation can be amended to apply also to taxes for 1950.

PART II—DETAILED ACCOUNT OF DISCUSSIONS

Under the revision made by the Revenue Act of 1942, the Secretary of the Treasury is required each year to compute and to proclaim a figure for determining the "reserve and other policy liability credit" allowed life-insurance companies in computing their taxable income. For 1947 and 1948 that figure was in excess of 1, being 1,0066 for 1947 and 1.0243 for 1948, with the result that life-insurance income for those years was relieved from tax. The Secretary's proclamations for the years 1947 and 1948 were made, respectively, on December 26, 1947, and on February 21, 1949 (Press Service Nos. S-577 and S-997, exhibits I (A) and I (B)). In connection with the proclamation made on December 26, 1947, the Secretary stated, in part:

"* * * This development raises questions of public policy with respect to the method of taxing life-insurance companies which call for the immediate at-

tention of the Congress and others concerned. Representatives of the life-insurance industry at their request have already conferred with the Treasury with regard to these problems.

* * * * * * *

"The present taxing formula applicable to life-insurance companies is based on conditions existing at the time of its adoption in 1942. I am confident that the life-insurance industry will cooperate with the Treasury and the Congress in developing revised methods of taxation that will be fair and equitable and will not endanger their obligations to their policyholders."

The meetings referred to by Secretary in his statement took place in the autumn of 1947 and were held for the purpose of discussing the problems raised by the fact that the figure to be proclaimed by the Secretary for that year was expected to result in no tax. The matter was first discussed at a meeting held with a representative of the Life Insurance Association of America on October 15, 1947. At a meeting held with members of a committee appointed to represent the industry on November 5, 1947, consideration was given to, among other matters, the question of whether remedial legislation should be made applicable to the taxable year 1947. Contemporary files of the conferees indicate that the representatives of the industry were told that the Treasury might consider recommending legislation applicable to the taxable year 1947 and that the companies might well govern themselves accordingly.

It was agreed at the meetings referred to above that the interest rate factors in the 1942 Revenue Act formula had become unrealistic. It was apparent that the representatives of the life-insurance industry were disposed to limit the correction to minor changes in existing law without changing its essential pattern. The Treasury, on the other hand, took the position that revised methods of taxing life-insurance companies should be developed. On February 25, 1948, a memorandum was submitted to the Treasury on behalf of the life-insurance industry entitled: "Possible Alterations in the Formula for Imposing a Federal Income Tax on Life Insurance Companies." In that memorandum four possible methods of correcting the formula were explored and computations based thereon were set forth. One of those methods was, in substance,[1] the one which was finally advanced as a concrete proposal by the insurance companies in the summer of 1949. As so proposed, it is the one reported on herein for application as a stopgap measure to the taxable years 1947, 1948, and 1949.

The Treasury's research staff had, in the meantime, completed a study which dealt not only with possible alterations in the formula, but with basic revisions in the methods of taxation to be used. A meeting was held on February 19, 1948, between Secretary Snyder, Under Secretary Wiggins and certain life-insurance-company executives (not the representatives of the industry referred to above). At that meeting the results of the Treasury Department's research were disclosed to the company officials. At a subsequent meeting held on February 25, 1948, those officials requested that the Treasury defer publication of the study in order that the industry might have a chance to study the results and to confer further with regard thereto. Pursuant to that agreement a meeting was held on April 21, 1948, at which the matter was further discussed. On June 14, 1948, the manager of the Life Insurance Association of America submitted to the Treasury certain material, based upon data which were readily available, bearing upon the consequences which would follow from the operation of several of the methods discussed in the study.

On February 26, 1948, Mr. Wiggins submitted to the chairman of your committee a list of some of the items which the Treasury Department believed desirable to have enacted into law during the then current session of the Congress. Item 11 of this list read as follows:

"11. *Income of life-insurance companies.*—It is recommended that the present method of computing the taxable income of life insurance companies under sections 201, 202, and 203 of the code be revised so as to more clearly and equitably reflect the taxable income of such companies. A detailed proposal for carrying this recommendation into effect is now in course of preparation."

Your committee considered the above list of items as well as other matters in executive session in May of that year and item 11, quoted above, was withdrawn in view of the request which had been made by the executives of the life-insurance companies for further time in which to study the Department's views. The basic tax legislation being considered by the committee at that time was H. R.

[1] The method finally advanced differs in that the "negatives are eliminated" as subsequently explained.

6712, Eightieth Congress, second session. That bill passed the House on June 19, 1948, but was not considered by the Senate Committee on Finance or by the Senate before the Congress adjourned on June 30, 1948. The bill was not taken up during the extraordinary session held between July 26 and August 7 of that year.

During the summer of 1948 and prior to the adjournment of the Congress, representatives of the American Life Convention, pursuant to a decision of its executive committee, canvassed the possibility of sponsoring corrective legislation to change the life-insurance company income-tax formula but determined not to take any action because of the imminence of congressional adjournment.

On March 28, 1949, the chairman of the joint committee on Federal income taxation of life insurance companies (representing the American Life Convention and the Life Insurance Association of America) wrote to the Secretary and, with reference to the Secretary's proclamation and statement of February 21, 1949, stated in part:

"* * * As you know, we have been conferring about this matter with the members of your staff but, to date, have reached no conclusions, largely because the problem of taxing life insurance is an extremely difficult one to solve. You will doubtless recognize that the unique nature of life insurance, and its large volume of outstanding policies with fixed and rigid contractual terms, impose definite limitations on the application of pure theory to the problem. It is our opinion, however, that the time has come to arrive at a practical solution to this problem even though it may not be perfect from a theoretical standpoint. It would be our hope that we could reach agreement on such a solution for immediate presentation to Congress. * * *" (See exhibit II.)

In that letter it was suggested that agreement might be reached on a proposal under which the Secretary's ratio would be "frozen" at 0.95. The letter concluded as follows:

"For all these reasons, we would sincerely hope that you might agree on this proposal in order that your suggestion to Congress for amending this provision of the Internal Revenue Code might be made with the substantially complete backing of the life-insurance business. Needless to say, we would be honored to discuss this proposal with you in more detail at any time you might suggest."

Pursuant to the above suggestion a number of conferences were held between representatives of the joint committee of the life-insurance companies, members of the staff of the Joint Committee on Internal Revenue Taxation, and representatives of the Treasury. The first such conference was held on May 4, 1949. It became apparent at that conference that the above suggestion did not meet with the approval of the Government representatives. At a conference held on June 9, 1949, the representatives for the companies advanced a substitute suggestion which was roughly estimated at that time as being the equivalent for the taxable year 1948 of a Secretary's ratio of 0.93. The suggestion was the same, in substance, as one which had first been advanced by the industry as a method of correcting the formula in its memorandum of February 25, 1948. It was modified at this time, however, by the inclusion of a feature, commonly referred to as "the elimination of the negatives," under which, in computing the formula, the ratio of any one company, if it exceeded 100 percent, would be treated as though it were 100 percent. The suggestion was later formalized by the industry in its letter of July 29, 1949, referred to below, and, as a method, it is the one reported on herein.

At the conference held on June 9, 1949, the representatives for the companies suggested that agreement be reached on some proposal to be adopted as a stopgap measure only, an examination of possible basic revisions to be carried on with a view to recommendations to be made at a later date for legislation applicable to the taxable year 1950 and to subsequent years. It was understood by all the participants at that and at subsequent conferences that such a stopgap measure if adopted would be applicable to the taxable year 1948 as well as 1949.

At a conference held on June 14, 1949, the representatives of the Treasury indicated that the substitute suggestion advanced by the representatives for the companies on June 9, 1949, was considered unsatisfactory even as a stopgap measure both from a theoretical as well as from a revenue standpoint. The Treasury representatives met again with the representatives for the companies on July 21, 1949, and proposed the adoption of a flat-rate tax of 3 percent of the net investment income of each company, that income not being reduced by any reserve and other liability credit, and that this plan be operative solely as a stopgap measure for the taxable years 1948 and 1949. At that meeting the representatives for the companies indicated that the real stumbling block in the

way of agreement between the companies and the Treasury was the abandonment in the proposal of the reserve-deduction formula. Inasmuch as the effect of the Treasury proposal was the same as a freezing of the Secretary's ratio of 0.92, the Treasury understood that a statement of the proposal in these terms would be acceptable to the companies. No objection was raised as to the revenue aspects of the proposal, it being estimated that it would be productive of a revenue of $45,000,000 for each of the years in questino. (See exhibit III.)

By letter dated July 29, 1949, addressed to Mr. John S. Graham, Assistant Secretary of the Treasury, the chairman of the joint committee of the life-insurance companies reported on the action taken by the insurance groups with respect to the Treasury's proposal (exhibit IV). In that letter he said:

"The companies represented were almost unanimously in opposition to the proposal because it involved a casting aside of principles which have had application in the tax statutes for life-insurance companies over a period of many years. The consensus of opinion was that these principles should be retained and that it would be unwise for the life insurance business to accept any temporary proposals which indicated that they were willing to relinquish them. The companies did not object to the taxes imposed by the application of your method. There was considerable opposition to paying taxes on 1948 income because it is now late in the year, and tax returns have already been filed by the companies."

The chairman went on to state that the joint committee for the companies had been authorized to put its substitute suggestion of June 9, 1949, into proposal form, to be effective for the taxable years 1948 and 1949. He pointed out that the governing bodies of the two trade associations which his committee represented had met and, in addition, that a good cross section of the companies had officers present. In all 32 companies had been represented.

Another meeting was held on August 1, 1949, at which the representatives for the companies discussed the proposals contained in their letter of July 29, 1949. The Treasury made no concession in its position at this meeting, it being understood, however, that it would weigh the arguments made.

The Secretary, in a letter to the chairman of your committee dated August 16, 1949, recommended the enactment of stopgap legislation with respect to the Federal income taxation of life-insurance companies, to be applicable to the taxable years 1948 and 1949 (exhibit V). In that letter, the Secretary stated his preference for a flat rate tax of 3 percent. He pointed out that the representatives for the companies desired to continue the principle of the present law but that they did not interpose objection to the temporary revision of the formula to produce approximately the same tax revenue for the years 1948 and 1949 that would result if the flat 3-percent tax were imposed. He concluded therefore, as follows:

"In the interest of expediting legislation and with a view to avoiding the need for extensive hearings before your committee on the relative merits of alternative proposals, I recommend the enactment of legislation at this session of Congress which will have the effect of freezing at 92 percent the 'reserve and other policy liability credit' ratio now required to be computed by the Secretary, to yield approximately $45,000,000 of income-tax revenue from life-insurance companies for each of the years 1948 and 1949. I wish to emphasize, however, that this recommendation is made only with respect to temporary legislation and should in no way be interpreted as an indication of the Department's views with respect to the type of permanent legislation which will be required to place the taxation of the life-insurance industry on a just and equitable basis."

The reaction of the life-insurance companies to the Secretary's recommendation is set forth in a letter addressed to Mr. Thomas Lynch, general counsel of the Treasury, dated September 16, 1949 (exhibit VI). In that letter it was stated:

"This [the Treasury's] proposal for the taxation of life-insurance companies may be divided into two parts. The first part defines the method of taxation and the second part retroactively assesses the tax. The companies are divided in their opinions as to both parts of this proposal. This division of opinion is reflected in the actions taken by the governing bodies. The committee gathers from this diversity of opinion the following conclusions as to where we now stand:

"1. Almost universal opposition exists to the application of a retroactive tax on the basis of the formula which the Treasury has suggested, although that sentiment is modified somewhat in the case of some companies who might be willing to accept retroactive taxes if the tax were based on the formula which is indicated as acceptable below.

"2. General agreement exists as to the sort of tax measures which the companies will accept."

The recommendations of the life-insurance companies with respect to the nature of the legislation which would be acceptable to them, namely, the substantive proposal set forth in their letter of July 29, 1949, modified, with respect to retroactivity, in the manner set forth above, were presented to the chairman of your committee by letter from the chairman of the joint committee for the companies dated September 30, 1949 (exhibit VII).

On October 10, 1949, the Secretary again wrote to the chairman of your committee with reference both to his original letter and with respect to the reaction of the companies to that letter (exhibit VIII). He stated:

"In formulating the recommendation transmitted to you on August 16, 1949, we were influenced by the assurance of the spokesman for the life-insurance industry that it had the concurrence of the two major associations of life-insurance companies. We are now informed that a number of the constituent members of the two life-insurance-company associations have indicated opposition to this recommendation, notwithstanding the fact that it had been considered acceptable by the committee which represented them in discussions with us for the past 2 years. There now appear to be differences of opinion within the industry both with respect to the imposition of a tax on 1948 earnings and with respect to the proposal to freeze the Secretary's ratio at 92 percent.

"In view of the lateness of the legislative session, I reaffirm my earlier recommendation and urge the Congress to enact legislation along the lines previously proposed which would impose a total tax liability of about $90,000,000 with respect to income received by the life-insurance industry in 1948 and 1949. * * *"

For immediate release, Friday, December 26, 1947
Press Service, No. S 577

EXHIBIT I (A)

TREASURY DEPARTMENT,
Washington.

Secretary Snyder today proclaimed the figure to be used in computing the "reserve and other policy liability credit" of life-insurance companies under the Federal income tax for the taxable year 1947. This figure, determined from year to year in accordance with a formula set up under statutory provisions, governs the portion of net investment income which life-insurance companies are allowed as a deduction for earnings needed to maintain their reserves and meet commitments to policyholders. The figure proclaimed for 1947 is 1.0066. As in previous years, the proclamation was made in the form of a Treasury decision.

In connection with the proclamation, the Secretary issued the following statement:

"Since the figure 1.0066 determined under T. D. 5595, December 19, 1947, to be used by life-insurance companies in computing their reserve and other liability credit for the taxable year 1947 is in excess of one, it will result in deductions in excess of the net-investment income on life-insurance reserves. This will not only have the effect of entirely relieving life-insurance companies from Federal income tax with respect to their life-insurance investment income, but will also exempt them in considerable part from tax on investment income derived from non-life-insurance reserves. Under the 1947 reserve and other policy liability credit ratio, only a small proportion of companies, those doing a relatively large volume of accident- and health-insurance business, will pay any Federal income tax for 1947. This development raises questions of public policy with respect to the method of taxing life-insurance companies which call for the immediate attention of the Congress and others concerned. Representatives of the life-insurance industry at their request have already conferred with the Treasury with regard to these problems.

"The figure for 1947 has been determined in accordance with the provisions of section 202 (b) of the Internal Revenue Code, as amended by section 163 of the Revenue Act of 1942, on the basis of representative data furnished by life-insurance companies on their income-tax returns for 1946. The figure for 1947 is in all respects consistent with corresponding figures determined for previous taxable years as follows: 1946, 0.9595; 1945, 0.9539; 1944, 0.9261; 1943, 0.9198; 1942, 0.93. Under the law, I have no alternative but to determine such a figure. However, the unavoidable result is the effective removal of Federal income-tax liability from life-insurance companies.

"The present taxing formula applicable to life-insurance companies is based on conditions existing at the time of its adoption in 1942. I am confident that the life-insurance industry will cooperate with the Treasury and the Congress in developing revised methods of taxation that will be fair and equitable and will not endanger their obligations to their policyholders."

EXHIBIT I (B)

Immediate release, Monday, February 21, 1949
S 997

TREASURY DEPARTMENT,
INFORMATION SERVICE,
Washington, D. C.

Secretary Snyder today proclaimed the figure to be used in computing the "reserve and other policy liability credit" of life-insurance companies under the Federal income tax for the taxable year 1948. This figure, computed annually in accordance with a formula prescribed by act of Congress, determines the portion of net-investment income which life-insurance companies are allowed as a credit (on account of reserve requirements and other commitments to policyholders) in arriving at net income subject to tax. Under the statute, the figure is the same for each life-insurance company and is based on industry-wide data for the preceding year. The figure for 1948, proclaimed in a Treasury Decision, is 1.0243.

In connection with the proclamation, the Secretary issued the following statement:

"Under the figure 1.0243 determined today under T. D. 5689, to be used by life-insurance companies in computing their 1948 reserve and other liability credit, this important industry will again be exempt from Federal income tax. Under the law, I have no alternative but to determine such a figure. Last year, when a similar situation arose, I directed attention to the need for corrective legislation.

"In the absence of corrective legislation, these companies will continue to be exempt indefinitely from Federal income taxation. This matter requires urgent attention, and at the first opportunity the Treasury Department will present to the Congress suggestions for taxing life-insurance companies. At their own request, representatives of the industry have already conferred with the Treasury on this matter. Our investigations have made it clear that the tax provisions applicable to the life-insurance industry can be revised to insure that this industry makes its fair contribution to Government revenues, with due regard to the companies' obligations to policyholders."

The figure for 1948 was determined in accordance with the provisions of section 202 (b) of the Internal Revenue Code, as amended by section 163 of the Revenue Act of 1942, on the basis of representative data furnished by life-insurance companies on their income-tax returns for 1947. The 1948 ratio of 1.0243 compares with corresponding figures determined for previous taxable years as follows: 1947, 1.0066; 1946, 0.9595; 1945, 0.9539; 1944, 0.9261; 1943, 0.9198; 1942, 0.93.

EXHIBIT II

AMERICAN LIFE CONVENTION
CHICAGO, ILL.

LIFE INSURANCE ASSOCIATION OF AMERICA
NEW YORK, N. Y.

JOINT COMMITTEE,
March 28, 1949.

Hon. JOHN W. SNYDER,
Secretary of the Treasury, Washington, D. C.

DEAR MR. SECRETARY: In the press release which accompanied your proclamation on February 21, 1949, of the figure to be used in computing the reserve and other policy-liability credit for the determination of the Federal income tax for life-insurance companies for the taxable year 1948, you directed attention to the need for corrective legislation and indicated that the Treasury Department, at the first opportunity, would present to Congress suggestions for taxing life-insurance companies.

Of course, the failure of the present law to yield a tax upon the life-insurance business in the last 2 years is due entirely to the reduced investment earnings of the companies resulting from depressed interest rates. This was a result which could have been and, as a matter of fact, was foreseen by Treasury officials at the time the present statute was enacted. The reduced investment income of companies has had the effect of substantially increasing the cost to policyholders as well as relieving the companies of income tax under the present formula.

Notwithstanding the fact that the life-insurance business is now paying heavy premium taxes to the States, the majority of those in the life-insurance business agree with you that some modification of the present formula should be enacted which would yield a reasonable Federal income tax from the companies. As you know, we have been conferring about this matter with the members of your staff but, to date, have reached no conclusions, largely because the problem of taxing life insurance is an extremely difficult one to solve. You will doubtless recognize that the unique nature of life insurance, and its large volume of outstanding policies with fixed and rigid contractual terms, impose definite limitations on the application of pure theory to the problem. It is our opinion, however, that the time has come to arrive at a practical solution to this problem even though it may not be perfect from a theoretical standpoint. It would be our hope that we could reach an agreement on such a solution for immediate presentation to Congress. To this end, and as chairman of the joint committee of the two principal organizations of life-insurance companies in this country, I should like to suggest that we might agree on a modification of the present law, as follows:

> Substitute for the present method of determining the adjustment for reserve and other policy liabilities credit a simple formula which would permit all life-insurance companies to take a credit for this purpose equal to 95 percent of their net investment incomes. This, in effect, would be nothing more than freezing the so-called Secretary's ratio at 95 percent.

The precise amendments to the Internal Revenue Code necessary to carry out this suggestion are set forth on the attached sheet.

As you know, since the passage of the 1942 Revenue Act, the Secretary's ratio has fluctuated between about 92 and 102.5 percent. The decision to suggest a constant ratio of 95 percent was reached because it might be considered a fair average of the Secretary's ratio over these years, although obviously on the low side (hence producing immediately a somewhat larger tax), and also because it is not unreasonable to assume that on the average, over a period of years under all circumstances which may now be forecast, life-insurance companies might be expected to need about 95 percent of their net investment incomes to support their reserve liabilities.

It will be obvious that this proposal would provide a number of advantages as compared with the present law:

(1) It would considerably simplify the complicated formula by which the reserve and other policy liabilities credit is now determined.

(2) It would completely get away from the uncertainties which have resulted in recent years over the unpredictable fluctuations in the Secretary's ratio.

(3) All life-insurance companies would pay some tax at all times as long as they reported any net investment income.

(4) It would be possible to estimate the amount of tax to be collected from the life insurance companies with comparable ease.

We believe that this proposed amendment to the Internal Revenue Code would afford as good a solution to our present difficulties as it is possible to find. It would result in a statute which would produce a relatively stable amount of tax and a statute which would recognize the need of the life-insurance business to obtain reasonable returns on its investments in order to support the reserve required to carry out its outstanding obligations. It would provide us with a tax formula that, because of its stability, would not have to be reexamined every few years as has been the case since the beginning of Federal income taxation in this country. At the same time, the tax produced would not unduly burden those thrifty persons who have attempted to assume the responsibility of providing for their dependents and their own old age, most of whom are persons of modest means and many of whom are not otherwise subject to Federal income tax.

For all these reasons, we would sincerely hope that you might agree on this proposal in order that your suggestion to Congress for amending this provision

of the Internal Revenue Code might be made with the substantially complete backing of the life-insurance business. Needless to say, we would be honored to discuss this proposal with you in more detail at any time you might suggest.

Sincerely yours,

A. J. McANDLESS,
Chairman, Joint Committee on Federal Income Taxation of Life Insurance Companies.

PROPOSED AMENDMENTS TO SECTIONS 201–203, INTERNAL REVENUE CODE

(1) In subsection (c) of section 201, strike paragraphs (3), (4), (5), and (6) and renumber paragraph (7).

(2) Amend subsection (b) of section 202 to read as follows:

"(b) RESERVE AND OTHER POLICY LIABILITY CREDIT.—As used in this section the term 'reserve and other policy liability credit' means an amount computed by multiplying the normal-tax net income by *95 per centum* (a figure, to be determined and proclaimed by the Secretary for each taxable year. This figure shall be based on such data with respect to life-insurance companies for the preceding taxable year as the Secretary considers representative and shall be computed in accordance with the following formula: The ratio which (1) the aggregate of the sums of (A) 2 per centum of the reserves for deferred dividends, (B) interest paid, and (C) the product of (i) the mean of the adjusted reserves at the beginning and end of the taxable year and (ii) the reserve earnings rate bears to (2) the aggregate of the excess of net incomes computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c))."

(3) Amend subsection (b) of section 203 to read as follows:

"(b) RESERVE AND OTHER POLICY LIABILITY CREDIT.—As used in this section, the term 'reserve and other policy liability credit' means an amount computed by multiplying the corporation surtax net income by *95 per centum* (the figure determined and proclaimed under section 202 (b))."

EXHIBIT III

JULY 21, 1949.

Mr. BRUCE E. SHEPHERD,
Manager, Life Insurance Association of America,
New York, N. Y.

DEAR MR. SHEPHERD: In accordance with your request, I am sending you a description of the stopgap plan for the taxation of life-insurance companies which we discussed this morning.

Under the proposed plan, as a temporary measure applicable only to taxable years beginning in 1948 and in 1949, a flat-rate tax of 3 percent would be levied upon the net investment income of life-insurance companies without any deduction for the reserve and other policy liability credit now provided in section 202 (b). In order to provide for a reduced rate of tax similar to that now provided by law in the case of corporations with less than $50,000 taxable income, there would be granted a specific deduction equal to 40 percent of the net investment income up to, but not in excess of $500,000. This specific deduction would be given to all life-insurance companies, thus providing a slightly more liberal treatment than the limited graduation now in the corporate tax schedule. Partially tax exempt interest would be completely excluded from net investment income for the purpose of this flat-rate tax. The presumptive income from nonlife reserves would continue to be taxed at the regular corporate rates, except that the rate of 3¼ percent now in section 202 (c) would be reduced to 3 percent, making that percentage more consistent with the present rate of return on investment.

It is contemplated that the committee reports accompanying this proposed legislation would emphasize the fact that it was merely a stopgap plan of taxation for the past and current years, pending a full study and examination of the subject looking toward a permanent solution to be adopted at the earliest practicable date.

Very truly yours,

THOMAS J. LYNCH, *General Counsel.*

EXHIBIT IV

AMERICAN LIFE CONVENTION
CHICAGO, ILL.

LIFE INSURANCE ASSOCIATION OF AMERICA
NEW YORK, N. Y.

JOINT COMMITTEE,
Fort Wayne, Ind., July 29, 1949.

Hon. JOHN S. GRAHAM,
Assistant Secretary of the Treasury, Washington, D. C.

DEAR MR. GRAHAM: The proposal for taxing life insurance companies set forth in Mr. Lynch's letter of July 21 was carefully considered by the governing bodies of the two trade associations which this committee represents. These bodies were represented and in addition a good cross section of the companies had an officer present. All told, 32 companies were represented at the meeting. The proposal was not received favorably. Its approval was vigorously pressed for by those members of the committee who were in favor of accepting it. You have my assurance that it was not hurriedly considered.

The companies represented were almost unanimously in opposition to the proposal because it involved a casting aside of principles which have had application in the tax statutes for life-insurance companies over a period of many years. The consensus of opinion was that these principles should be retained and that it would be unwise for the life-insurance business to accept any temporary proposals which indicated that they were willing to relinquish them. The companies did not object to the taxes imposed by the application of your method. There was considerable opposition to paying taxes on 1948 income because it is now late in the year, and tax returns have already been filed by the companies.

The committee was instructed in this meeting to negotiate with you along the lines of the second proposal which we made. You will remember that in this proposal we used the average valuation rate of interest in computing the Secretary's ratio and individual companies with ratios in excess of 100 percent were treated as though their ratios were 100 percent. Prior to the meeting we did not have authority from one of the groups to negotiate for a tax measure along these lines. The meeting gave us authority to make this proposal with the understanding that if it becomes effective promptly we would make returns on the basis of 1948 income and pay a tax in 1949. The law also would be effective as to 1949 operations with a tax payable in 1950. There was complete understanding upon the part of representatives of the companies present that this would be stopgap legislation.

The committee was directed to discuss with you some changes which would exempt "across the board" part of a company's investment income, along the lines suggested in Mr. Lynch's letter. This was to be sought for the benefit of the smaller companies.

I have talked with Mr. Shepherd about giving out some information concerning the negotiations which are being conducted. He will come to your office on Monday. You may discuss this problem with him and work out any arrangement which will be satisfactory to you and to him.

As you indicated over the telephone and as I understand it, we are still considering the matter open to exploration and discussion and I shall hear from you before further action is taken.

Sincerely yours,

A. J. MCANDLESS,
Chairman, Joint Committee on Federal Income Taxation of Life Insurance Companies.

EXHIBIT V

TREASURY DEPARTMENT,
Washington, August 16, 1949.

Hon. ROBERT L. DOUGHTON,
Chairman, Joint Committee on Internal Revenue Taxation, Washington, D. C.

MY DEAR MR. CHAIRMAN: You are familiar with the staff work which has taken place between the Treasury and the Joint Committee on Internal Revenue Taxa-

tion, during the past several months, with respect to the difficult problem of suggesting an equitable change in the revenue laws concerning the taxation of life insurance companies. Recommendations for permanent change in legislation have not been completed by the two staffs and will, undoubtedly, require much additional work prior to the next session of Congress. However, because of the need for corrective legislation, which is likewise recognized by the industry, it is recommended that favorable consideration be given at this time to the enactment of what might be termed "stopgap" legislation covering the taxable period beginning after December 31, 1947, and prior to January 1, 1950.

For the past two taxable years the operation of the present law has resulted in the exemption of life insurance companies from Federal income tax. On December 26, 1947, and again on February 21, 1949, I called attention to the need for corrective legislation in connection with the proclamation of the figure to be used in computing the "reserve and other policy liability credit" required of me under the statute. In the February 21, 1949, statement, I stated that "at the first opportunity the Treasury Department will present to the Congress suggestions for taxing life-insurance companies."

The taxation of life-insurance companies presents a special problem. The nature of this problem has long been recognized and since the Revenue Act of 1921 special provisions of the income-tax law have applied to life-insurance companies. In general, these provisions have started with a figure termed "net investment income" which represents interest, dividends, and rents earned on insurance-company assets less investment management expenses. In arriving at taxable income, however, a deduction from net investment income has been allowed to cover interest obligations under policy contracts and State regulatory requirements. Various methods of computing this deduction have been used since 1921. Although this so-called policy liability credit has been allowed as a deduction to life-insurance companies, the interest so accrued to policyholders has never been considered taxable income in the hands of policyholders.

The method of taxing life-insurance companies was revised by the Congress in 1942. One of the basic changes was to abandon the previous concept of taxing each individual company on its own experience and in lieu thereof, the elements of tax for each company were to be determined in accordance with a formula based on industry-wide data for the preceding taxable year. The statute provides that an insurance company is entitled to a "reserve and other policy liability credit" equal to a flat percentage of net investment income. The percentage is determined each year by the Secretary of the Treasury in accordance with the statutory formula. With certain minor adjustments, the ratio is obtained by relating the aggregate interest allowance for all of the companies in the industry to their aggregate net investment income. The amount which the formula allows for interest on life insurance policy reserves is not the actual reserve interest requirement of the industry but is arrived at by taking an arbitrary percentage of their reserves equal to the average of 3¼ percent and the actual rate of interest assumed by the companies in computing their reserves. In ascertaining this average, the 3¼ percent is weighted 65 percent and each company's own rate is weighted 35 percent.

For several years following the 1942 act, the tax liabilities of insurance companies accorded with those expected from the legislation. However, liabilities subsequently decreased and, as I have indicated, a state of complete exemption has prevailed since 1946. The ratios obtained under the statutory formula and proclaimed were as follows for the years 1942 to 1948: 1942 0.93; 1943, 0.9198; 1944, 0.9261; 1945, 0.9539; 1946, 0.9595; 1947, 1.0066; 1948, 1.0243.

The primary factor causing the rise in the deduction ratio derived from the statutory formula has been the heavy weight attached to the arbitrary assumption that the companies need 3¼ percent of their reserves to meet their policy interest obligations. While representative in 1942, this figure has become totally unrepresentative in recent years because of the substantial decrease in the interest rates assumed by the companies on policy reserves. Moreover, since the deduction representative for the industry, all companies automatically become tax-exempt under the law when the average equals 100 percent of net investment income.

The tax liabilities of life-insurance companies are compared with their net investment income for the years 1929 to 1946 in the attached table. These figures reflect changes in tax rates as well as the method of computing the tax base. These data bring out clearly, however, the erratic results of life-insurance company taxation for the past 20 years.

Our respective staffs concur that the present statutory formula is a complicated approach to determine the tax liability of life-insurance companies. However, until changes can be proposed for a more equitable solution to the problem, they suggest the enactment of stopgap legislation for the years 1948 and 1949. On the basis of the findings of our staffs, I believe that a stopgap measure which would meet immediate requirements is a flat rate tax of 3 percent of net investment income. Our estimates indicate that this measure would produce approximately $45,000,000 of tax revenue for each of the years 1948 and 1949.

The representatives of the associations of life-insurance companies have outlined their views on the subject of remedial legislation. They concur in the need for stopgap legislation but do not concur in the proposal for a flat tax of 3 percent since they desire to continue the principle of the present law. However, they do not interpose objection to the temporary revision of the formula to produce approximately the same tax revenue for the years 1948 and 1949 that would result if the flat 3-percent tax were imposed.

The Government should receive tax revenue from fire-insurance companies. Until the Congress has an opportunity to explore the possibilities of more equitable taxation of life-insurance companies, at the next session, there should be enacted stopgap legislation. Likewise, there is an indicated need on the part of the life-insurance companies to know the amount of their tax liabilities for the years 1948 and 1949.

In the interest of expediting legislation and with a view to avoiding the need for extensive hearings before your committee on the relative merits of alternative proposals, I recommend the enactment of legislation at this session of Congress which will have the effect of freezing at 92 percent the "reserve and other policy liability credit" ratio now required to be computed by the Secretary to yield approximately $45,000,000 of income-tax revenue from life-insurance companies for each of the years 1948 and 1949. I wish to emphasize, however, that this recommendation is made only with respect to temporary legislation and should in no way be interpreted as an indication of the Department's views with respect to the type of permanent legislation which will be required to place the taxation of the life insurance industry on a just and equitable basis.

Our staff is available, to assist in drafting legislation, if you so desire.

Sincerely yours,

JOHN W. SNYDER,
Secretary of the Treasury.

EXHIBIT VI

FORT WAYNE, IND., *September 16, 1949.*

Mr. THOMAS LYNCH,
Legislative Counsel, Treasury Department, Washington, D. C.

DEAR MR. LYNCH: We have had two meetings of the governing bodies which authorized this committee. Member companies were invited to participate in these meetings so that we could sample the opinions of the companies as to tax proposals and as to your recommendation to the Ways and Means Committee. We have never had this recommendation in definite form but have assumed from our conversations that the plan was to freeze the Secretary's ratio at 92 percent and to use this formula as the tax base in calculating the companies' tax for 1948 and 1949. This legislation, it was understood, was to be a stopgap measure.

This proposal for the taxation of life-insurance companies may be divided into two parts. The first part defines the method of taxation and the second part retroactively assesses the tax. The companies are divided in their opinions as to both parts of this proposal. This division of opinion is reflected in the actions taken by the governing bodies. The committee gathers from this diversity of opinion the following conclusions as to where we now stand.

1. Almost universal opposition exists to the application of a retroactive tax on the basis of the formula which the Treasury has suggested, although that sentiment is modified somewhat in the case of some companies who might be willing to accept retroactive taxes if the tax were based on the formula which is indicated as acceptable below.

2. General agreement exists as to the sort of tax measures which the companies will accept.

The business will accept an amendment to the present law with the Secretary's ratio calculated from the data given in their 1948 returns making use of the average valuation rate of interest required for life reserves in such calculations.

Further, the companies will accept a modification of the calculation with ratios of individual companies treated as though such ratios were 100 percent in those cases where the ratios exceed 100 percent. This, from the data which we have at hand, would produce a Secretary's ratio applying to 1949 business of about 98.5 percent. We were authorized to submit such a statement of position to the chairman of the Ways and Means Committee.

The committee is not attempting to explain away the changes and shifts in opinion voiced by the business which have occurred. The changes, however, are perhaps not more than should be anticipated in dealing with a tax measure, for it is apparent that it is only after taxes have become imminent that opinions on tax measures become clear and precise.

Early in our conferences this year, we indicated to you that we thought that the companies would raise no objection if a suitable tax were applied to the business of 1948. We have been wrong in this conclusion. The situation, of course, has changed substantially in the intervening months. Many decisions have been made relative to policyholders' surplus and general financial conditions which would make it unfair to retroactively assess a tax on the life-insurance business and its policyholders.

At the present time the only thing we can tell you is the foregoing. There is full agreement on the part of the two governing bodies that they will accept a tax measure with the Secretary's ratio calculated upon the average valuation rate of interest. The opinion exists in the committee that there are few companies which would make an appearance in opposition. There might not be any. That is the outcome we would attempt to secure.

Sincerely yours,

A. J. McANDLESS,
Chairman, Joint Committee on Federal Income Taxation of Life Insurance Companies.

EXHIBIT VII

FORT WAYNE, IND., *September 30, 1949.*

Re taxation of life-insurance companies.

Hon. ROBERT L. DOUGHTON,
Chairman, Ways and Means Committee, Washington, D. C.

DEAR MR. DOUGHTON: It is our understanding that Secretary of the Treasury Snyder has recommended to the Ways and Means Committee that the method of taxing life-insurance companies provided by sections 201–203, Internal Revenue Code, be changed (1) by freezing the "figure to be determined and proclaimed by the Secretary" at 92 percent and, (2) by making this formula applicable, as a stopgap to the taxable years 1948 and 1949.

The American Life Convention and the Life Insurance Association of America, trade associations comprising a membership of 227 life-insurance companies writing over 95 percent of the life insurance in force in the United States, have given careful consideration to this proposal. Meetings of the governing bodies of both organizations have recently been held at which the full membership was invited to express views. As a result of these meetings, the following facts may be reported.

(1) Each of the governing bodies has authorized me to say that the life-insurance companies would not object to a revision of the present formula which would recognize the change which has occurred in the level of their interest earnings since the 1942 act was enacted. This revision in the tax would subject the companies to a tax on their 1949 business with the tax payable on March 15, 1950. The details of such revision of the law are set forth on the attached sheet.

(2) There is general opposition to Secretary Snyder's stopgap proposal.

(3) There is strong opposition to a tax which appears retroactive in principle and in particular to the application of this revision or any other new tax to the business of 1948.

The measure we suggest would raise about $38,000,000 in taxes. There is good reason to believe that few, if any, companies would appear in opposition to it and that many companies would be in favor of this revision.

Sincerely,

A. J. McANDLESS,
Chairman, Joint Committee on Federal Income Taxation of Life Insurance Companies.

AMENDMENTS TO SECTIONS 201 (C) (4) AND 202 (B), INTERNAL REVENUE CODE

1. Amend Section 201 (c) (4), Internal Revenue Code to read as follows:

"(4) AVERAGE VALUATION [RESERVE EARNINGS] RATE.—The term *'average valuation rate'* [reserve earnings rate] means a rate computed by [adding 2.1125 per centum (65 per centum of one-fourth per centum) to 85 per centum of the average rate assumed in computing life-insurance reserves. Such average rate shall be calculated by] multiplying each assumed rate of interest by the means of the amounts of the adjusted reserves computed at that rate at the beginning and end of the taxable year and dividing the sum of the products by the means of the total adjusted reserves at the beginning and end of the taxable year."

2. Amend Section 202 (b), Internal Revenue Code to read as follows:

"(b) RESERVE AND OTHER POLICY LIABILITY CREDIT.—As used in this section the term 'reserve and other policy liability credit' means an amount computed by multiplying the normal-tax net income by a figure, to be determined and proclaimed by the Secretary for each taxable year. This figure shall be based on such data with respect to life-insurance companies for the preceding taxable year as the Secretary considers representative and shall be computed in accordance with the following formula—the ratio which (1) the aggregate of the sums of (A) (1) 2 per centum of the reserves for deferred dividends, (B) interest paid, and (C) the product of (i) the mean of the adjusted reserves at the beginning and end of the taxable year and (ii) the *average valuation* [reserve earnings] rate bears to (2) the aggregate of the excess of net incomes computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c); *provided, however, that if for any company the sum of (A), (B), and (C) is larger than the excess of net income computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c), then in such event with respect to such company the sum of items (A), (B), and (C) in the computation of item (1) shall be replaced by the excess of net income computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (C).*"

EXHIBIT VIII

TREASURY DEPARTMENT,
Washington, October 10, 1949.

Hon. ROBERT L. DOUGHTON,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D. C.

MY DEAR MR. CHAIRMAN: In my letter dated August 16, 1949, I recommended stopgap legislation for revising the income-tax provisions applicable to life insurance companies for the taxable years 1948 and 1949, to produce about $45,000,000 of revenue for each of these 2 years. The Treasury and joint committee staffs preferred to obtain this revenue by the imposition of a temporary flat-rate tax on net investment income, but in the interest of expediting legislation, I concluded that it would be desirable to recommend the method preferred by the life insurance industry, which would revise the "reserve and other policy liability credit" ratio prescribed by the 1942 legislation.

In formulating the recommendation transmitted to you on August 16, 1949, we were influenced by the assurance of the spokesmen for the life insurance industry, that it had the concurrence of the two major associations of life insurance companies. We are now informed that a number of the constituent members of the two life insurance company associations have indicated opposition to this recommendation, notwithstanding the fact that it had been considered acceptable by the committee which represented them in discussions with us for the past 2 years. There now appear to be differences of opinion within the industry both with respect to the imposition of a tax on 1948 earnings and with respect to the proposal to freeze the Secretary's ratio at 92 percent.

In view of the lateness of the legislative session, I reaffirm my earlier recommendation and urge the Congress to enact legislation along the lines previously proposed which would impose a total tax liability of about $90,000,000 with respect to income received by the life-insurance industry in 1948 and 1949. Our investigations indicate that the level of taxation which will result from the proposed legislation is well within the life-insurance companies' taxpaying capacity.

BEST AVAILABLE COPY

This industry has paid no income tax for ether 1947 or 1948 and had a relatively small tax liability for 1946. Moreover, under present law no tax liability is indicated for 1949. During these years its net investment income increased steadily from 1.3 billion to over 1.5 billion dollars. I believe that the individual companies have been fully aware of the need for making provision for tax liabilities on 1948 income. They have been on notice since our first meeting with their representatives in 1947 that the Government considered the tax formula enacted in 1942 to have become entirely unworkable and that the Department would recommend remedial legislation to become effective as soon as practicable. Moreover, the several meetings which the Treasury and joint committee staffs had with representatives of the industry as recently as this summer were conducted with the mutual understanding that the proposals for stopgap legislation being developed would apply to both 1948 and 1949 taxable years.

In my judgment our lengthy investigations and discussions have adequately explored the considerations involved in arriving at an equitable basis for the taxation of this industry for 1948 and 1949. Unless legislation is enacted promptly, I am concerned that revenue from this industry may be irretrievably lost for 1948 and possibly also for 1949. This would be extremely inequitable from the viewpoint of the other segments of our economy subject to the heavy rates of taxation necessitated by the Government's large revenue requirements.

I wish again to make it clear that this recommendation is made with the reservation that it is for temporary legislation required in the interest of equity to assure some immediate tax payments by this important industry. It should not be interpreted to reflect the Department's views with regard to a satisfactory and effective approach to a more permanent method of taxation which will be submitted to you during the next legislative session.

In the interest of expediting congressional consideration, I enclose draft legislation covering this proposal.

Sincerely yours,

JOHN W. SNYDER,
Secretary of the Treasury.

PART III—DETAILED DISCUSSION OF THE TECHNICAL PROVISIONS OF THE JOINT RESOLUTION

FIRST SECTION

Under existing law, income taxes (normal and surtax) are imposed on life-insurance companies at the rates provided for corporations generally. The taxes are imposed, however, only with respect to adjusted normal-tax net income (as defined in sec. 202 of the Internal Revenue Code) and adjusted corporation surtax net income (as defined in sec. 203). In the determination of the adjusted normal-tax net income and the adjusted corporation surtax net income of the life-insurance company, the company is allowed a credit which is, in both cases, called the "reserve and other policy liability credit." These credits are arrived at by multiplying the normal-tax income of the company for the taxable year, or its corporation surtax net income, as the case may be, by a figure which is determined and proclaimed for each taxable year by the Secretary of the Treasury. Existing law (sec. 202 (b) of the code) provides that the figure so determined and proclaimed shall be based on such data, for the preceding taxable year, with respect to life-insurance companies as the Secretary considers representative, and that the figure shall be computed in accordance with a formula based upon the ratio which the aggregate of three specified types of items for such companies bears to the aggregate of the net incomes (computed with certain adjustments) of such companies.

Subsection (a) of the first section of the joint resolution, as reported, amends the second sentence of section 202 (b) of the Internal Revenue Code. Although this amendment leaves unchanged the formula to be used in arriving at the income taxes payable by life-insurance companies for taxable years other than taxable years beginning in 1947, 1948, and 1949, it does make two changes in such formula for taxable years beginning in 1947, 1948, and 1949. Both changes result in a smaller numerator, in the computation of the ratio referred to in the preceding pargraph, than is obtained under existing law. Neither change affects the amount of the denominator of such ratio. Under existing law, one of the three items which make up the numerator of the ratio is the product of (1) the mean of the adjusted reserves at the beginning and end of

the taxable year and (ii) the reserve earnings rate (defined in sec. 201 (c) (4) of the code). The first change made by the amendment is to provide that in computing such product there shall be used, in lieu of the reserve earnings rate, the average rate of interest assumed in computing life-insurance reserves. Such average rate shall be determined in the manner provided in the second sentence of section 201 (c) (4) of the code.

The second change provides that if the Secretary of the Treasury, in computing the ratio, finds that the net effect of including the data with respect to any life-insurance company is to increase the numerator more than such data increases the denominator, he shall limit the net change in the numerator resulting from the inclusion of such data to the net change in the denominator resulting therefrom.

The following will illustrate the application of the second change made by the amendment. The Secretary of the Treasury, having selected the data of life-insurance company X as representative, finds that the net income (adjusted as required by sec. 202 (b)) of company X for the taxable year 1946 was $100,000. This $100,000 will be used by the Secretary in making up the denominator of the ratio which will determine the figure to be used for the taxable year 1947. The Secretary further finds from the data of company X for the year 1946 that the sum of (A) 2 percent of its reserves for deferred dividends, (B) interest paid by it, and (C) the product of (i) the mean of its adjusted reserves at the beginning and end of the taxable year 1946 and (ii) the average rate of interest assumed in 1946 by company X in computing its life-insurance reserves, was $105,000. Were it not for the second change made by the amendment, the Secretary would add $105,000 to the numerator of the ratio, thereby increasing the numerator $5,000 more than the inclusion of the data of such company increased the denominator of the ratio. Under the amendment, only $100,000 would be added to the numerator of the ratio.

In the case of a few life-insurance companies the Secretary of the Treasury may find that the net effect of including data with respect to such companies is a subtraction from the denominator of the ratio. In the treatment of the data of such a company, the effect of the second change made by the amendment would be to require the Secretary, in lieu of making an addition to the numerator of the ratio, to subtract from the numerator an amount equal to the amount subtracted from the denominator by reason of the inclusion of such data.

Subsection (b) of the first section of the joint resolution amends section 203 (b) of the code to make it clear that the figure to be used in computing the reserve and other policy liability credit under section 203 (b) (for the purposes of the surtax) for any taxable year beginning in 1947, 1948, or 1949, is the same figure which the Secretary of the Treasury shall determine and proclaim for such year under section 202 (b) of the code as amended by subsection (a) of the first section of the joint resolution

Subsection (c) of the first section of the joint resolution provides that the amendments made by the joint resolution shall be applicable to taxable years beginning after December 31, 1946. However, as noted above, (the amendments do not effect a change in the formula to be used in computing the income taxes of life-insurance companies for taxable years beginning after 1949, since the legislation is proposed merely as a "stopgap" measure pending the development and enactment of a satisfactory long-range basis for the taxation of life-insurance companies. Subsection (c) also provides that the Secretary of the Treasury shall, within 60 days after the date of the enactment of the joint resolution, determine and proclaim the figures to be used by life-insurance companies in computing their reserve and other policy liability credits for taxable years beginning in 1947, 1948, and 1949.

SECTION 2

Section 2 of the joint resolution, as reported, provides for the filing of returns and the payment of taxes by life-insurance companies with respect to taxable years beginning in 1947, 1948, and 1949.

Under these provisions, every life-insurance company subject to the taxes imposed by section 201 of the code is required to file a return for 1947, for 1948, and for 1949, even though under existing law it may have filed a return for any or all of such years. The return required under these provisions for any such year may not be filed before the Secretary has proclaimed (after the enactment of the joint resolution) the figure to be used in computing the reserve and other

policy liability credits for such year and must be filed on or before the fifteenth day of the third month following the close of the month in which the joint resolution is enacted. Any such return shall constitute the return for the taxable year for all purposes of the code, must meet the requirements of section 52 (a), and shall be filed as required by section 53 (b) (2) and other relevant provisions of the code. Thus, such a return shall constitute the return for the purpose of supplement L, relating to the assessment and collection of deficiencies; supplement M, relating to interest and additions to the tax; and supplement O, relating to overpayments. No return with respect to the taxes imposed by section 201 of the code for a taxable year beginning in 1947, 1948, or 1949, which is filed by a life-insurance company on or before the date of the Secretary's proclamation required under section 1 (c) of the joint resolution, shall be considered for any of such purposes, or for any other purpose, of the code as the return for such year.

The provisions of section 56 (a) of the code (relating to the time of payment) will not be applicable to the payment of taxes for such 3 taxable years. Instead, such taxes shall be due and payable on the 15th day of the third month following the close of the month in which the joint resolution is enacted. The provisions of section 56 (b) of the code (relating to installment payments) are, however, not affected, and a life-insurance company may, at its election, pay the taxes due for any such year in four equal installments in accordance with the provisions of that section.

Section 2 of the joint resolution further provides that all payments made with respect to the taxes for 1947, 1948, or 1949 imposed by section 201 of the code under the law in effect prior to the enactment of the joint resolution, to the extent that they have not been credited or refunded, shall be deemed to be payments made at the time of the filing of the return required by the joint resolution on account of the taxes for such year. (Taxes for 1947 and 1948 were paid by some life-insurance companies doing health and accident business.) The amount which will be so credited will include, in addition to the tax itself, any amounts paid as interest, penalty, or additions to the tax.

For example, assume that under existing law a life-insurance company writing health and accident insurance paid, for its taxable year 1947, $16,000 in taxes, an additional amount of $846 asserted as a deficiency by the Commissioner of Internal Revenue, $101 as interest thereon, and a negligence penalty of $42; for its taxable year 1948, $6,000 in taxes; and no tax for its taxable year 1949. Under section 2 of the joint resolution the following amounts would be deemed to be payments made, on account of such taxes, at the time of the filing of the returns provided for by the joint resolution: (A) on account of the taxes for the taxable year 1947, $16,989; (B) on account of the taxes for the taxable year 1948, $6,000; and (C) on account of the taxes for the taxable year 1949, none. Such payments would be so treated, of course, only to the extent that they had not previously been credited or refunded.

In treating such taxes as paid at the time of the filing of the return required by section 2 of the joint resolution, such payment (in the event the return is filed before the due date prescribed by sec. 2) will be subject to the provisions of section 322 (b) (4) of the code which provides special rules applicable for certain purposes where a tax payment is made at the time of filing a return which is filed before its due date.

Part IV—Changes in Existing Law

JOINT RESOLUTION AS INTRODUCED

In compliance with paragraph 2a of rule XIII of the Rules of the House of Representatives, changes in existing law made by the joint resolution, as introduced, are shown as follows (new matter is printed in italics, existing law in which no change is proposed is shown in roman):

"Internal Revenue Code

"Sec. 202. Adjusted Normal-Tax Net Income.

"(a) Definition.— * * *

"(b) Reserve and Other Policy Liability Credit.—As used in this section the term "reserve and other policy liability credit" means an amount computed by multiplying the normal-tax net income by a figure, to be determined and proclaimed by the Secretary for each taxable year. This figure shall be based on such data with respect to life insurance companies for the preceding taxable year

as the Secretary considers representative and shall be computed in accordance with the following formula: The ratio which (1) the aggregate of the sums of (A) 2 per centum of the reserves for deferred dividends, (B) interest paid, and (C) the product of (i) the mean of the adjusted reserves at the beginning and end of the taxable year, and (ii) the reserve earnings rate bears to (2) the aggregate of the excess of net incomes computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c). *Notwithstanding any other provision of this subsection, the figure to be used in computing the reserve and other policy liability credit for taxable years beginning in 1948 and 1949 shall be 0.92.*

* * * * * * *

"Sec. 203. Adjusted Corporation Surtax Net Income.

"(a) Definition.— * * *

"(b) Reserve and Other Policy Liability Credit.—As used in this section, the term "reserve and other policy liability credit" means an amount computed by multiplying the corporation surtax net income by the figure determined and proclaimed under section 202 (b). *Notwithstanding any other provision of this subsection, the figure to be used in computing the reserve and other policy liability credit for taxable years beginning in 1948 and 1949 shall be 0.92.*"

JOINT RESOLUTION AS REPORTED

For the information of the Members of the House, changes in existing law made by the joint resolution as reported to the House are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman:

"Internal Revenue Code

"Sec. 202. Adjusted Normal-Tax Net Income.

"(a) Definition.— * * *

"(b) Reserve and Other Policy Liability Credit.—As used in this section the term "reserve and other policy liability credit" means an amount computed by multiplying the normal-tax net income by a figure, to be determined and proclaimed by the Secretary for each taxable year. This figure shall be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary considers representative and shall be computed *as follows:*

"*(1)* In general.—*Except as provided in paragraph (2), the figure shall be computed* in accordance with the following formula: The ratio which [(1)] *a numerator comprised of* the aggregate of the sums of (A) 2 per centum of the reserves for deferred dividends, (B) interest paid, and (C) the product of (i) the mean of the adjusted reserves at the beginning and end of the taxable year and (ii) the reserve earnings rate bears to [(2)] *a denominator comprised of* the aggregate of the excess of net incomes computed without any deduction for tax-free interest, over the adjustment for certain reserves provided in subsection (c).

"*(2) Special rule for 1947, 1948, and 1949.—In the case of the taxes imposed for a taxable year beginning in 1947, 1948, or 1949, the figure to be used for such year shall be computed as provided in paragraph (1) except that—*

"*(A) in computing the product required under clause (C) of paragraph (1) there shall be used, in lieu of the reserve earnings rate, the average rate of interest assumed in computing life insurance reserves. Such average rate shall be calculated in the manner provided in the second sentence of section 201 (c) 4; and*

"*(B) if the Secretary, in computing the ratio, finds that the net effect of including the data with respect to any life insurance company is to increase the numerator more than it increases the denominator, he shall limit the net change in the numerator resulting from such inclusion to the net change in the denominator resulting therefrom.*

* * * * * * *

"Sec. 203. Adjusted Corporation Surtax Net Income.

"(a) Definition.—* * *

"(b) Reserve and Other Policy Liability Credit.—As used in this section, the term "reserve and other policy liability credit" means an amount computed by multiplying the corporation surtax net income by the *applicable* figure determined and proclaimed under section 202 (b)."

INDIVIDUAL VIEWS OF THOMAS A. JENKINS

The insurance business is a very important one in our economy. Practically all our people are interested in insurance in some way. House Joint Resolution 371 came before the Ways and Means Committee on the report of a subcommittee. While the subcommittee's report is unanimous, still it is a well-recognized fact that a very large segment of the life-insurance companies do not approve this proposed legislation.

Companies that have stated objections to the joint resolution include Equitable Life Assurance Society of New York; Union Central Life Insurance Co., Cincinnati, Ohio; Acacia Mutual Life Insurance Co., Washington, D. C.; Pyramid Life Insurance Co., Little Rock, Ark.; and probably 10 or 12 other companies located in various parts of the country.

I do not assume to speak for any of these companies, but in various ways they have indicated opposition to this proposed legislation.

I maintain that when a sizable segment of any great business is dissatisfied with proposed legislation affecting them, they should be permitted an opportunity to express their views. Neither the subcommittee nor the whole committee has held hearings to which the general public was invited. As a result, there is no printed record available to the Congress or the general public upon which to judge the merits of the joint resolution or the opposition to it.

The joint resolution is complicated and technical, but essentially it provides for determining the taxable income of a life-insurance company by each company applying an industry-wide average to its own earnings Life-insurance companies are not all alike. There are differences in their financial structures, in the interest rates that they guarantee to the public and in their other commitments to policyholders, and in the way in which their premium rates are figured. Some companies have protested strongly that, because of the differences among life-insurance companies, the bill is inequitable. These companies contend that a tax law based on averaging is unjust unless the average is based on exactly the same facts. They also contend that the bill fails to meet the test of taxing according to the ability to pay. They also claim the bill is not general in its application. I feel that both sides of the controversy should be set forth in this report.

Because of the way the present formula for taxing life-insurance companies has worked out, these companies have not been required to pay any income taxes for the taxable years 1947 and 1948 and apparently would not pay any for 1949. The bill proposed to cure this situation by applying retroactively a different formula to the taxable years 1947 and 1948, as well as to the taxable year 1949. A number of companies have expressed their opposition to these retroactive provisions of the bill. While retroactive tax laws have been sustained by the courts, it is conceded by everyone that the present bill goes further than any case that has heretofore been decided by the courts. There is obviously, as some companies assert, a question of the constitutionality of legislation reopening tax liability after a period of 3 years.

I am also concerned with the effect of such retroactive tax legislation on the general public and on all business. This is a very serious step in tax legislation and should not be taken without the fullest opportunity to develop all points of view at hearings open to the general public. The precedent established by this joint resolution will create uncertainty for all classes of corporate taxpayers.

Several of the small companies in the life-insurance business have pointed out the desirability of special provisions being inserted in the joint resolution to encourage small insurance companies and stimulate their growth. This point of view, too, is one that seems very worthy of full exploration.

In stating these views, I am not unmindful of the need of our Government for revenue from taxes levied on a sound and just basis and which will not disturb unduly the business conditions of our country. The life-insurance companies have shown their awareness of the problem of financing our huge Government and have worked diligently with Government officials on the problem of taxing life-insurance companies. The present joint resolution apparently satisfies a substantial number of the companies. However, the differences among the companies is so great that I feel the Members of Congress should know of these differences. These differences could have been ironed out, I think, if more time had been given for these aggrieved companies to present their views. The Government should not levy unfair taxes. Unfair taxes are usually unjust taxes.

THOMAS A. JENKINS.

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Representative DOUGHTON. Mr. Chairman, Mr. Simpson and Mr. Camp are both members of the subcommittee, and I would like for them to be heard.

The CHAIRMAN. Yes, sir. We would be glad to hear from them.

STATEMENT OF HON. RICHARD M. SIMPSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Representative SIMPSON. Mr. Chairman and genetlemen, first of all I want to endorse House Joint Resolution 371 and that which Mr. Lynch has stated in support thereof. I address myself to one point which expresses my opinion and, I believe, the opinion of a good many on the committee.

I feel that House Joint Resolution 371 which is described as stopgap legislation, is good, is a proper way to collect a tax for investment income from the life-incurance companies in the years 1947, 1948 and 1949, and I think, too, that the formula is good for the future.

I recognize that the committe took the position that the matter should be gone into in far greater detail and possibly a new plan evolved with respect to life-insurance company taxation in the future. But when the matter was discussed a number of us suggested that this, instead of being temporary, should be continued indefinitely or until changed by another act of Congress.

That was not the policy adopted by the committee, and rather we have come to a description of this legislation as stopgap meaning it will terminate with 1949.

I suggest, gentlemen, that by the time you complete this study on the matter now before you, you will accept this bill as permanent legislation. I recognize some departments of Government do not agree with that view. However, as was suggested earlier, I think that the study that you will give to this will lead to the conclusion that this legislation should be made permanent.

Mr. Lynch mentioned the fact that the life-insurance industry is considered on an industry-wide basis for taxing purposes, rather than as an individual company, as are corporations ordinarily, when it comes to the payment of corporation taxes.

I had considerable doubt on that point, thinking, personally, that a life-insurance company should be considered strictly on a factual, personal, individual basis, just as a corporation is. But after consideration and study, consideration of arguments presented, some of which are technical and which I frankly could not explain to you now, but which will be before you, I have come to the conclusion that the industry-wide approach is the proper approach; and it is that which we are following in this House Joint Resolution 371.

In conclusion, I do endorse House Joint Resolution 371, and, having, already stated that I think it would be desirable legislation for the future, will leave that to your judgment.

The CHAIRMAN. Thank you very much, Mr. Simpson.

Representative DOUGHTON. This is Mr. Camp, who is also a member of the committee, Mr. Chairman.

The CHAIRMAN. All right, Mr. Camp.

STATEMENT OF HON. A. SIDNEY CAMP, A REPRESENTATIVE IN THE CONGRESS FROM THE STATE OF GEORGIA

Representative CAMP. Mr. Chairman, there is little left for me to say. I endorse everything that our subcommittee chairman and Mr. Simpson have said.

I was rather interested in trying to find permanent legislation, and I insisted that we try to explore the field and see if we could not make a permanent bill out of this. I came to the conclusion that it will require a great deal of study to write permanent life insurance taxation legislation, and that probably this is the best we could get after such study.

Here was my reaction: Some companies write insurance on a 3-percent reserve basis. Then you will find a competitor in another section of the country on a 3¼-percent basis. And those policies have been in force for 25 or 30 years under standard forms, including some that are even on a 3½-percent and 3¾-percent reserve basis.

Most of the companies have revised their reserve basis because reduced interest rates, largely as to Government securities, have come down. Now, then, when you levy a tax on each individual company, it is going to require a great deal of exploration and study to arrive at just how to handle it.

I am convinced that what we have done here is as near as we could possibly arrive at it without a great deal of research being made.

I was impressed by the fact that so many of the companies, in fact nearly every American life-insurance company, had their finance officer or president at our committee hearings. And almost without exception the whole group agreed to the provisions of this bill. And they are very serious about this thing. They do not want to bein the position of not paying tax.

They have thought they owe some tax, but under the formula they could not arrive at the figure and they also said at the conferences, "We have reserves to pay it; we just have not known how much it was."

There were only about three I remember who wanted this bill set aside until a permanent bill could be written, and I think those companies have been mentioned by those who preceded me.

I endorse it, and I certainly hope that we can pass this bill and do that research and study that is necessary to change it in the future to a permanent basis if possible. Thank you.

The CHAIRMAN. Thank you very much, Mr. Camp.

Senator BUTLER. Mr. Chairman?

The CHAIRMAN. Senator Butler.

Senator BUTLER. In the research work that has been done by the subcommittee of the House, have you determined the amount that probably would be collected for 1947, 1948, and 1949 under this formula?

Representative SIMPSON. Yes.

Representative CAMP. Mr. Lynch has the exact figure.

Representative LYNCH. Between $90,000,000 and $93,000,000.

Senator TAFT. For 2 years or 3 years?

Representative LYNCH. For 3 years, sir. And in 1950 if we extend it, as might be done for a year, for experimental purposes, unless it is determined to be permanent, they tell me that we are going to be

pleasantly surprised, from the Government's point of view, at the amount of money that will be brought in under this formula. They estimate, I think, about 40 to 45 million dollars.

Senator BUTLER. For 1950?

Representative CAMP. I think it was for 1950. That is what they estimated, sir.

The CHAIRMAN. Are there any questions?

Thank you very much, gentlemen.

Representative CAMP. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Kirby, suppose we hear from you now. You can answer any questions that might be asked.

STATEMENT OF VANCE N. KIRBY, TAX LEGISLATIVE COUNSEL, OFFICE OF GENERAL COUNSEL FOR THE TREASURY, DEPARTMENT OF THE TREASURY, WASHINGTON, D. C.

Mr. KIRBY. Mr. Chairman, I have no prepared statement to make.

The CHAIRMAN. We did not want you to make a prepared statement. We wanted to know from you: Is this bill approved by the Treasury?

Mr. KIRBY. This bill is approved by the Department. It is not exactly the same bill that the Secretary recommended to the chairman of the House committee for enactment, but during the course of considerations by the subcommittee of the Ways and Means Committee the staff of the Treasury and the staff on the Joint Committee on Internal Revenue Taxation, worked on this provision. The product is acceptable to the Department.

It brings in approximately the same revenue that would have been brought in under the bill that the Secretary recommended for enactment last year.

The CHAIRMAN. How long were the negotiations going on with the insurance companies? Or how early were they begun?

Mr. KIRBY. From the end of 1947, the Department has tried to work out with the insurance companies a better system than we have now.

The CHAIRMAN. Were you working with the companies?

Mr. KIRBY. We were working off and on with the representatives of the insurance companies.

The CHAIRMAN. What is the basis on which this tax is calculated, just briefly, in this stopgap legislation?

Mr. KIRBY. The basis of this tax is the net investment income of the companies. From the net investment income there is a deduction which really is the cause of the entire controversy. That is the deduction for additions to the reserves in view of their contractual liabilities to policyholders.

Now, that is a very difficult figure to determine. Back in 1942 the Congress enacted a provision that roughly permitted, for the purpose of the revenue liability a 3¼-percent weighting, to the extent of 65 percent, and then an averaging of the companies contractual liabilities to the extent of 35 percent.

Now, as pointed out by Representative Lynch, that 3¼ percent has become outmoded, due to the fact that interest rates have dropped substantially, and insurance companies are now writing policies, and have been for some years, on a lower assumption rate than 3¼ percent.

The CHAIRMAN. Let me ask you: Was the 1942 formula inserted in the 1942 tax act a compromise, or an agreed formula between the companies and the Treasury?

Mr. KIRBY. It was very much a compromise. The Department did not want the averaging of this deduction over the industry. The insurance companies, however, felt very strongly about it. I think they still, you will find, feel strongly that there should be an averaging of this factor.

Senator TAFT. Some of them do and some of them do not, I take it.

Mr. KIRBY. Oh, it isn't very evenly divided, Senator. I think there is just about one company on one side, and the rest on the other.

The CHAIRMAN. I had the impression that it was somewhat of a negotiated formula in 1942 when we put it in the act. I had that impression.

Mr. KIRBY. The Treasury finally——

The CHAIRMAN. Acquiesced?

Mr. KIRBY. Acquiesced in it. But it was not the Treasury's proposal or real feeling that it was the correct proposal. However, we finally acquiesced.

I don't want to minimize that legislation. It improved the taxing provisions very greatly, at least from the Government's standpoint. It increased the taxes on life-insurance companies very greatly in 1942.

The CHAIRMAN. As against 1941 and previous years?

Mr. KIRBY. As against prior years; yes.

Senator MILLIKIN. What happened whereby we ceased collecting taxes from insurance companies?

Mr. KIRBY. As indicated, the frozen figure of 3¼ percent became outmoded due to the fact that interest rates generally dropped since 1942.

Now, in view of the fact that the formula now contains 3¼ percent, which is allowed as a deduction, it has, as an average, wiped out the net investment income of the life-insurance companies.

Senator TAFT. Because it is higher, or because the net investment income is lower?

Mr. KIRBY. Because the net investment income is lower—lower in relation to the reserves.

Now, the net investment income, as a figure, has increased very greatly.

Senator TAFT. But the percent return on investments has increased?

Mr. KIRBY. Yes.

Senator TAFT. Is that the reason why the taxes have disappeared?

Mr. KIRBY. That is right.

Senator BUTLER. They have changed their policies, too?

Mr. KIRBY. That is correct. They have written their policies on the assumption of a lower investment figure.

Senator TAFT. That would not affect the net investment income, I should think, would it?

Mr. KIRBY. No; that does not affect the net investment income.

Senator TAFT. They are still deducting 3¼ percent, which they always did. But as I understand it, the return on their investments is lower. Is that the reason why the net figure has finally disappeared?

Mr. KIRBY. Well, the net investment figure has always increased, I believe, since——

Senator TAFT. No; I am talking about the rate of the investment.

Mr. KIRBY. I don't have that figure, Senator Taft, but we can get that for you.

Senator TAFT. Unless you know it, you cannot tell me why it is that there is no tax. That is what I want to know. Why is it that there is no tax now where there was 4 years ago?

Mr. KIRBY. Because of the change in the interest rate and the change the life-insurance companies have made in selling their policies.

Senator TAFT. That is what I want to understand. Why is that? I do not get that. Because it does not make any difference what they sell their policies for, does it? They arbitrarily deduct 3¼ percent anyway; they did 4 years ago and do now.

Mr. KIRBY. That is right.

Senator TAFT. What difference does it make what basis they sell them on? Why do you not put in the record a complete description, right from the bottom, to somebody who does not know anything about insurance at all? Why do you not start and explain how life insurance operates, and so on?

Mr. KIRBY. We have distributed to your committee a full description, Senator, of the present operation of the life insurance tax treatment.

Now, in 1939 the life-insurance companies were getting about 3.54 return on their total investment, and in 1940 it dropped a little to 3.43; in 1941, 3.41; in 1942, 3.4; in 1943, 3.29; in 1944, 3.19; in 1945, 3.07; in 1946, 2.92; in 1947, 2.88; in 1948, 2.96.

Their ratio has dropped.

Senator TAFT. That is the return on their investments, the percent of return they get on their investments; is that it?

Mr. KIRBY. Yes; the net rate of interest earned on life insurance reserves. It is the ratio of the total net investment earnings of the United States companies to their aggregate mean ledger assets.

Senator TAFT. Whereas this law kept the deduction on a three-fourteenth percent basis.

Mr. KIRBY. It keeps the deduction frozen to the extent of 65 percent at 3¼ percent, and the balance to the extent of 35 percent, an averaging of the company's contractual liabilities.

Senator MILLIKIN. It makes an excessive deduction, is that right?

Mr. KIRBY. That is right.

Senator MILLIKIN. And because of the excessive deduction you could not collect any taxes, is that not all there is to it?

Mr. KIRBY. That is right. And it becomes excessive because you have a frozen figure at 3¼ percent, which is no longer representative.

Senator TAFT. While your interest rate on your investments has been going down.

Mr. KIRBY. Yes.

Senator MILLIKIN. Now, is this resolution on the theory that the life-insurance companies owe this money? Does the Treasury claim they owe anything for these retroactive years?

Mr. KIRBY. Under the present law there is no tax liability.

Senator MILLIKIN. No tax liability?

Mr. KIRBY. That is right. But the feeling is, or the Department's position is, that the formula has become outmoded and it is unrealistic to have a frozen rate in there which does not represent the current interest requirement.

Senator MILLIKIN. Let us assume it has become outmoded. This resolution does not rest upon the theory that the life insurance companies now owe any retroactive payments on account of the situations you are talking about.

Mr. KIRBY. That is entirely correct.

Senator MILLIKIN. So that unless we do make it retroactive, there will be no obligation.

Mr. KIRBY. That is correct.

The CHAIRMAN. Is it the fact that the insurance companies are now writing insurance on the assumption that interest rates will be lower? I suppose somebody else can answer from the insurance companies' point of view. Are they now writing insurance on that assumption?

Mr. KIRBY. Oh, yes; they have been for years.

The CHAIRMAN. So their investment income will be less, because of the reduced interest rates, but they are still taking off the 3¼ percent.

Mr. KIBRY. That is still used because it is in the statute.

The CHAIRMAN. It is in the law.

Senator MILLIKIN. Why should the insurance companies want to pay retroactively? Are they afraid that if they did not we will tax them more than they would be taxed by the operation of this bill? Or why should the life insurance companies be passing their money out?

Mr. KIRBY. Well, I think that you will want to ask that of the companies. I believe that they want to pay their fair share of taxes.

Senator MILLIKIN. Under the law they have had no fair share, so why would they be wanting to pay a fair share retroactively?

Mr. KIRBY. I believe they would indicate to the committee that this formula has become outmoded.

Senator MILLIKIN. Well, assume that is true.

Mr. KIRBY. And it became outmoded by at least 1947.

Senator MILLIKIN. Why should a life-insurance company or any other company form a moral judgment on a law and say, "We are going to toss policyholders' money out the window on a retroactive theory"?

Senator MARTIN. May I ask: Suppose it had been the other way, that it had been unfavorable to the life insurance companies.

Mr. KIRBY. You mean if it had been too favorable to the Government?

Senator MARTIN. I mean if it had been favorable to the Government.

Mr. KIRBY. There is no objection, I assume, to retroactive legislation in favor of the taxpayer.

Senator MARTIN. I think that is an important thing to determine.

Senator MILLIKIN. I am seriously trying to get at why the life-insurance companies want to make this payment that they do not have to make. What is the reason for it?

Mr. KIRBY. Well, I really think that that should come from the companies themselves. But my conclusion is that they feel that the statute is wrong, that it should have been corrected at an earlier stage.

Senator MYERS. It is good public relations, I think, too.

Senator BUTLER. A line or two from a letter that I had from a Nebraska insurance company might partially answer that.

It says:

> There has been some opposition, including—

And it gives the name.

> However, I believe that the majority of the life-insurance companies favor the proposed bill, including the retroactivity feature, in order to get the matter settled.

Senator TAFT. It is not being settled. That was my suggestion.

The CHAIRMAN. It is being settled for the past years by this bill.

Are there any more questions of Mr. Kirby at this time?

Senator TAFT. Yes, I would like to ask one question.

Who gets this income if we do not? Where does it go?

Mr. KIRBY. It is the net investment income that is being retained by the life-insurance companies.

Senator TAFT. These companies are not stock companies, are they?

Mr. KIRBY. Most of them are mutual companies. I think about 25 percent of the life-insurance business is written by stock companies. I think the balance is written by mutuals.

Senator TAFT. Supposing we do not tax them. What happens to this income? Where does it go?

Mr. KIRBY. With the stock company it would either go to surplus or to dividends.

Senator TAFT. With the stock companies it would go to dividends. I can see that. But where does it go otherwise?

Mr. KIRBY. I think probably with respect to the mutual it will go out to the policyholders, probably in dividends, I suppose.

Senator MARTIN. It would either go in dividends or to strengthen the policyholders' policy? Is that not what it does?

Mr. KIRBY. Or to unassigned reserves, perhaps.

Senator MARTIN. Yes. It strengthens the policyholders' policy.

Senator TAFT. How does it differ, for instance, from not taxing the profits of cooperative organizations, of other cooperative organizations? What is the distinction, if I may ask it, between this tax and the tax that we had the struggle on, that we had in '42 on the subject of taxing mutual insurance companies? Like the Lumberman's and so forth?

Mr. KIRBY. As to the mutual casualty companies, the fire and casualty companies, we wrote in, I think, a limited exemption for casualty companies up to $75,000. If their gross income, I think, was less than $75,000, they were completely excluded. If they were in excess of that, I think they were taxed.

Senator TAFT. We had quite a fight in this committee on that, I think in '42, on the subject of taxing fire-insurance companies, like the Lumberman's Mutual, and we finally did not tax them on the same basis as stock companies; we taxed them on a somewhat lower basis, although we did impose some tax.

Mr. KIRBY. Yes, they are definitely taxed.

Senator TAFT. Relating to premiums, or something of the sort; is that right?

Mr. KIRBY. I think that is true. I am not entirely sure about the

treatment of casualty insurance companies. But they are not exempt, I know. The larger ones are subject to tax.

Senator TAFT. Do you see any fundamental difference between this kind of a company and the farm cooperative buying or selling?

Mr. KIRBY. I think it is a form of doing business on a cooperative basis. The owners of the company are basically the policyholders.

Senator TAFT. Is it taxed at 38 percent when you get through?

Mr. KIRBY. Finally, if there is anything left, we do impose a 38 percent tax. But there has not been anything left in the last few years.

Senator TAFT. I understand that. But these estimates of $30,000,000 are based on a 38 percent tax?

Mr. KIRBY. Yes, you would impose the 38 percent tax after you got through with this formula.

Senator MILLIKIN. Mr. Chairman, this presents a sort of a strange irony. A lot of us have been "yak-yaking" against a double taxation of dividends. Now, here is a case where there has been no double taxation of dividends, and we are tearing our shirts into pieces to do it retroactively.

Mr. KIRBY. Well, it is a pretty select few that are getting this present advantage.

The CHAIRMAN. Suppose we now get some of the insurance people themselves.

Senator BUTLER. Mr. Chairman, I would like to ask the representative of the Treasury one other question.

The CHAIRMAN. He will be here all the while, Senator Butler. But go ahead.

Senator BUTLER. I wonder why the regular tax law for the rank and file of corporations, business firms, would not apply to the insurance companies.

Mr. KIRBY. Prior to 1921, I believe, they were treated as an ordinary corporation subject to the regular rates. But their business is so different from the ordinary business run by a corporation that it is rather difficult.

The CHAIRMAN. It is a difficult thing to ascertain the net earnings properly by virtue of the nature of this business.

Mr. KIRBY. That is quite true. They have got these contractual liabilities that they assume, but for the future. And it is quite difficult to compute those out and I think that is their basic problem.

The CHAIRMAN. Well, Mr. Kirby, you will be with us?

Mr. KIRBY. Yes, I will be, Senator.

The CHAIRMAN. Mr. McAndless?

You are the representative of the Life Insurance Association of America, are you?

STATEMENT OF A. J. McANDLESS, CHAIRMAN, JOINT COMMITTEE ON FEDERAL INCOME TAXATION OF LIFE INSURANCE COMPANIES, APPEARING ON BEHALF OF LIFE INSURANCE ASSOCIATION OF AMERICA AND THE AMERICAN LIFE CONVENTION

Mr. McANDLESS. Yes, Mr. Chairman.

The CHAIRMAN. You may be seated, if you wish.

You may have noticed that the committee is a bit curious to know why taxpayers are anxious to pay a tax that is not a tax liability.

Mr. McAndless. I notice that such a question prevails. I am surprised, too, that out of these discussions with the subcommittee we have become quite successful in making them very expert in insurance matters. They qualify almost as actuaries in their degree of understanding of this problem and the complexity of it.

Mr. Chairman, I am chairman of the Joint Committee of the American Life Convention and the Life Insurance Association of America that was appointed to deal with this question of Federal income taxation of life insurance companies. That is quite a distinguished committee. There are on it Mr. L. W. Dawson, president of the Mutual Life Insurance Co., of New York; A. T. MacLean, president of the Massachusetts Mutual Life Insurance Co., of Springfield, Mass.; Claris Adams, president of the Ohio State Life Insurance Co., of Columbus, Ohio; H. R. Bassford, vice president of the Metropolitan Life Insurance Co., of New York; Louis R. Menagh, Jr., vice president of the Prudential Life Insurance Co., of Newark, N. J.; Francis W. Cole, chairman of the Travelers Insurance Co., of Hartford, Conn.; and J. M. Bryan, first vice president of the Jefferson Standard Life Insurance Co., of Greensboro, N. C.

The Chairman. This enumeration includes representatives of both stock and mutual companies?

Mr. McAndless. Both stock and mutual, both industrial and ordinary companies, companies writing life insurance only and those also writing health and accident insurance.

The Chairman. Well, sir, we will be glad to hear you.

Mr. McAndless. The combined memberships of these two organizations total 225 United States and Canadian legal reserve life-insurance companies. All of these companies but one do business in this country. Their assets represent 95 percent of the total assets of all legal reserve life-insurance companies operating in the United States. In this brief statement I shall attempt to set forth some of the reasons why these two associations are supporting House Joint Resolution 371.

We believe the formula for taxing life-insurance companies prescribed by sections 201–203, Internal Revenue Code, as it would be amended by House Joint Resolution 371, is the most equitable yet devised for both the Federal Government and the companies.

The proposed formula produces a reasonable total amount of tax revenue from all companies. It continues to recognize the principle which Mr. Kirby referred to, established by the Internal Revenue Act of 1921, that investment income is the only source of income for a life-insurance company and it is based on the sound principle that a large part of this investment income must be set aside by the company to build and maintain its reserve as required by the basic principles of insurance and by the various State laws governing solvency.

Also, the new formula levies a reasonable burden of taxation against each individual company. It is grounded upon the sound and reasonable assumption that, in the long run, companies require about the same percentage of net investment income to maintain their reserves. If the proposed "stopgap" formula is adopted as a permanent basis of taxation, all life-insurance companies will pay taxes each year. The situation now existing under the present law cannot be repeated under the proposed law because section 202 (b) (2) (B), as it would be amended, provides that the reserve credit of a company cannot exceed the net investment income of that company.

That is the item that Chairman Lynch of the subcommittee referred to, when he spoke of companies that had a requirement in excess of their net investment income being treated as though that requirement were 100 percent.

The formula embodied in House Joint Resolution 371 is based on the average valuation rate of all companies. A suggestion has been made that each company use its own valuation rate, but we believe there are objections to that approach to this problem. Secretary Snyder has indicated that such an approach would require certain safeguards to prevent misuse.

Exhibit A, attached hereto, compares the taxes which would have been paid in 1948 for a representative list of the larger companies on the proposed average valuation formula with the taxes which would have been paid on the so-called company-by-company basis, using the "safeguarded weighted average valuation rate." It demonstrates clearly that the proposed formula would spread the burden of taxation equitably among all companies on the basis of net investment income. The last column shows how unfair it would be to the companies to use a formula providing for taxation on each company's weighted average valuation rate. For example, you will note that several large companies would pay no tax at all.

A rough estimate indicates that the new formula would raise about $41,000,000 of revenue on the operations of 1949. Chairman Lynch said in 1950 it would raise about that amount, but our estimate indicates that it will raise $70,000,000 on the operations of 1950. This is indicative of the level of yield that may be expected under this formula. Certainly this is not a token tax. When added to the $125,000,000 premium tax now being paid annually to the States, it will impose a substantial burden on life insurance companies and will undoubtedly have considerable effect on policyholders' dividends.

The majority of the life insurance companies have indicated a willingness to accept taxes for the year 1947 and 1948 for the reason that the question of a tax formula has long been under discussion by the companies and the Treasury Department. When the formula prescribed by the present law first broke down, this committee was formed and the Treasury Department was notified, as early as July 1947, that there would be little or no tax for that year. It was hoped, then, that an agreement at an early date might be reached for a revision of the tax formula. At that time and throughout 3 years of negotiations most of the companies have held the opinion that they should be on a tax-paying basis.

Senator MILLIKIN. Mr. Chairman, may I ask a question?

The CHAIRMAN. Senator Millikin.

Senator MILLIKIN. As distinguished from what you have just said, was there a general understanding in the industry that there would be a retroactive tax?

Mr. McANDLESS. A general question was asked of us by the Treasury people when we were negotiating on this. Early in 1948 is the earliest date I can remember, although some of their minutes indicated the question was asked earlier. It was, "Would the companies object to a tax on the business of 1947?" And we replied that we thought if it was enacted early, the companies would have no objection to such a tax.

Senator MILLIKIN. Was that not at that time?

Mr. MCANDLESS. That was at that time.

Senator MILLIKIN. Has there been any general understanding in the life insurance business that there would be a retroactive tax?

Mr. MCANDLESS. Nothing except that we explained, when we went before our governing bodies to discuss this matter, that the Treasury had suggested this tax be payable either on 1947 or on 1948 operations, and we had made the statement that we thought the companies would not object to it.

Since the summer of 1947, this committee has been trying in good faith to find a solution for this tax problem and to reach an agreement on a revised method of taxation. No one likes a tax which reaches back to a closed accounting period, but in view of the negotiations which have been going on, it is difficult to muster reasons in opposition to the proposed tax.

If a formula embracing the essential principles which I have discussed had been agreed upon at an early stage of these discussions, the life insurance companies would have paid the taxes for the years 1947 and 1948 contemplated by House Joint Resolution 371. Most of them are still ready to pay those taxes and do not believe in doing so they would be setting any precedent which would be damaging to other taxpayers.

The CHAIRMAN. Mr. McAndless, may I ask you this question: Are there any companies, so far as you know, or to bring it down to a finer point, is there a company that would find itself embarrassed by the payment of this tax retroactively at this time?

Mr. MCANDLESS. It is pretty well known in the life insurance business that this tax may be retroactive. I am chaiman of this committee, and although I know a great many men in the business, I have only heard from one company that it would be embarrassing to them, and that was a very small institution.

The CHAIRMAN. That was why I was asking.

Mr. MCANDLESS. But that company paid $10,000 in dividends last year, when they did not increase their surplus, so I did not think the objection was very valid.

The CHAIRMAN. The dividends are gone, though, are they not, so far as the company is concerned?

Mr. MCANDLESS. That is right.

The CHAIRMAN. Well, now, suppose a single company raises the issue touching the validity of this act, and suppose, let us assume, that they did obtain a favorable decision. Would not the Treasury have to make refunds to all who had paid in if they wished to take them?

Mr. MCANDLESS. I am not a lawyer, Mr. Chairman. I am an actuary. Some of the legal people here can give you an opinion on that question.

The CHAIRMAN. Yes, sir.

Any question, Senator Millikin?

Senator MILLIKIN. Would the life insurance companies object if this same formula were made effective for the future?

Mr. MCANDLESS. I think the life insurance companies would welcome this if it was made effective for the future. One of the resolutions passed by these organizations at a meeting in Chicago was to the effect that the industry favored this legislation for the year 1950 and all years thereafter unless changed by Congress. We look at it as at least containing the nucleus of a permanent solution to this question.

There might be slight modifications which we would like to make in the future, but we think it is in the direction of a permanent solution of this question of taxing life insurance companies, because it automatically adjusts itself to changing conditions in the life insurance business with reference to the rates of interest earned and the valuation rate of interest used by the companies.

The CHAIRMAN. Any further questions by any member of the committee?

If not, we thank you, Mr. McAndless.

(The material attached to Mr. McAndless' prepared statement follows:)

EXHIBIT A.—*Comparative results, Federal income tax, taxable year 1948*

[In thousands]

Company number	Net investment income [1]	38 percent tax on "average valuation" formula [1]	38 percent tax on "company by company" formula [1]
(1)	(2)	(3)	(4)
A1	$246,224	$4,843	$3,821
A2	190,333	3,556	0
A3	123,719	2,407	0
A4	108,515	1,979	2,589
A5	59,012	1,181	1,418
A6	54,913	1,002	1,376
A7	50,925	929	0
A8	42,454	2,340	1,004
A9	35,794	1,009	1,375
A10	33,062	606	1,658
A11	30,718	560	737
A12	30,330	553	177
Total A	1,005,999	20,965	14,755
B1	26,102	476	1,249
B2	20,250	369	1,691
B3	18,300	427	483
B4	16,104	294	0
B5	15,588	284	323
B6	$13,776	$251	$304
B7	11,250	217	98
B8	11,374	207	323
B9	9,944	187	274
B10	9,519	174	177
B11	10,072	221	43
B12	9,399	171	356
B13	8,685	161	195
B14	6,405	160	0
B15	7,050	129	130
B16	6,429	122	0
B17	4,629	84	0
B18	7,265	133	760
B19	5,031	94	59
B20	5,391	98	0
B21	5,612	154	696
B22	5,001	91	0
B23	5,886	107	190
Total B	239,092	4,611	7,341

[1] The captions heading the columns are explained below.

The following notes are given in further explanation of the captions heading each of the columns:

(1) Company number: Companies are listed in order of size of admitted assets divided into size groups.

(2) Net investment income: As shown in line 15, page 1, of 1948 tax returns.

(3) Thirty-eight percent tax on "average valuation" formula: 38 percent times 1948 normal-tax net income decreased by 95.20 percent reserve interest deduction and increased by the amount of adjustment for non-life-insurance reserves. 95.20 percent represents an estimate of the secretary's ratio for 1948 (based on 1947 tax returns) using the formula of House Joint Resolution 371. The tax has been calculated at 38 percent of normal-tax net income for all companies, ignoring the step rates applicable to companies with income under $50,000 and the effect of a slightly different income base for surtax.

(4) Thirty-eight percent tax on "company by company" formula: 38 percent times 1948 normal-tax net income decreased by an amount representing the interest required to maintain the company's reserves and increased by the amount of adjustment for non-life-insurance reserves. A zero tax is shown for companies for which this calculation produces a negative tax. The amount required to maintain the company's reserves has been obtained by calculating a secretary's ratio for the individual company based on the figures from schedule A of its 1947 tax return. In this calculation the interest required to maintain reserves has been obtained by using a rate equal to 35 percent of the company's actual

average valuation interest rate plus 65 percent of 2.99 percent, which is the average valuation interest rate of all the companies for 1947. This individual company secretary's ratio has then been applied to the normal-tax net income to obtain the reserve interest deduction. A weighted average valuation interest rate instead of the company's actual average rate has been used on the assumption that this is necessary to avoid unfair discrimination and undesirable consideration of tax consequences in the determination of the interest rates used by the companies, as pointed out in the discussion of this approach in the statement of the Secretary of the Treasury.

The CHAIRMAN. Mr. Adams of the American Life Convention.

STATEMENT OF CLARIS ADAMS, PRESIDENT, THE OHIO STATE LIFE INSURANCE CO., COLUMBUS, OHIO, AND MEMBER OF THE JOINT COMMITTEE ON FEDERAL INCOME TAXATION OF THE AMERICAN LIFE CONVENTION AND THE LIFE INSURANCE ASSOCIATION OF AMERICA

Mr. ADAMS. My name is Claris Adams from Columbus, Ohio. I am president of the Ohio State Life Insurance Co.

The CHAIRMAN. And not of the American Life Convention?

Mr. ADAMS. No; one of the smaller and better life-insurance companies of the United States, the smallest company represented on the committee.

Our statement will take 10 minutes, and I hope that will be all right.

The CHAIRMAN. You may proceed. We do not want to make any snap judgment. We want to find out the facts about this.

Mr. ADAMS. A tax upon life-insurance companies is a tax upon policyholders. It is, therefore, a tax upon the savings of 80,000,000 Americans. These are not ordinary savings. They represent emergency dollars laboriously accumulated by sacrifice in order to provide protection for helpless dependents or, alternatively, against hopeless old age.

Investment-wise life insurance is probably the greatest economic common denominator in the United States. There are more policyholders than freeholders, stockholders, bondholders, savings-bank depositors, and even wage earners. Policyholders outnumber personal income-tax payers by at least 50 percent. To the vast majority of these their policies represent the principal part of their modest estates, the final fruits of the labor of a lifetime. Therefore, few matters in our whole economy make more difference to more people than the cost of insuring their lives and this depends in part both upon the method and the level of life-insurance taxation.

For almost 30 years life-insurance companies have been taxed according to the philosophy implicit in House Joint Resolution 371. Prior to 1921 they were taxed upon a crude adaptation of the general corporate plan. The defect of this method was fundamental because it was an attempt to apply a similar measure to unlike things, to wit, general commercial enterprises and the institution of life insurance. The experience under this law makes a recent assertion of the Treasury staff, to wit, that the "actuarial problems and uncertainties involved in the life-insurance business raise difficulties in measuring the net income on a basis comparable with that of other corporations" a conspicuous example of understatement.

This law was satisfactory to no one, least of all the Government. It was the cause of multitudinous administrative difficulties. It was the source of constant annoyance and a flood of litigation. Furthermore it did not produce the revenue expected.

Life insurance differs from other enterprises because all of its calculations are based upon long-term contracts and only true measure of its net income is a long-term measurement. Premiums are based on an expected rate of mortality, actuarially calculated. If mortality experience is more favorable than the rate assumed the actuarial charge against he policyholder's premium is correspondingly less and the difference is returned to him. This is not a profit, it is a refund. Furthermore, if some of such margins are put to surplus, they are still held for the protection of policyholders, and no profit accrues to anyone. The surplus of a life-insurance company is the policyholder's reservoir. The water in the reservoir comes from the same source, and is of the same character, as the water in the dividend stream.

The only real profit made by life-insurance companies is the interest earned over and above that assumed by the actuaries in calculating premiums. All other income comes from the premiums and represents the policyholder's own money devoted to his own use without profit to anyone.

In 1921 the Treasury proposed a new form of taxation which taxed the companies on their sole source of real profit, to wit, interest earned in excess of reserve requirements. The only defect in this law, and the successive statutes based upon the same principle, was that an attempt was made to guess what interest earnings would be and an arbitrary rate was fixed as the interest return necessary to maintain reserves. Each time the guess was currently realistic. In 1921 it was fixed at 4 percent, in 1932 at 3¾ percent, and in 1942 at 3¼ percent. However, interest rates steadily declined and it was necessary for the companies to increase reserves by revaluing them on a lower interest basis; that is increase them so that if they earned less, they could still carry out their contract obligations. This threw the law out of gear.

The vice of an arbitrary estimate imbedded in the statute itself has been corrected in House Joint Resolution 371. Instead of a fixed figure the average valuation rate of the whole business, year by year, will be used in the formula.

This is eminently fair between companies because it does not penalize those which have been the most conservative by increasing reserves and thus reducing the valuation rate most promptly in the light of current experiences. It is based upon sound principle which has the support of 99 percent of all life-insurance companies in America. We believe this law should be given a change to prove itself, both as a satisfactory administrative instrument and as revenue producer for the Government, not only in 1950 but thereafter, until experience indicates that a change is necessary.

Considerations which make excess interest the only true profit of life-insurance companies and therefore the only proper basis for income tax apply with greater theoretical force to mutual life insurance companies than to stock companies. Actually, however, there is no essential difference. So far as I know no tax bill ever enacted by any governing body in the United States has made a differential between the two classes of companies in life insurance.

Senator MILLIKIN. What is the actual difference?

Mr. ADAMS. In the mutual company the surplus is developed from the policyholders' premiums. In the stock company, the stockholders put it up. However, my argument here is a pragmatic one, as you will see.

Senator MILLIKIN. Let me take you back, then, to your paragraph on the page ahead:

> The only real profit made by life-insurance companies is in the interest earned over and above that assumed by the actuaries in calculating premiums. All other income comes from the premiums and represents the policyholders' own money devoted to his own use without profit to anyone.

Would that apply to a stock company?

Mr. ADAMS. That would apply to a stock company, with the exception of the money actually paid to stockholders in dividends. As long as it is held—and I have no argument that the money actually paid to stockholders as dividends is not a profit.

Senator MILLIKIN. I thought your statement there was a little too broad.

Mr. ADAMS. Well, I was given 10 mintues, and I have to paint this with a broad brush. Therefore, I am not arguing the philosophy of this law, because I assume that after 30 years' trial you would not turn this over in one-half day's hearing. It is a matter of too much importance to too many people.

Both types of companies, stock and mutual, sell basically the same product in the same market, at a comparable price, in a fiercely competitive field. As a matter of fact, the mutuals dominate the business. Approximately 80 percent of all of the insurance in force is on the mutual, or so-called participating plan. Most of the very large companies are mutuals. Most of the small companies are stock companies. In many States there is no statutory method of organizing a mutual company. One of the most wholesome things in the life-insurance business is that new companies are being organized all the time—good companies, sound companies, safe companies, stock companies—serving in general their own localities.

A differential in tax would be an unbearable burden on the younger progressive stock life-insurance companies, which are serving both life insurance and the American public well. Furthermore, so far as I know, with one single exception, the mutual companies of the United States have never asked for a tax advantage and are not asking for one now.

So far there is practically unanimous agreement among life-insurance companies, at least an overwhelming majority, in support of House Joint Resolution 371. However, there is a residue of dissent against the so-called retroactive features of the bill. This opposition is extremely vigorous but numerically small despite some recruitment by catchword from outside the ranks of life insurance.

No one really likes retroactivity. However, the responsible officers of an overwhelming majority of life insurance companies are convinced that under the peculiar circumstances of this case the taxes proposed in this bill for 1947 and 1948 are neither inequitable to the companies, nor unjust to their policyholders. Neither do we regard this proposed levy as a dangerous precedent, because the situation is unique, as I shall show, and the authority of a precedent applies only to cases of like circumstances.

Senator MILLIKIN. What do you think is your legal duty so far as your powers under your charters are concerned to pay out money for taxes that you do not have to pay out under existing law?

Mr. ADAMS. We will not do that. We will not pay it out unless you pass the bill requiring us to pay it. This is the reason that I think it is a unique situation.

Senator MILLIKIN. What do you think is the legal duty of a life-insurance company to resist a retroactive payment of taxes which you are not required to pay currently?

Mr. ADAMS. If it were that simple, I would be here on the other side of the proposition. For the reasons I am about to state, I think this is a peculiar situation. And heavens knows, if, knowing all of the facts, as a matter of grace, this committee would levy less taxes—I am not saying that wings are sprouting on my shoulders, but I think this is a good-faith principle.

Senator MILLIKIN. Well, there is a great question of principle that affects us in many directions. This business of retroactive application of taxes is not an easy question to solve. We have to watch our precedents here.

Mr. ADAMS. I have to serve a principle here, though, and I will show you why.

Senator MILLIKIN. You go ahead with your broad brush.

Mr. ADAMS. It was the intent of the Revenue Act of 1942 to tax the investment income of life-insurance companies in excess of reserve interest requirements. This margin, all companies contended in 1942, and all companies contend today, is the valid measure of their true taxable income, which is properly subject to the general corporate levy.

There were actually surplus margins earned in excess of interest requirements by the industry in both 1947 and 1948, as well as in 1949. However, they escaped taxation because of the arbitrary estimate in the law as to the interest rate required to maintain reserves, to wit, 3¼ percent, which had become outmoded with changing conditions.

As interest rates declined life insurance reserves in great volume were significantly enlarged so that they could be fully maintained at a lower interest level. As a consequence the actual average interest reserving rate of the industry fell considerably below the estimated statutory rate of 3¼ percent. Therefore, although there were appreciable earnings properly subject to tax upon our own theory of sound taxation of life insurance, no tax was payable in 1947 and 1948.

This result was not intended when the life-insurance provisions of the Revenue Act were written by the Treasury and the companies in close collaboration, and were passed by the Congress upon their joint recommendation. Under those circumstances the Treasury officials contend, which contention is concurred in by the House of Representatives, that the life-insurance companies received a windfall through the nonpayment of taxes in 1947 and 1948, due to a latent defect in the law. This windfall, it is asserted, is both legally and morally a legitimate subject of recapture. To this proposition the overwhelming majority of life-insurance companies feel that they cannot in good conscience object.

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You will see this is not our original proposition. But this bill was passed upon that theory, and we believe that we could not in good conscience object.

Senator MILLIKIN. Had you actually added to your reserves the amount of the old allowable deduction, you would strengthen your insurance companies, would you not?

Mr. ADAMS. Yes. I can only speak for myself. This 1947 law took us by surprise. We had expected to pay taxes in 1947. We put up reserves in 1946 and 1947, and when through the vagaries of the law it developed that no tax was payable, we took down that reserve and put it into our surplus.

I do not know who else, but being on the committee, and knowing that we were in this discussion with the Treasury, in my company I put up reserves in 1948 to pay for 1948. How universally that was done, I am not sure.

Senator MILLIKIN. Had you entered the amount of the legal deduction into your reserve funds, your insurance companies would have been strengthened.

Mr. ADAMS. Certainly.

Senator MILLIKIN. You did not have to reduce your contribution to the reserves.

Mr. ADAMS. No. As a matter of prudence, I put them up.

Senator MILLIKIN. I knew you were a smart fellow by looking at you.

Mr. ADAMS. There is also much validity in the contention of the Treasury that the repeated statements of the Secretary, calling for remedial legislation, and the long series of conferences between the accredited tax committee of the industry with Treasury officials, reaching back to 1947, in an honest effort to arrive at a sound solution of this perplexing problem, put the life-insurance companies on notice that some bill of this general nature was in prospect and therefore they cannot properly plead surprise which is the essential vice of retroactive legislation.

Senator MILLIKIN. But could they plead surprise at retroactive legislation? They had warning that there would be a tax, but did they have warning that there would be a retroactive tax? That is the real issue.

Mr. ADAMS. Perhaps.

Senator, may I trespass to this extent: being a member of a committee representing 225 companies headed by rugged individualists is quite a problem. We first had to compose all of the differences in our own committee. Then we had consultation with the Treasury, over a couple of years. And as to this bill, I might throw this in, though it probably is not a good part of the record. If it has not been for Dr. Gallup, this would have been worked out in '48. But the people over in the Treasury read these polls, and they left the Treasury. We started with them and were very close to an agreement and then when it came up again, they were all a different group, and we had to start all over again. So I do not know whether you want to attribute that to Mr. Dewey or to Dr. Gallup.

Senator MILLIKIN. You are touching on a very gloomy subject.

Mr. ADAMS. But the fact is that we started with an entirely different group than we ended up with, and they are both very able people, and

the fact that we are still here with any blood in our veins is a tribute to ourselves.

Now, as I want to say, this is compromise all the way through. Any tax bill is. There are many considerations. And I only want to say this: Sure, as I say, you may ask, "Why do you come in and want to pay taxes?" Well, there are two reasons. I believe life insurance has a good public character and is built up on good public relations. We do not like to see the columnists say that the companies are tax dodgers, and so on and so forth; so we think we ought to pay a reasonable tax. This is what the House Ways and Means Committee and ourselves all agree on. And personally, we don't think it ought to be stopgap. We think that you should continue it and give it a chance. You can always change it. And if you put a termination date on it, by some inadvertence we may find ourselves, both of us, in the same situation we were in in 1947. This bill would expire, and there wouldn't be a new bill to take its place.

Thank you very much.

The CHAIRMAN. Mr. Parkinson.

Senator MARTIN. Mr. Chairman, I would like to interject that while Mr. Parkinson is from New York, he is a very fine Pennsylvanian, and president of the Pennsylvania Society of New York. We are very proud of him.

The CHAIRMAN. We are very glad to have you, Mr. Parkinson.

STATEMENT OF THOMAS I. PARKINSON, PRESIDENT, EQUITABLE LIFE ASSURANCE SOCIETY, NEW YORK CITY, N. Y.

Mr. PARKINSON. I am very happy at that introduction. May I be seated?

The CHAIRMAN. Oh, yes, sir.

Mr. PARKINSON. I am president of the Equitable Life Assurance Society, which is wholly a mutual company. It is a bit embarrassing to follow the representatives of the trade associations of our business, and to have to take a position completely different from that which they have just taken.

Senator MILLIKIN. How many policyholders are there in your company.

Mr. PARKINSON. There are, of policyholders and group certificate holders, a little over five and a half million.

Senator MILLIKIN. What is the size of your reserves?

Mr. PARKINSON. Our reserves are close to $4,900,000,000. Our assets are about five and a quarter billions.

Senator MILLIKIN. What is your annual turn-over of business?

Mr. PARKINSON. Our annual new business?

Senator MILLIKIN. How much do you take in a year?

Mr. PARKINSON. Our annual new life insurance business is about $600,000,000. Our group insurance is about $400,000,000 more. We have a large annuity business, and some other group coverages, like hospitalization.

We appreciate what has been said here today with respect to our willingness to meet our obligation to pay taxes, but we can't help emphasizing our duty to our policyholders, and, as has been suggeseted here, our duty to pay—from our policyholders' funds—only in accordance with law.

I don't like anybody to suggest that I am a tax dodger, but I certainly am not in any position to volunteer any payment, even to a needy Federal Treasury, unless the law justifies the payment. Our position is that this is a retroactive law, camouflaged as an income tax, and it is in reality a direct tax on that portion of our property which was our income in 1947 and 1948.

Senator MILLIKIN. Would you say that in real substance it is an attempt by the insurance companies to make a gift of their assets to the Federal Government?

Mr. PARKINSON. Senator, I do not think they have any intention of making a gift. I think that is true of anyone who has been here, and of anyone for whom a statement has been made. It is a retroactive tax, similar to any other retroactive tax that the Congress has ever considered, and I know of no retroactive income tax that the Congress has ever enacted.

Senator MILLIKIN. We have enacted retroactive taxes, but I doubt whether we have ever enacted them at the request of the victim before.

Mr. PARKINSON. I have no recollection, Senator, of any retroactive income tax ever enacted by Congress.

Senator MILLIKIN. Yes, we have done that.

Mr. PARKINSON. And I have in my hand, here, a photographic copy of a debate on the Senate floor in 1944, when an attempt was made to levy a retroactive tax on the public-utility companies. Senator Connally objected, and after a debate, in which Vice President Barkley, Senator Taft, Senator LaFollette, and others, participated, the proposal was rejected by a voice vote on the floor of the Senate.

Again I say, Senator I know of no retroactive income tax that has ever been enacted by Congress.

Senator MILLIKIN. If you will study the memo which is attached to one of these statements here, you will see quite a few cases by the Supreme Court of the United States that have validated retroactive taxes under particular circumstances.

Mr. PARKINSON. I am sorry, Senator. I still insist that no retroactive income tax has ever been validated by the Supreme Court or ever been enacted by the Congres. So that, if you do enact this one, you will be establishing a precedent, not only because of the receptivity of folks in the business but also as a method of taxation.

We believe—our lawyers are responsible for this conclusion—that when the earnings of a taxpayer have been determined for any year, his books have been closed, his dispositions made, and his return made under the then existing law, any tax thereafter imposed as an income tax is retroactive and violates the provision of the Constitution that requires a direct tax to be apportioned among the States in accordance with population. And we think that this proposal is no exception. It is a simple type of retroactive tax, and we don't know why the poor policyholders of the life-insurance companies should be selected for that experiment.

The policyholders will bear this tax. We in the Equitable increased our dividends in 1947, increased them again in 1948. We had no thought of such a thing as a retroactive tax to be paid under a law enacted a couple of years later. Now, if this retroactive tax be imposed, the result will be that our policyholders of today, who are different from the personnel of our policyholder group in 1947 and

1948, will have to bear the burden of the tax. Just as sure as we sit here, it will not be the corporate institution that will bear the tax, with power to pass it along to someone else. It will be the membership of our association. And that will be true of every other mutual company.

The tax will decrease our capacity to pay dividends and will increase the net cost to our policyholders. And we feel that we cannot agree to that without telling you gentlemen who are responsible for public policy in this matter just what the situation is. And I warn you, respectfully I warn you, that the so-called acceptance of this tax by some of the gentlemen who have been here before me, does not mean that they will not seek a refund if and when the legality of the tax is brought into question. I don't think there is any representative of any company here who says that he agrees to this tax in the sense that his company is going to pay it who will not seek a refund if and when its legality is brought into question. And if he did not seek a refund, you know as well as I do that he would respond in personal liability to his policyholders or his stockholders.

If you pass this tax, it is going to be one of the juiciest plums for the tax experts that has ever come out of Congress. There are going to be $90,000,000 of questionable taxes. And we will all be in the courts, not some of us, not 95 percent of us, but all of us, questioning its validity and seeking a refund.

Now, if we who object to this tax were really acting contrary to the public welfare, I think we would have to ask you to multiply its amount by 10, because nothing could be a better investment of our funds than to pay to the Treasury what turns out to be an invalid tax, and get a refund at 6 percent. And that, of course, is what is involved.

It is a retroactive tax. It is probably invalid. And it certainly will be the subject of litigation.

It is not true that we are the only company that objects to this tax. There are many statements that have been made here this afternoon that I would have to take issue with. Perhaps it is better for me simply to say to you that in addition to the Equitable, the Pacific Mutual, the Union Central, the Northwestern Mutual, the Mutual Benefit, the Mutual Life, the Continental, are all opposed to this tax, and have said so. And while there has been discussion of a change in the tax over a couple of years, so is there always discussion for a couple of years of any important change in the tax law. But in this case, as in those, the discussion has never included a proposal that when the discussion ended, and a decision was made, that decision would be made retroactive.

It is true, as has been suggested here this afternoon by one of the Senators, that the discussion of a change in the tax has been under way for a couple of years; but that discussion did not, until the middle of 1949, ever include a suggestion of the payment of retroactive tax. And the Life Insurance Association, in August of last year, voted against a retroactive tax.

Senator MILLIKIN. Give me that last statement again, please.

Mr. PARKINSON. The Life Insurance Association of America voted against a retroactive tax in August of last year, and its representatives thereupon communicated its objections to the Treasury representatives.

Senator MILLIKIN. And when was the first time that the question of a retroactive tax ever came to the attention of the industry generally?

Mr. PARKINSON. The first time it ever came to the attention of the Life Insurance Association, as distinguished from the committee which Mr. McAndless represents, was really in the summer of 1949. The first time it came before the board of directors of the association was in August of 1949, and they were instructed at that time that we would not agree to a retroactive tax for 1948. No one had ever suggested that we go back to a retroactive tax of 1947. It came up again before the board of the Life Insurance Association on the 21st of October, and there was the unanimous resolution of that board directing its committee and its officers not to agree to a retroactive tax. At that time it meant 1948. It was never until the meeting of that committee with Judge Lynch's subcommittee of the Ways and Means Committee that any proposal was made to include a retroactive tax for 1947. We, the innocent members of the Life Insurance Association, who have not been on the inside of the negotiations with the Treasury or with that subcommittee, have never yet learned what it was that happened in the meeting between the committee of the association and the subcommittee of the Ways and Means Committee that made for the spectacle that you see here this afternoon. I think it is an extraordinary spectacle that the representatives of this great industry, with the duty that they owe to their policyholders, should be here asking for a retroactive tax—a retroactive tax that must affect the interests and the rates and the costs of their policyholders.

Senator MILLIKIN. If you will permit me to continue a respectful difference of opinion with you, the Supreme Court in some of its decisions in passing on these retroactive cases has indicated that you could carry retroactivity to the point where it would violate the fifth amendment. The date at which the industry or the taxpayers generally became cognizant that there might be a new tax entered into its opinions, and was a very important factor. That is why I am pressing to find out when the industry generally first heard there might be a retroactive tax on this thing. I cannot ask you to answer that, because you do not agree that the Supreme Court has ever decided that.

Mr. PARKINSON. I am quite sure the Supreme Court has never decided on a retroactive income tax, Senator. I must emphasize that idea. A retroactive income tax is questionable under the Constitution for two reasons. You might have a retroactive excise tax that would be questioned under the fifth amendment, the due-process clause; but a retroactive income tax—now, I shouldn't be doing this, because my lawyers should be doing it—a retroactive income tax is questioned first under the due-process clause, and second under the constitutional provision that no direct tax shall be levied unless it is apportioned. And I am saying to you that the Supreme Court has never passed on the question of whether a retroactive tax called an income tax is an income tax under the sixteenth amendment.

The CHAIRMAN. However, we have power undoubtedly to impose retroactively a remedial statute. That is in favor of the taxpayer, however, and not against.

We came very near doing it in the case of the processing tax, when the Supreme Court held the Agricultural Adjustment Act to be unconstitutional. Then we were asked to impose a tax on the windfall that had been presumably actually collected from the public

by the taxpayer. And I do not believe that that was applied retroactively beyond that particular year in which the tax was passed.

I may say I was never particularly proud of the decision that we reached, even in that case, because to the extent that the taxpayer, the complaining taxpayer, had actually collected it out of the public, there was no inequity in requiring to pay into the Treasury. But to the extent that he had simply forgiven that to the seller of cotton or other goods affected by that Agricultural Adjustment Act, it did raise a very serious question in my own mind.

Mr. PARKINSON. The nearest you ever came, Senator, to passing a retroactive income tax was the Revenue Act of 1918, which was finally adopted in February 1919. The distinction that I am trying to make here is, as represented by that case, that while the tax was made applicable back to the year 1918, at the time it was enacted, the taxpayer had not yet filed or been required to file his tax return for the year 1918. I don't think you will find, Senator, any case where Congress has imposed a retroactive income tax after the date when a return was required and the first payment of tax was required under the preexisting law.

And may I say that it gives me very great pleasure to add, Senator, that I participated in the drafting of the Revenue Act of 1918 as a member of the Judge Advocate General's staff and as the first legislative counsel of the Senate committees. Those were the days when Senator Simmons and Senator Penrose were the chairmen of this committee. I was their legislative counsel and had a very great deal to do with the problem which we are discussing now. That is the reason why I think I am able to be a bit emphatic about my statements as to previous retroactive income tax legislation.

Now, may I say a word about the mysteries of this institution of life insurance? They are not nearly so complicated or so mysterious as people seem to think or as has been suggested here this afternoon.

May I take a moment to say to you that the reason we have assets and the reason the things we have said today are true is that we do this business under the level-premium plan. Now, our actuaries can tell you precisely what it will cost to insure a man of a given age under a given mortality table with a given assumption as to interest rate available on investments in any year from this time to the end of his expectancy. If we insured you year by year, you would pay a small sum the first years, if you were young, and you would pay a larger sum each year thereafter as you grew older, because the cost of insuring any human being increases with his age. The trick of the level-premium plan of life insurance, which was developed under the old Equitable Assurance Society of London in 1760, is this: That we charge you a level premium through your expectancy. The premium you pay under that plan is more than it costs in the early years of the policy and less than it costs in the later years of the policy. It is because we charge you more than the cost of the insurance in the earlier years that we have assets. We wouldn't have any considerable assets if it were not for the fact that we charge you in the early years of the policy more than it costs us to insure you. But by the same token, the premium you pay in the later years of your insurance is inadequate. It does not pay the cost of the insurance.

No, God Almighty does not intervene and supplement that inadequate premium. The addition to that inadequate premium is made out of the fund that we accumulated in the early years of the policy. Now, this is actuarial, you may say, Senator, but although I never went beyond the thirteenth grade in arithmetic, I say it is arithmetical. Unless the fund that we accumulate in the early years of that policy's life is maintained against loss, and with annual accumulations at the interest rate assumed by the actuary when he made the premium, we will not have that fund with which to supplement the inadequate premiums of later years.

That is the reason that we have always asked you here in Congress to recognize the fact that our interest earnings are devoted to maintaining that fund in order to keep the institution sound. We don't accumulate it for the policyholders themselves. We accumulate it to make it possible for the institution to perform its contracts. And if we don't accumulate it, if we lose it, if the interest rate falls too low, if he tax authorities take from us too much, we won't have the fund upon which our capacity to supplement that inadequate premium to the later years depends. That is the whole story.

There is nothing here before this committee beyond that which was before the Senate Finance Committee in 1919, 1920, and finally in 1921.

There had been, as someone said, an attempt, under the income tax of 1913, to tax this business as other corporate taxpayers were taxed. It produced nothing but litigation. It did not produce revenue. And it was under the very able leadership of the then tax expert of the Treasury, Dr. Thomas Adams, the Yale economist, that Congress decided that the right way to tax this business was to place the tax only on that portion of the taxpayers' income that was in excess of what it needed to maintain its policy premium reserve.

Now, when Dr. Adams first drew that law—and again I say I had the privilege of participating with him in making the first drafts, when he first drafted that proposal—it was applicable to each taxpayer. Each taxpayer was permitted to deduct from his gross earnings that which he needed to maintain his policy reserve. And it was changed before it went through Congress to provide that an average amount might be deducted by all companies, and that average amount was written into the law at 4 percent.

And then, in 1930 or thereabouts, the 4 percent was made 3¾ percent. Then in 1942, as has been said here, the 3¾ percent was disposed of and 3¼ percent was used for a portion, and the actual experience of the companies for the balance.

But in all of those discussions, may I emphasize, it took 2 or 3 years to determine what the new tax should be, and in none of them was any proposal ever made that the final adjustment should be made retroactive for back years.

It is not our fault, Senator, that the tax law applicable to life-insurance has not been changed during the last couple of years. And it is no such mysterious or difficult job as has been so often suggested. I was almost ready to say that a tax applicable to the future that would be fair to this business and keep it solvent, at least not make it insolvent, and yet give the Treasury a revenue, could be decided upon by the technical men of this business in as much time as this hearing is taking.

Now, you may ask me why that hasn't been done in all the discussions in the past. Perhaps I ought not to say it, but it is on the end of my tongue that the discussions which have been had up to this time have not been with the technicians but with the tacticians.

We who oppose this proposal are constantly growing in number, and the idea that this entire business, or nearly the entire business, is agreeable to this tax is not accurate. And I could, if I wanted to, read you some more indications that there is not only objection to this tax among the companies, especially the mutual companies, but there is concern about this tax from the State commissioners of insurance. I have letters on my desk right here from the superintendent of New York and the commissioner of Massachusetts, indicating that they have great concern about the retroactive tax, and about the willingness, apparently, of the business to accept it. In addition, I am assured that the subject of the tax and the attitude of the companies toward it will be on the agenda of a spring meeting of the State commissioners, which will take place in a few weeks.

Now, I am quite sure that the job which is before the Congress and which will remain there until it is solved, that is, imposing a fair tax on this business for the future, can be done in a reasonably short time. We would not object to a prospective tax being applied to the income for 1949, because we place great emphasis on the time when the tax is imposed in relation to the expiration of the date for filing the income-tax return of the taxpayer. The Treasury has extended for two more months the time within which life-insurance returns for 1949 may be made. The Treasury can extend that time for a longer period. As long as the time has not passed within which we are required by law to submit our returns for last year, we would, we are advised, be within our legal rights to pay the tax and not contest it, and Congress would be within its legal rights to impose it.

The Congress can in some way determine what tax ought to be paid by this business, and relate it back to 1949.

Senator MILLIKIN. Let me ask you with complete directness: Is there any shadow of a hint or implication that if these taxes are not paid retroactively, lumps will be put on you in the future?

Mr. PARKINSON. The only information I have on that, Senator, is hearsay. We were told that as a result of the conference between the representatives of the business and Judge Lynch's subcommittee, from which I may say our representatives were excluded, it was indicated to the representatives of the business that they should take this or expect something worse. But in my long experience in the business world, in dealing with my friends in the Government as well as in the business, that is not an unusual phrase.

Senator MILLIKIN. That does not make you feel any better?

Mr. PARKINSON. No, sir; in most instances it makes me feel much worse, Senator.

The CHAIRMAN. Any questions?

Had you finished what you desired to say, Mr. Parkinson?

Mr. PARKINSON. Yes, sir. I would like, if you will permit me, to submit a more definite statement, that you might include in your record, and I would like to expose you now, if you desire it, to our counsel, Harrison Tweed, of the Milbank firm in New York, who is here, if you want to ask him any questions. I do not think he has any

statement to make, but he is the substantial legal authority that stands behind my reflections on the law.

The CHAIRMAN. We will be very glad to hear him. He is listed next anyway.

Thank you, Mr. Parkinson.

Mr. PARKINSON. Thank you.

The CHAIRMAN. All right, Mr. Tweed, we shall be glad to hear from you.

STATEMENT OF HARRISON TWEED, MILBANK, TWEED & HOPE, NEW YORK CITY, COUNSEL FOR EQUITABLE ASSURANCE SOCIETY

Mr. TWEED. My name is Harrison Tweed, of New York.

Mr. Chairman and members of the committee, I am only going to say one word. It is quite obvious that Mr. Parkinson doesn't need any lawyers to help him out. He didn't say so, but he is a lawyer himself, and has been for a good many years.

The only thing that I would add at all to what he said is one factor, which had to do with the retroactivity, and that is that because of the change in the persons who are policyholders, a tax for 1917 would fall to some extent at least on those who were not policyholders, in the year 1917 at all, but who had recently become policyholders.

The CHAIRMAN. You mean '47?

Mr. TWEED. Forty-seven, yes. So that out of the earnings of the company, which would ordinarily go to them in dividends, there would be subtracted the amount of this tax for 1947, which simply is one more demonstration of the retroactivity to which objection is taken.

On the constitutional point, I am not going to speak. I am simply going to say that the ethics of Congress coincide exactly with the conceptions of the Supreme Court of the United States as to what is proper in retroactive income legislation.

Congress has refused, on the occasions which have been mentioned, and others, to go back with any kind of an income tax beyond a reasonable period, and not to have anything which is in the nature of an arbitrary tax.

Now, this tax does go back beyond the period that has ever been sanctioned by the Court or the Congress. It is also arbitrary in almost all respects. It is arbitrary, because it comes into existence simply because a system of taxation didn't produce revenue. There was nothing the matter with that system of taxation, except that financial conditions changed, the result of which was that there were no taxes payable during those years. It is not very different from the fact that an exemption was given by staute, and if that is a very bad year for lawyers, it may be that no lawyers get enough income to come up to the exemption. But I think that Congress would not visualize the possibility of changing the exemption subsequently. Perhaps that may be because so many of them are lawyers, and they have sympathy with lawyers, but I am quite sure they would not do it anyway.

The CHAIRMAN. Well, we have adopted the principle of carry-forward and carry-back. That has some relationship.

Mr. TWEED. But that would be a very similar thing, to take that away; and I am quite sure Congress would not think of doing that.

And I think this is arbitrary also in the way it has been negotiated, that is has been treated not as something that Congress is going to do in its wisdom, as something that it thinks is the right thing to do, but as the result of negotiation with some of the companies who apparently have the conception that it is better for them to do this and give up this money, rather than take a chance on what might happen to them if they don't agree to this.

The CHAIRMAN. Would you object to submitting to this committee a brief on the question that you have been referring to?

Mr. TWEED. I should be very glad to, Mr. Chairman.

The CHAIRMAN. Without unnecessary elaboration, because what we want to get is the facts.

Mr. TWEED. I will promise you that it will be a brief brief.

The CHAIRMAN. We will be very glad to have it. If you will refer to the memoranda prepared by Congressman Lynch, and if you saw any reason to draw any distinction between those cases, if you would set that forth, and what you consider to be the sounder principle here, it might be helpful to this committee.

Mr. TWEED. Very well, sir.

The CHAIRMAN. Mr. Stannus.

STATEMENT OF W. N. STANNUS, SECRETARY, PYRAMID LIFE INSURANCE CO., LITTLE ROCK, ARK.

Mr. STANNUS. Mr. Chairman, I am W. N. Stannus, secretary of the Pyramid Life Insurance Co., Little Rock, Ark.

The CHAIRMAN. Yes, sir. You may be seated if you wish to.

Mr. STANNUS. Thank you.

The Pyramid Life Insurance Co. of Little Rock, Ark., is a small company, as life insurance companies go. We are 25 years old and have approximately $40,000,000 of insurance in force. We appreciate very much the opportunity to appear at this hearing for it is our desire and principal objective to present some of the problems of the small life insurance company as they relate to Federal income taxation.

Our interest in the matter naturally has been strong since the beginning of committee hearings, but more keenly aroused upon receipt of a letter from Mr. William Montgomery, president of the Acacia Mutual Life Insurance Co. Following receipt of this letter, we wrote the president of each legal reserve life insurance company in the United States in which we set out a compromise proposal we felt would be fair to the industry and at the same time produce substantial taxes for the Government. It was based on Mr. Montgomery's formula but with an extension of the graduated-tax principle for companies with low income. Our proposal was that the net taxable income be found by taking one-half of the sum of the free investment income and the amount derived by the average valuation rate formula. For companies with less than $75,000 of net taxable income, the first $25,000 should be nontaxable with the next $50,000 taxable at the regular corporation income tax rates. For companies having from $75,000 to $100,000 of net taxable income, the exemption should be the difference between the amount of the net taxable income and

$100,000. For companies having $100,000 or more of net taxable income there should be no exemption.

In this manner, companies having less than $100,000 of net taxable income would pay less tax than if there were no exemption, for the exemption will be reduced gradually so that beginning at $100,000 the tax would be the same as that provided by any proposal thus far made. The loss of tax to the Federal Government should be negligible, since 38 companies in the United States accounted for approximately 97 percent of the total free investment income of all American companies in 1948.

As evidence that our proposal was not made to be of specific benefit to the Pyramid Life Insurance Co., we submit that a tax based on the average valuation rate formula without consideration of free investment income would be more beneficial to us than one including a free investment income factor. Our free investment income is proportionately very much higher than the average for the industry.

Our response to this proposal was quite gratifying, although as you may readily imagine, those who had worked hard to reach agreement on the average valuation rate formula were disappointed that we should inject still another idea into a subject already fraught with complications. The considerable correspondence received from smaller companies was, in the great majority, favorable to our proposal.

We certainly have no bone to pick with big business, for the United States requires big business in order to be big. But most big businesses grew during a period in which income tax was of little or no importance. Prior to the passage of the first permanent Federal Income Tax Law in 1913, the so-called giant life insurance companies of today had already reached great size. The period from 1885 to 1906 was one of great prosperity and phenomenal growth. The total amount of new insurance issued and the total amount of life insurance in force both increased about fivefold. While there were many contributing factors, yet freedom from any appreciable amount of income taxes certainly favored this growth.

The Congress of the United States has found it necessary to investigate charges of monopolistic practices, but we submit that the answer should come through stronger competition arising out of the grass roots of the industry itself. Given the proper opportunity and incentive, the management of our young and small businesses will furnish that competition. In addition to the basic principle that insurance is loss sharing, there is the principle of large numbers to share these losses, and all premium rates and values are based on this principle. In so doing, the profit possibilities for each $1,000 of insurance is practically nonexistent until a company reaches several millions of dollars of insurance in force. Therefore, it is just as logical to allow exemptions and a graduated tax rate for the small insurance company as it is to allow exemptions and a graduated tax rate in computing personal income taxes.

Another reason for extending the graduated scale for Federal income taxes, has to do with the often-discussed question of double taxation. The stock of most small corporations is tightly held in the hands of those managing the business. The manager-owner pays income tax on the salary he draws which is usually relatively small in order that he may leave the profits to increase the size of his business.

If he is required to pay income tax at the rate of 38 percent, there is much less opportunity for his business to grow. With large corporations there is more reason to tax the income of the company and again tax the dividends to the nonmanaging owners of the stock.

The question has doubtless occurred to you of why should small life insurance companies be the recipient of tax advantages greater than those extended other companies. Our answer is that we think the extension of the graduated scale of taxes should be extended to all small companies. Perhaps the insurance industry can be the stepping stone to such a modification.

In conclusion, therefore, we should like to sum up our thinking as follows:

Small life insurance companies, or all small corporations, for that matter, should have an exemption of first $25,000 of net taxable income when the total net taxable income is less than $75,000.

The next $50,000 should be taxable at the regular corporation income-tax rates; and, for companies having $75,000 to $100,000 of net taxable income, the exemption should be the difference between the amount of the net taxable income and $100,000.

For companies having $100,000 or more of net taxable income, there should be no exemption. This is right and proper since it enables small companies better to compete with large companies which were required to pay practically no income taxes during their period of growth and development.

As for the matter of the proper base for net taxable income we are quite willing to accept the will of the majority. We firmly believe, however, that whatever base be decided upon the principle of the graduated tax should go hand in hand with the principle of nominal exemption which has always been recognized in levying personal-income taxes.

Now, if you please, I just have a few more remarks to make that are not incorporated in my formal statement. These are additional reasons why small life-insurance companies are not in a comparable position competitionwise with larger companies.

Since they are not so well known, no matter how good their reputation among those who do know them, there is more sales resistance encountered by the sales representatives of small companies.

This often necessitates giving a higher commission contract for the men selling the business, involving more acquisition costs.

Next, life insurance is a highly technical business, requiring the services of highly educated and trained men, such as actuaries, attorneys, investment counselors, doctors, and statisticians. These services are relatively high for the small company in relation to the cost per thousand of insurance in force, no matter how conservative the management may be in using the part-time counsel of consulting actuaries and the like.

Life insurance is a volume business and a company must have many millions of insurance in force before it can afford such mechanical equipment as punch-card accounting to reduce unit costs.

For these and many other reasons, a life-insurance company does not make a profit until it has attained moderate size. Our company is not far different from most, wherein our president and founder has actually contributed nearly a quarter of a million of his own per-

sonal funds, after the initial investment, to make the company grow to a profitable size.

But life-insurance companies are financial institutions, dealing with the funds of policyholders over long periods of their lifetime, and every precaution should be taken to protect the solvency of a life-insurance company once it has been organized.

Our tax proposal will help greatly to do this, with small revenue loss to the Government, none under present law.

Senator MILLIKIN. How do you feel about the proposal before us?

Mr. STANNUS. I feel that a retroactive tax is unfair. We were not able to keep up with all the affairs as they happened at all the hearings.

Actually, we filed our income-tax return for 1947 and 1948 and forgot about it. Then in late 1949 we understood that there was a possibility of its becoming retroactive and at the end of the year did set up what we estimated might be our tax for those other years.

Senator MILLIKIN. Thank you very much.

The CHAIRMAN. Thank you very much, sir.

I think it is obvious we cannot complete the hearings this afternoon, but if there is any witness who would not find it convenient to make another appearance and would like to be heard this afternoon, we would be glad to hear him.

The next witness on the list informs us that he can come back at any time since the company is located here in Washington.

Then we have Mr. Klocksin.

STATEMENT OF CLARENCE C. KLOCKSIN, LEGISLATIVE COUNSEL, NORTHWESTERN MUTUAL LIFE INSURANCE CO., MILWAUKEE, WIS.

Mr. KLOCKSIN. I am from Milwaukee, Wis., Senator. It would not take me probably even as much as 10 minutes' time.

The CHAIRMAN. You would like to appear, then, at this time; is that correct?

Mr. KLOCKSIN. Yes, sir.

The CHAIRMAN. You may come around and we will hear you.

Mr. KLOCKSIN. My name is Clarence C. Klocksin, of Milwaukee. I am legislative counsel of the Northwestern Mutual Life Insurance Co. of that city.

The Northwestern Mutual Life Insurance Co. has consistently opposed the retroactive taxes and appeared before Congressman Lynch's subcommittee last October 31 in opposition to the tax bill then under consideration, which is merged in present House Joint Resolution 371.

My statement is as follows:

American life-insurance companies have a long record of paying substantial taxes toward the maintenance of both State and Federal Governments.

The amount of taxes so paid by them aggregated many millions of dollars. In the 25-year period 1925 to 1949, inclusive, Northwestern Mutual paid taxes to the States amounting to $64,510,000 and to the Federal Government $15,862,000, a total of $80,372,000.

Because the business of life insurance has been operated throughout under the regulation of the States it naturally has followed that the States have exercised a primary right to tax such companies. The

situation thus existing has in no way denied the right of the Federal Government to levy a tax on the life companies, but the fact remains that the general tax policy of the States with respect to life insurance has been to largely hold the power to impose such levies in their own jurisdictions.

The history of Federal taxation of life-insurance companies seems to recognize the prerogatives of the States in this connection.

It is true that the Congress, through successive amendments to the tax laws, has been eminently fair in its tax treatment of such companies. The Congress has steadfastly and rightfully adhered to the principle of not imposing a tax on the amount of interest required to maintain the policy reserves of the companies.

The declining interest yield on our securities, including substantial holdings of Government bonds, has for the last 3 years left the Government with practically no revenue from such companies. To be sure this was a situation to be remedied by the Congress. Certain it was that our company was willing at all times to pay its fair share of the tax burden as determined by the Congress.

Except for original House Joint Resolution 371 imposing a tax on life-insurance companies for the years 1948-49 which was introduced in September 1949, no notice of any plan to tax life-insurance companies was given to or received by our company until hearings were scheduled October 31, 1949, before Congressman Lynch's subcommittee of the House Ways and Means Committee.

It should here be noted that our company is not a member of either the American Life Convention or Life Insurance Association of America, whose Joint Taxation Committee had heretofore been having discussions with officials of the Treasury relative to a tax on life-insurance companies.

On October 31, 1949, our company appeared before the subcommittee referred to and, although agreeable to the substitute plan or method of taxation under consideration, known as the average reserve valuation rate, we voiced strong objections to the retroactive taxes therein proposed.

At that time testimony was given to the effect that on the basis of our 1948 operations our dividend schedule for the year 1949 had been substantially reduced. Our net interest rate for 1948 had dropped to 3.01 percent, the lowest point in the company's history.

I am pleased to say at this time that for the year 1949 our rate of interest return has risen to 3.13 percent.

Life-insurance companies generally close their books on December 31 of each year and in compliance with State laws they must file with the respective insurance departments of the States in which they do business detailed schedules of their operations of the past year, commonly known as the annual statement.

In accordance with such practice, the actuaries of the companies must determine from the books of accounts the amounts necessary to be set aside for policy reserve and other contract requirements and also the amounts to be set aside as surplus or dividends to policyholders required to be determined by State laws. Once the books are closed the schedules are published and filed as above referred to.

Life-insurance companies have long followed the practice of fortifying their reserves and other contractual liabilities by amounts known as contingency reserves or unassigned surplus.

The laws of a number of States, including New York, provide for the accumulation of such reserves and usually limit the amount thereof to 10 percent of the total policy reserve liability of an insurer. This is considered sound business policy just as it is in the case of banks and other financial institutions.

I should interpolate here that the Northwestern has had for many years an average percentage of 6 to 6½ percent of its policy reserve liability in so-called contingency reserves or unassigned funds, although, as I pointed out, the limit of the law in about five or six States, in North Carolina, in addition to New York, Tennessee, and some Western States, is limited to 10 percent.

Considering that, that is a safe and a desirable margin in which life-insurance companies may go and to have those amounts for asset fluctuation or for other items in the business.

We have set aside some in connection with liability for our installment contract interests that run for life and for many years where we need these amounts. That is why, when these amounts were set aside in 1947 to these various accounts that we have in the Northwestern and the books were closed, we doubt that when we come into 1949 and now we are in 1950, that it is fair or right to go back and charge them up now for taxes.

Although, as I go on in my statement, I will show that we have set up a liability for those proposed retroactive taxes.

The books of our company, as well as those of others, were closed in 1947 and 1948 and all funds were either disbursed or earmarked or accounted for at that time. Before closing our books for 1949, we set aside or reserved the sum of $3,600,000 for tentative Federal tax liability for the years 1947, 1948, and 1949, as contemplated by the pending joint resolution.

The reason for such action was that Congress had given definite indications of imposing back taxes for 1947 and 1948, so that the responsibility therefor, if the joint resolution is approved, will belong to the Congress.

We find in the case of our company, under House Joint Resolution 371, if it is approved our back tax liability will be for 1947, $1,116,000. For 1948 it will be $1,004,000, and for 1949 it would be $1,480,000.

The increase in the last figure shows what has been suggested by earlier speakers today, that we are going to find in this plan that they have for the average valuation rate an increase to the Federal Government in taxes as we go ahead because of the fact that the assumed rates of interest are going to go down.

On that average assumed rate of interest, the principal deduction item that is involved is the deduction therefor from the amount of investment income.

Our company had a 3-percent interest rate from 1899, and before that we had 4 percent; but in 1899 we changed to 3, and 3 years ago, January 1, 1947, we changed to 2. There are only a very few companies that went as low as that. Some went to 2¼, and some to 2½.

But the point I make is that the average valuation rate is going to decrease in percentage and, of course, the Government's income is going to increase considerably. Our figure has jumped under this present resolution from about just a million to almost a million and a half, from 1948 to 1949, as I gave the figures.

And if we have some further improvement in the interest rate ahead, which our company has had—and I think our experience will be typical—that also will help very greatly.

We would submit to your committee a question: If similar retroactive tax treatment were to be imposed for individual taxpayers or for other corporations, would it receive your sanction?

Certainly, in that event you would hear a roar of protest across the land that would be deafening.

The Northwestern Mutual Life has about a million policyholders who are located in every section of this country. Some are Members of the Congress. The policyholders are the ones who would have to pay the proposed tax levy. A number of them have written our company to register their emphatic protest of the retroactive taxes.

For the trustees and officers of our company, who represent the policyholders, I want to record their earnest objection to the proposed imposition of taxes for the years 1947 and 1948 as embraced in House Joint Resolution 371.

The CHAIRMAN. Are there any questions?

Thank you, sir, for your appearance.

Are there any other witnesses who wish to be heard at this time?

If not, the committee will stand in recess and we will notify those witnesses who have not appeared today of the subsequent date of the hearing.

(Thereupon, at 4:50 p. m., the committee recessed, to reconvene subject to the call of the Chair.)

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TAXATION OF LIFE-INSURANCE COMPANIES

WEDNESDAY, MARCH 29, 1950

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met at 10 a. m., pursuant to call, in room 312, Senate Office Building, Senator Harry Flood Byrd presiding.

Present: Senators Byrd, Johnson of Colorado, Hoey, Myers, Millikin, Taft, Butler, and Martin.

Also present: Mrs. Elizabeth B. Springer, chief clerk.

Senator BYRD. The hearing will come to order.

Senator George, the chairman, I am sorry to say, is indisposed, and unable to be here today.

The Chair would like to announce that Mr. Harrison Tweed has given a memorandum to the committee with respect to the request made of him at the last meeting, and that is available to anyone who desires to see it. It will be included in the record at this point.

(The memorandum referred to follows:)

MEMORANDUM RE HOUSE RESOLUTION 371 SUBMITTED TO THE SENATE COMMITTEE ON FINANCE BY HARRISON TWEED, AS OF COUNSEL FOR THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, SUPPLEMENTING HIS STATEMENT AT THE HEARING ON MARCH 16, 1950, AND ANSWERING THE FACTUAL AND CONSTITUTIONAL ARGUMENT OF HON. WALTER A. LYNCH

THE FULL FACTS ARE ESSENTIAL TO AN APPRECIATION OF THE ETHICAL AND LEGAL QUESTIONS

House Joint Resolution 371 would impose a tax in the estimated aggregate amount of $92,500,000 based on life insurance company income earned during the years 1947, 1948, and 1949. The propriety and the constitutionality of the tax have been condemned on the ground that it would be arbitrarily retroactive.

The 1942 formula was not unreasonable

The resolution has been declared by its sponsors to be required because the formula adopted by the Revenue Act of 1942 failed to produce any revenue in the years 1947 and 1948.

The 1942 formula was a reasonable and appropriate measure of tax at the time of its adoption. Report No. 2333 of the Ways and Means Committee, dated July 14, 1942, declared that the formula had been adopted in order "to arrive at an equitable solution of the proper amount to be allowed as a deduction" to maintain reserves. Senate Report No. 1631, submitted for this committee by Senator George on October 2, 1942, made the same declaration.

The 1942 formula produced during the 7 years from 1942 through 1948 an aggregate revenue in excess of $142,000,000. This is to be compared with an aggregate revenue of $4,181,000 produced in the preceding 7-year period, 1935 through 1941, under earlier legislation and it is worthy of note that Congress made no attempt to enact retroactive taxes in 1942, despite the very small revenue of the preceding years.

Failure of 1942 formula to produce adequate revenue was caused solely by lowered interest rates

The 1942 formula would have produced satisfactory revenue, even in the years 1947 and 1948, if the monetary policy of the Government had not greatly reduced interest rates. This automatically reduced the yield on life insurance company investments. In 1942 the yield on investments for 49 life insurance companies, holding approximately 89 percent of the admitted assets of all legal-reserve life insurance companies in the country, was 3.40 percent. In 1947 the yield on investments for the same 49 companies had dropped to 2.87 percent. The ledger assets of the same companies in 1947 were more than $43,000,000,000 and the reduction of 0.53 percent in yield on investments represented a decline in earnings of $240,000,000. If the latter amount had been available to the companies a tax revenue would have been produced under the 1942 formula in excess of $91,000,000. A similar situation existed in 1948 and 1949. It would be no more reasonable for the Congress to reduce retroactively the deductions established under the 1942 formula for life insurance companies than to reduce the deductions allowed to individuals when the reason, in either instance, was merely the fact that general economic conditions had reduced net income available for taxes.

No factor other than declining investment yields has operated since 1942 to prevent the formula of that year from producing an adequate revenue. Statements made by representatives of the Treasury Department that there were other factors are inaccurate. The factor cited by a representative of the Department at the hearing before this committee on March 16, 1950, namely, a reduction in interest rates fixed under the companies' insurance and annuity contracts, would have had the effect not of reducing the revenues to be obtained by the Government under the 1942 formula but of increasing them.

Recommendations for permanent life insurance taxes could have been presented to the Congress

The effect of the Government's monetary policy in reducing interest rates and investment yields was apparent in 1942 and continuously thereafter. Thus, the Treasury Department had ample opportunity to present to the Congress a considered revision of the 1942 formula so that suitable revenue might be produced for future years. Discussions looking to such a revision of the 1942 formula were held for the first time between representatives of the Treasury Department and representatives of the two major associations of life insurance companies in the fall of 1947. Although several suggestions were made on behalf of the life companies in the course of the discussions, the Treasury Department made no definite proposal for a considered revision until July 1949, at which time it decided upon a retroactive tax.

Instead, the Treasury Department, without notice, urged retroactive taxes

The first definite proposal for a retroactive tax applicable to 1948 was made by Thomas Lynch, General Counsel of the Treasury, on July 21, 1949. There had been references to a tax applicable to 1948 as early as November 1948, but, obviously, such references did not suggest retroactivity until sometime well along in the year 1949.

The first intimation of a tax applicable to 1947 was received by the life insurance companies on October 27, 1949, following a meeting the preceding day between representatives of the Treasury Department and representatives of the two major associations. It is to be noted that House Joint Resolution 371, as submitted by Chairman Doughton on October 10, 1949, purported to impose a tax applicable only to 1948 and 1949. The 1947 tax was urged by the Subcommittee on the Taxation of Life Insurance Companies of the Committee on Ways and Means in its report dated January 3, 1950, in lieu of the resolution as submitted by Chairman Doughton.

Prior to October 27, 1949, the possibility of a tax retroactive to the year 1947 had not in any manner been brought to the attention of the Equitable Life Assurance Society of the United States whose share of the taxes proposed by House Joint Resolution 371 would be approximately $8,300,000 or about 9 percent of the entire amount to be raised under the resolution. It is believed that most of the other life insurance companies were similarly without earlier notice that consideration was being given to a tax retroactive to 1947.

Motive behind retroactive taxes may be establishment of precedent

House Joint Resolution 371 has gone back, not 1 year, but 2, to 1947, and while the Treasury Department's motive in doing so has not been disclosed, there appears to be more than a possibility that a test of retroactive taxes is deliberately sought to establish a favorable precedent for their future use.

Retroactive life insurance taxes are necessarily a precedent for retroactive taxes on individuals

It has been asserted that the levy of the proposed tax would create no precedent for a similarly retroactive tax on individuals or on other corporations (transcript of hearing before this committee on March 16, 1950). The alleged distinction is that the vague discussions which were had between representatives of the Treasury Department and representatives of the two associations of life insurance companies sporadically in 1947 and thereafter to date eliminate the vice of retroactivity. But if that were true, the repeated and nationally publicized statements of President Truman during the same period insisting that Congress increase surtax rates on individual and corporate incomes would have the same effect and such an increase retroactively for 3 years would be justified. The two situations are exactly analogous. There is no theory on which the Government could support House Joint Resolution 371 in the courts which would insure that a decision in its favor sustaining the retroactive tax would not become a legal precedent for retroactive income taxes on other corporations and on individuals.

Life-insurance companies were not properly represented by industry associations

The discussions between representatives of the Treasury Department and representatives of the life-insurance associations were also claimed to assure that the proposed tax would not be held unconstitutional as a deprivation of property without due process. However, as Senator Millikin recognized at the hearing on March 16, 1950, the discussions, until the middle of 1949, were concerned only with a new formula for current and future taxes, not the retroactive application of a new formula. When the discussions shifted in July 1949 to retroactive taxation, the governing body of the Life Insurance Association of America adopted a resolution under date of August 29, 1949, confirmed by a second resolution adopted on October 21, 1949, flatly condemning, rejecting, and opposing retroactive taxes for 1948.

Not until March 9, 1950, did the board of directors of the association officially reverse the position taken in August and October and authorize the officers of the association to support the retroactive tax proposal contained in House Joint Resolution 371. Moreover, the reversal was upon a vote of 6 in favor (including 1 Canadian company), 1 in opposition, and 3 abstaining, there being 10 members present of the total membership of 15 on the board.

The opposition within the life-insurance industry is substantial

The testimony presented to this committee that 95 percent of the life-insurance companies have approved House Joint Resolution 371 is not only contrary to the facts but is also obviously designed to mislead.

The extraordinary willingness, if not anxiety, of the two major life-insurance associations, and certain of the member companies, to accept the burden of House Joint Resolution 371 suggests a fear of something worse and a belief that the acceptance of the resolution will prevent a greater evil. The Equitable, and, I believe, some of the other companies, want no part in any arrangement whereunder a lump sum by way of retroactive exaction will be bargained against future sound life insurance tax legislation. Such a bargain would not be consistent with the interests of policyholders or the duty of the Congress to collect adequate revenues.

The retroactivity of the proposed tax is both arbitrary and unfair

A considerable part of the burden of the tax would fall upon new policyholders of the last 2 years who held no policies in 1947 and 1948. At the same time, a large number of policyholders, whose policies were in effect during 1947 and 1948 but have since matured, would wholly escape.

Record of Congress shows opposition to retroactive taxation

The Congress has in the past resisted the temptation to impose income taxes retroactively. It has been unyielding in its adherence to sound principles and in its respect for constitutional limitations no matter how great the need for

additional revenue. There are at least two important instances of such forbearance:

(*a*) In the Sixty-fifth Congress, in 1917, when the cost of war required additional revenue, a proposal (H. R. 4280) was made to levy an additional tax on 1916 incomes. This committee rejected the proposal in the following language:

"This tax seemed to the committee to be in principle both morally and economically unsound and to deserve exclusion as retroactive legislation. The incomes of the past calendar year have paid their taxes, and the balance has either been spent upon subsistence and the expenses of living or it has been saved and added to capital, in which form it will yield returns which will bear taxes in the ensuing years. To tax this tax-paid income again is not only double taxation of a peculiarly obnoxious kind, but would possibly compel the taxpayer to impair his capital by paying this second tax and thus diminish the Government's sources of taxation. This tax, if persisted in, would fall upon money already distributed and would interfere with contracts already made. It would, in a word, be one of those disturbing taxes which would alarm business and check industrial productivity, to which we must look as our chief source of taxation. It is very poor economy to take money in a way which will cause losses far outweighing the momentary gain. Moreover, it is to be remembered that if we admit the principle of retroactive taxation running back 6 months we also assert the right to carry it back for 1 year or 10 years, or for any length of time. To do this would hold out a threat of uncertainty in tax conditions, and almost the greatest foe of business productivity and prosperity is uncertainty. For these reasons the committee had no doubt as to the wisdom of striking from the bill the retroactive tax on incomes. * * *" (S. Rept. No. 103, 65th Cong., 1st sess.)

(*b*) The second and more severe temptation came in 1943. An obvious oversight in the Revenue Act of 1942 had enabled public-utility companies to reduce excess profits taxes by payment of dividends on preferred stocks and certain companies had taken advantage of the oversight. A proposal that the Revenue Act of 1943 should remedy the oversight was rejected in the Senate after Senator Taft, its chief supporter, had withdrawn his support. The Congressional Record of January 12, 1944, pages 109 to 111, shows that the debate on the proposal evoked the following comments:

Senator Connally: "I do not like retroactive legislation of this or any other kind."

Senator LaFollette: "I believe it is a very difficult situation, but it seems to me that, in common justice, we will have to let those who did take advantage of it unfairly get away with it in order not to do an unjustice to those who acted in good faith. * * *"

Senator Barkley: "These are a few of the companies which would be required to pay additional amounts out of their treasuries, after they had paid dividends, and made plans, and paid all the other taxes they were supposed to pay. * * * It seems to me that it is absolutely unjust to require them to go back and pay these other amounts for the 2 years."

Similar opposition to retroactive taxes is shown in court decisions

The refusal of the Congress to resort to retroactive taxes closely parallels the attitude of the Supreme Court on the constitutional point. The Court has not sustained any income tax which sought to extend its application retroactively beyond the period of a reasonable necessity derived, not from the need of revenue, but from legislative and accounting realities. Some leeway is proper. Income taxes are not, as a matter of accounting, determinable promptly upon the receipt of the income or property to be taxed; their computation must be postponed at least until the end of the taxable year. The Congress requires a reasonable period of time for the enactment of tax legislation which, in the light of sources and amounts of income disclosed by returns for earlier years, will result in an equitable distribution of the tax burden. These accounting and legislative necessities have been generally recognized by the courts but such recognition in no sense implies judicial approval or retroactivity.

Memorandum of Representative Lynch in support of constitutionality discussed

Representative Walter A. Lynch appeared before this committee on March 16, 1950, and submitted a memorandum on the constitutionality of retroactive income taxes. One of the cases cited by Representative Lynch merely recognizes the necessities of accounting and legislation to which reference has been made above (*Brunshaber* v. *Union Pacific R. R.*, 240 U. S. 1 (1915)). The Brunshaber

case sustained the Revenue Act of 1913 which was enacted on October 3 of that year and taxed income earned beginning March 1, 1913, immediately after the adoption of the sixteenth amendment; thus, the case did not involve an attempt to tax income of a year prior to the year of enactment.[1]

Another case cited by Representative Lynch, *Stockdale* v. *Insurance Companies* (20 Wallace 323 (1873), concerned itself with the problem of retroactive taxes only in a dictum to the effect that the constitutionality of the Civil War income tax of 1864 had not been questioned. At the time of the decision in the Stockdale case, income taxes were considered to be indirect taxes which required no apportionment and consequently no objection on the ground of failure to apportion was raised before the Court. Moreover, an objection based on arbitrary retroactivity violative of the fifth amendment was similarly precluded since it was not until 1915 that the Supreme Court, in *Brushaber* v. *Union Pacific R. R.*, supra, recognized the fifth amendment as a limitation on the taxing power of Congress.

Representative Lynch also cited *White Packing Co.* v. *Robertson* (89 F. 2d 775 (4th Cir. 1937)), which was concerned with the so-called unjust enrichment tax imposed upon that portion of the income of processors attributable to excise taxes collected in part of 1934, in 1935, and in part of 1936 under the Processing Tax Act which had been declared unconstitutional in January 1936 by *United States* v. *Butler*, (297 U. S. 1 (1935)). Thus, though seemingly retroactive for approximately 2 years, the unjust enrichment tax was, in fact, imposed upon income to which the taxpayer had become entitled only a few months prior to the enactment of the tax. The unjust enrichment tax was passed on June 22, 1936, as part of the Revenue Act of that year; this was less than 6 months after the decision of the Supreme Court of the United States in *United States* v. *Butler*, supra. Judge Parker, writing the decision of the Court in the White case, emphasized that the income taxed had, for practical purposes, been received in the year of enactment:

"Here the tax is imposed on income which has recently been earned * * * and which for practical purposes has come into the possesion of the taxpayer during the year in which the tax is imposed. * * *"

Representative Lynch, as well as other proponents of House Joint Resolution 371, have confined their arguments upon the constitutionality of the proposed retroactive tax to the question of due process and they have placed their strongest reliance on the case of *Welch* v. *Henry* (305 U. S. 134 (1938)), sustaining an income tax of the State of Wisconsin. Representative Lynch and other proponents of the proposed retroactive tax ignore the constitutional requirement that direct taxes be apportioned and the case of *Welch* v. *Henry*, involving as it does a Wisconsin tax, is no authority whatever upon the apportionment question.[2]

Importance of constitutional requirement of apportionment

There is a time at which income becomes capital. It is submitted that this time is not later than the date fixed by law for the filing of returns and the payment of tax for the preceding taxable period; that is to say, not later than the end of the 2½ months' period immediately following the conclusion of the year in which the income was received.[3] There is no later point in time at which a reasonable line may be drawn between income and capital and, if no line is drawn, all capital, and eventually all private property, will be open to destruction by taxation. The Supreme Court of the United States would not, I submit, sustain an income tax applicable to income of previous taxable years, irrespective of the reasonableness of the retroactivity from the point of view of revenue requirements or even from the point of view of the due process clause,

[1] Proponents of the proposed retroactive life-insurance taxes have also relied upon the Revenue Act of 1918, which was enacted on February 24, 1919. The delay in enactment was caused by the end of the war and the consequent necessity of revising tax bills which were at that time before Congress. Even under those highly unusual circumstances, reluctance was expressed to enact income-tax legislation applicable to a preceding year. The then Secretary of the Treasury said: "Prosperity cannot be maintained if business is kept in uncertainty as to taxation," and added that a retroactive tax "is a gross injustice to business and all forms of enterprise" (S. Rept. No. 617, 60th Cong., 3d sess.).

[2] Upon the question of due process, *Welch* v. *Henry* decided only that it was not unreasonable for a State legislature to tax income of a particular taxable year under legislation enacted at the next legislative session. (See *Wheeler* v. *Commissioner* 143 F. 2d 162 (9th Cir., 1944), reversed on other grounds in 324 U. S. 542 (1945), holding that certain provisions of the Second Revenue Act of 1940, when applied to 1938 transactions, were unconstitutionally retroactive.)

[3] This has been recognized in *Van Norman Co.* v. *Welch*, 141 F. 2d 99 (1st Cir., 1944), where the court stated that it was unreasonable to require a taxpayer to hold books open after the due date for tax returns.

because it would feel obliged to require apportionment under the applicable provisions of the Constitution.

The Constitution in article I, sections 2 and 9, requires the apportionment of direct taxes. Although income taxes were originally held to be indirect (*Springer* v. *United States*, 102 U. S. 586 (1880), and *Pacific Insurance Co.* v. *Soule*, 7 Wallace 433 (1868)), the Supreme Court in *Pollock* v. *Farmers' Loan and Trust Co.* (157 U. S. 429 and 158 U. S. 601 (1895)), held that a tax on the income derived from real or personal property was, in effect, a direct tax on the property itself and void unless apportioned. The sixteenth amendment was adopted to eliminate the consequent necessity of apportioning income taxes. The amendment removed that necessity only; it did not extend the taxing power of Congress to new subjects (see *Peck and Co.* v. *Lowe*, 247 U. S. 165, 172–3 (1918); *Brushaber* v. *Union Pacific R. R.*, supra, nor did it repeal or modify the constitutional requirement of apportioning direct taxes on real or personal property (*Eisner* v. *Macomber*, 252 U. S. 189, 206 (1920)). Accordingly, then, it becomes essential in the words of the Court in *Eisner* v. *Macomber*, supra, for the purpose of determining whether Congress may levy the proposed retroactive taxes on life-insurance companies without apportionment:

"* * * to distinguish between what is and what is not 'income' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which it alone derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

The word "income" as used in the sixteenth amendment is "entirely distinct from principal or capital" (*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185 (1918)). It was originally argued, notably by Senator Elihu Root, that "When income is received, it immediately becomes principal." While this argument did not prevail, even those who directly opposed Senator Root's position acknowledged the conversion of income into capital at the end of the taxable year. In the development of the law and in recognition of legislative necessity, the limit of time within which income may remain income without conversion into capital has been extended almost to the due date for the filing of tax returns in respect of the taxable year, namely, to March 15 immediately following the taxable year. As heretofore stated, if the limit of time is extended beyond March 15, there is no subsequent, logical stopping point and the distinction between capital and income falls.

SUMMARY

There are two principal challenges which may be made to the constitutionality of the proposed taxes: The first challenge is based upon the fifth amendment and asserts that the taxes, inasmuch as they are retroactive far beyond the practical necessities of accounting and legislation, are an unreasonable deprivation of property. Little would be gained in discussing here the numerous cases involving other challenges to tax legislation based on alleged violation of the fifth amendment. The courts have done no more than establish a standard of reasonableness for application to the particular facts of each case. This memorandum has, for that reason, emphasized the facts deemed to be important upon the question of reasonableness. The second challenge is more a question of law and less a question of fact, namely, the assertion that the proposed retroactive taxes are capital levies requiring apportionment under the provisions of the Constitution. There is no basis upon which the Supreme Court of the United States could sustain the proposed retroactive taxes in the absence of apportionment without eliminating all distinction between income and capital. It should not be argued seriously that the Supreme Court of the United States would abolish the distinction between capital and income and thereby destroy the foundations of private property.

The tax proposed by House Joint Resolution 371 is not retroactive only for the short period required by legislative and accounting necessities. Far from it. The proposed tax is not only excessively retroactive, but it is also arbitrary in all other respects. It is arbitrary in conception because it is designed to produce revenue which has not been realized under preexisting law, although this result was foreseeable by the Treasury Department. It has been arbitrarily negotiated because the Treasury Department appears to have threatened the insurance companies that if they did not accept a retroactive tax they would get "something worse." It is arbitrary in computation because the revision of the formula has been manipulated to produce approxmiately $92,500,000, a fig-

are related primarily only to the revenue requirements of the Government. It is arbitrary in application because the revised formula applies without variation to a great many different companies doing business in different ways and under different conditions. It is arbitrary in its effect on policyholders because many who should share its burden would escape, and many who should not be affected would be required to pay. Finally, it is arbitrary because it is admittedly not a proper measure for the future taxation of life-insurance companies.

The more important matter of future taxation should be determined at this time and interrelated with any current tax which then appears necessary. The Equitable would, of course, be entirely willing to pay a current tax upon the basis adopted by Congress for future taxation. It is submitted that the consequent loss of the greater revenues of House Joint Resolution 371 is fully compensated by that adherence to principle which distinguishes our form of government.

HARRISON TWEED.

MARCH 27, 1950.

Senator BYRD. The first witness to be heard is Mr. Schmuck, general counsel of the Acacia Mutual Life Insurance Co., Washington, D. C.

STATEMENT OF EDWARD J. SCHMUCK, GENERAL COUNSEL, ACACIA MUTUAL LIFE INSURANCE CO., WASHINGTON, D. C.

Mr. SCHMUCK. We appreciate the opportunity to have the views of our company considered by your committee in connection with the pending resolution. In the interest of conserving the time and energy of the members of the committee, I wonder if we may offer for the record the prepared analysis of this problem which we have submitted, and if I may talk briefly to the basic question.

Senator BYRD. Your statement will be made a part of the record at this point.

(The statement referred to follows:)

STATEMENT ON BEHALF OF ACACIA MUTUAL LIFE INSURANCE CO. TO THE COMMITTEE ON FINANCE OF THE SENATE, MARCH 16, 1950

Acacia Mutual Life Insurance Co. appreciates the opportunity to be represented and to have its views heard by your committee in your consideration of House Joint Resolution 371, amending the provisions of the tax law fixing the method of income taxation of life insurance companies.

Acacia is a mutual life insurance company holding a charter granted by special act of the Congress of the United States. It is composed of 195,000 policyholders with total insurance in force of $972,000,000 and assets of $210,000,000.

We appear today in the thought that possibly Acacia, as a result of its study and research, may be of assistance to your committee in the development of a method of taxation of life insurance companies which will be fair to the Government and to the more than 80,000,000 life insurance policyholders in this country, taking into consideration the effects which the method of taxation adopted will have on the cost of life insurance furnished to these millions of policyholders. In doing this we are actuated by the motives of any good citizen—namely, an earnest desire to be of the utmost help in arriving at the best all-around solution to this tax problem.

The history of Federal legislation affecting life insurance companies indicates a keen appreciation by the Congress of the social and economic value of encouraging the American people to make individual and independent provision for themselves and their dependents against the hazards of death and old age through the medium of life insurance and retirement benefit policies. We are confident, therefore, that your committee will keep before it in your deliberations that amendment of the tax law affecting life insurance companies should not impair the ability of individuals to acquire and maintain adequate life insurance protection.

Our approach to the problem of establishing a fair and proper method of taxing life insurance company income proceeds from the three basic principles which we have always considered fundamental to any tax law affecting the life insurance business. These principles are as follows:

1. The life insurance industry as a whole should pay income taxes in an aggregate amount which is fair to the industry as a whole and to the Government.
2. There should be a fair and equitable distribution of the aggregate income tax among the individual life insurance companies comprising the industry.
3. The tax basis or formula should give recognition to the statutory and contractual obligation of each individual company for adding interest to its policy reserves.

THE PENDING LEGISLATION

There is pending before your committee House Joint Resolution 371, passed by the House of Representatives, which establishes a so-called stopgap or interim amendment of the provisions of the Internal Revenue Code controlling taxation of income of life-insurance companies. The amendment is limited to the taxable year 1949 and, retroactively, to 1947 and 1948. House Joint Resolution 371 provides an arbitrary and artificial method of imposing taxes on the life-insurance companies on the basis of the so-called average valuation rate formula. In essence, the House Joint Resolution 371 formula represents a modification of the formula established by the 1942 law. It is proposed to change that part of the 1942 law establishing the method of determining the percentage credit which each company may take for investment income applied to meet its statutory and contractual policy reserve interest requirements and other policyholder interest requirements. Under the House Joint Resolution 371 formula, there would be obtained each year the ratio between the aggregate net investment income of all life-insurance companies for the preceding year and the reserve and other policyholder interest requirements of all the life-insurance companies for the same year, excluding, however, from the calculation any requirements of individual companies exceeding 100 percent of the net investment income of such companies. This latter exclusion is generally referred to as "excluding the negatives." The resultant percentage is to be applied by each company in calculating the portion of its net investment income which may be taken as a credit, without regard to whether its actual reserve and other policyholder interest requirements are greater or less than the industry-wide average.

It is our opinion that this averaging method is not only arbitrary and artificial but, as we shall demonstrate below, is wholly unfair and inequitable, granting substantial tax preference to some companies while imposing serious and unwarranted tax burdens on a substantial number of other companies, with the weight of the disadvantage being borne by the smaller companies.

There are alternatives to both the specific formula provided in House Joint Resolution 371 and to the so-called industry-wide or averaging concept for determining the income taxation of life-insurance companies which first appeared in the tax law in 1942 and underlies House Joint Resolution 371. The Secretary of the Treasury appeared before the Committee on Ways and Means of the House of Representatives on February 3, 1950, and offered proposals for permanent legislation for taxing the income of life-insurance companies to replace the stopgap provisions embodied in House Joint Resolution 371. We concur completely with the statement made by the Secretary of the Treasury in that appearance that, "I consider the industry-wide average which has been used since 1942 a most inequitable basis for permanent taxation." We feel that it is also a most inequitable basis for stopgap legislation.

In this memorandum it is our purpose to present: (1) our objections to the inequitable results of the industry-wide or averaging method of determining life insurance company income tax; and (2) alternative methods based essentially on determination of the tax liability of individual companies on the basis of their own experience. We are setting forth below, as briefly as clarity will permit, an analysis of fundamentals of the life insurance business which in our opinion is necessary to a full understanding and sound evaluation of the provisions of House Joint Resolution 371 and the possible alternatives to that legislation. We sincerely hope that your committee, in its deliberations, will

give serious consideration to the inequities implicit in any averaging formula for determining the income tax liability of a life insurance company; that expediency may not be permitted to perpetuate injustices in the tax law; and that the action of your committee in amending the provisions of the tax law applicable to life insurance companies will result in a tax basis fair and just to both the Government and the individual companies.

MUTUAL LIFE INSURANCE COMPANIES

Approximately 70 percent of the life insurance in force in this country has been issued by mutual life insurance companies. These companies are a form of cooperative enterprise owned by the policyholders and from which, therefore, no individual proprietary interest derives any personal profit. The policyholders are the mutual life insurance companies and all rights and privileges of these companies belong to the policyholders. The management of these companies are in effect trustees for their policyholders.

The premiums paid by policyholders of a mutual life insurance company are actually a deposit with the management of the company to cover the individual policyholder's share of the mortality funds, the legal reserve to support policy obligations, and the operating expenses. As a cooperative enterprise, a mutual life insurance company might soundly contend that like a mutual savings bank or a farmers cooperative or any other cooperative enterprise, it should not be subjected to an income tax. However, it is not now, and never has been, our position that mutual life insurance companies should be exempt from income taxation.

Since 1921 life insurance companies have been taxed on the basis of their net investment income (interest, dividends, and rents less investment expenses) less a deduction for interest required to maintain policy reserves and, also, a deduction for other miscellaneous interest obligations. The income which mutual life insurance companies earn by the investment of both their legal reserves and their surplus funds is their only real income. To the extent that investment income is not needed as a part of the legal reserve and for other policyholder obligations to satisfy contractual and statutory requirements, it is in our opinion properly subject to an income tax levy consistent with the basic principles set forth above.

STOCK LIFE INSURANCE COMPANIES

The remaining 30 percent, a substantial portion of the life insurance in this country, has been issued by stock life insurance companies. These companies are organized, as are any other privately owned business corporations, for the personal profit that their stockholders may derive from the sale of life insurance and retirement benefit contracts to the public.

The sources of the profits of stock life insurance companies are the premiums paid by the policyholders in excess of the cost of the insurance protection they receive and the investment income in excess of reserve requirements. The profits paid to the stockholders in the form of cash dividends or allocated to them in the form of stock dividends are business profits in every sense of the word. The surplus accumulations also belong to the stockholders.

DIFFERENCES BETWEEN MUTUAL AND STOCK COMPANIES

It is obvious, therefore, that there are real and fundamental differences between the mutual life insurance companies which are cooperative enterprises and the stock life insurance companies which are private profit enterprises. In a mutual company there is no individual proprietary interest; in a stock company the proprietary interest of the stockholders is paramount. In a mutual company funds available for dividends are paid only to policyholders; in a stock company, similar dividends may be paid to policyholders on policies providing for such participation, but beyond that, all funds available for dividend distribution are private profits to the stockholders. In a mutual company the surplus funds are accumulated for the benefit of its policyholders; in a stock company the surplus funds are the property of the stockholders as in any other privately owned business corporation. In a mutual company, both premium deposits and investment income are applied solely and exclusively to the benefit of the policyholders who compose the company; in a stock company premium deposits

and investment income are applied first to satisfy the contractual and statutory obligations to policyholders, second to dividends or refunds to the policyholders under participating policies, and third, the remainder to the private profit of the stockholders.

We feel that a clear understanding of these fundamental differences between the two types of companies operating in the life insurance business is important to a sound evaluation of the possible bases for the income taxation of life insurance companies.

INVESTMENT INCOME APPROACH

It is our opinion that at least for mutual life insurance companies, free investment income is the proper base of taxable income. By free investment income we mean the amount which is arrived at by deducting from net investment income (interest, dividends, and rents, less investment expenses) the amount of interest required to maintain contractual and statutory policy reserves and the miscellaneous interest obligations to policyholders and their beneficiaries.

The only funds regularly received by a mutual life insurance company other than its investment income are premium deposits. Neither the whole nor any part of the gross premium deposited with the company constitutes income. The entire amount of the premium is a deposit made by the policyholder with the company from which, as indicated above, the company applies whatever amount is necessary to cover the pro rata share of payments to policyholders and beneficiaries, to maintain legal reserves and to pay operating expenses. In addition, in those companies in which the investment income may be insufficient to meet the amount of guaranteed interest which must be added to the legal reserves to fulfiill contractual and statutory requirements, the deficit must either be made up from surplus or a portion of the gross premium will have to be used for that purpose.

The gross premium generally exceeds the exact amount needed for these policyholder and operating requirements. In a mutual company, this excess of the premium deposit, together with free investment income, if any, in part is refunded to the policyholder in the form of dividends and in part is allocated to the surplus account maintained for the added security of the policyholders. Since the surplus account is maintained for the sole benefit of the policyholders, with no individual proprietary interest entitled to any part thereof, it is apparent that any excess from the gross premium which is placed in this account retains its nature as a deposit by the policyholder with the company and does not constitute income to the company. For these reasons, we submit that in theory and in fact free investment income is the only amount received by a mutual life insurance company which is properly subject to income taxation.

It is our opionion that in fairness to the Government, all free investment income should be subjected to normal corporate income taxation. As a matter of fact, however, the tax has never been imposed on the full free investment income of the life insurance companies, either taken as a whole or taken individually.

The fact that the full free investment income of the companies has not been taxed, has resulted because the reserve interest deduction permitted by the Government ever since 1921 has always been calculated at an arbitrary flat rate for each company regardless of the substantial differences among companies with respect to their actual reserve interest requirements. Under the income tax laws in existence prior to 1942, the Government provided that each and every company should use the same flat rate of interest in calculating its deduction for interest required to maintain policy reserve funds, disregarding the wide variations there were among the companies as to the rate required in accordance with their actual statutory and contractual obligations. (From 1921 through 1931 the rate was 4 percent; from 1932 through 1941 the rate, with a minor variation, was 3¾ percent.)

Industry-wide method—1942 law

In the 1942 amendments to the Revenue Code, Congress took account of the fact that because of the defects in prior laws many companies, including most large companies, were paying no tax even though they had actual free investment income. Acacia, in its appearance before the Ways and Means Committee in that year, urged the imposition of a tax on a basis giving full recognition to the reserve interest requirements of the individual companies but avoiding the use of any arbitrary basis for determining such a deduction.

In the law finally adopted in 1942, recognition was given in principle to the statutory and contractual requirements of the company for adding interest to its policy reserves. Again, however, the deduction was not based upon the actual reserve interest requirements of the companies but upon another arbitrary and artificial method for computing the deduction at the same rate for all companies. Specifically, the 1942 law provided for averaging, for the entire life insurance industry, an arbitrary 3¼ percent allowance and the actual aggregate reserve interest requirements of the industry, these two factors being given weights of 65 percent and 35 percent, respectively. This industry-wide average was then applied to the net investment income (after deducting investment expenses) of each life insurance company. The result again was a failure to tax the actual and full free investment income of all the companies and again the formula operated inequitably in the distribution of the tax among all of the companies comprising the life insurance industry.

Primarily because of the continuing trend toward a lower rate of earnings on investments, the total taxable income of the life insurance industry reduced rapidly, with the final result that for the taxable years 1947 and 1948, and probably 1949, the total net investment income of the life insurance industry was less than the amount of deduction permitted according to the arbitrary 1942 formula for the interest required to maintain reserves and for other policy obligations. Therefore, although enough individual companies had enough free investment income in these 3 years to have produced a total of approximately $90,000,000 of taxes over these years, if the tax had been imposed at the regular corporate tax rates upon the actual free investment income of each individual life insurance company, nevertheless under the 1942 formula, the Government actually received no taxes for these years.

Our studies indicate that the 1942 formula has been unfair to the Government at all times, since the aggregate amount of free investment income of individual companies has been greater in each year since 1942 than the total taxable income calculated in accordance with the 1942 tax formula.

The 1942 tax formula has also been markedly unfair and inequitable, as would be any averaging formula, in the distribution of the tax burden among the individual companies. Many life-insurance companies were required to pay substantial amounts of income taxes when they had no free investment income at all or less free investment income than the amount of taxes they paid. Other companies paid taxes at substantially higher than normal corporate tax rates because their percentage of free investment income was less than the average. This shifting of an unfair tax burden to some companies was, of course, accompanied by an equally unjust tax preference for those companies whose percentage of free income exceeded the average. Our studies indicate that in many instances companies were paying taxes, because of the averaging method, on taxable income amounting to as little as 25 percent of their actual free investment income. For each such company, of course, the ratio of the taxes paid to its actual total free investment income was less than 10 percent, as compared with the usual corporate income-tax rate of 38 percent.

The inequities of the averaging method are readily apparent. This method is a unique deviation from all other provisions of the general income-tax law which impose taxes on the basis of the actual experience of the individual or corporate taxpayer. Worse still, it appears that the shifting of tax under the averaging formula is in general of greatest advantage to the large companies and disadvantageous to the smaller companies. It must be remembered that, if one of the largest companies is given a tax preference through an artificial averaging formula, the weight of the taxes thus shifted is great in terms of dollars and accordingly the dollar burden of taxation thereby imposed upon the smaller companies is disproportionately large for them.

Industry-wide method—House Joint Resolution 371

House Joint Resolution 371 provides merely a variation of the averaging method, continuing in aggravated form the inequities of the 1942 formula. If House Joint Resolution 371 is approached by an examination of its result, it is clear that it is based on taxing the actual full free investment income of the life insurance industry as a whole, but not in the hands of the individual companies having the free investment income. In effect, under this formula there would be obtained each year the ratio of total free investment income to the total net investment income of all life insurance companies for the preceding year. Each company would pay a tax for each taxable year on the basis of this industry average ratio calculated on the industry experience of the preceding

year. The lag of 1 year results from the amount of time required after the close of a taxable year for compiling the aggregate results of the industry for that year upon the basis of which the industry average ratio would be calculated.

Based on 1948 experience this formula would produce an average interest deduction of 93.55 percent, which would mean that each company for the year 1949 would pay a tax of 6.45 percent of its net investment income whether or not the actual interest requirements of the individual company were 100 percent, or more, of its net investment income or 93.55 percent of its net investment income or less than that. While the average valuation rate formula is based on the actual fee investment income of the industry, with the 1-year lag indicated above, it is nevertheless objectionable because the distribution of the tax burden under this plan would continue the inequities as between individual companies that existed under the old plan. Our calculations indicate that, in general, the impact of this averaging formula would be most severe upon the smaller companies. The tax burden thus developed could be as much as four times as great, for the bulk of these smaller companies, as the tax on those companies would be if paid by them on the basis of their individual free investment income.

The exact figures needed for the distribution of the tax burden among all life insurance companies on the basis of their individual free investment income or on the basis of an averaging method could be computed simply from the tax returns of the companies. However, the exact figures needed for such distributions are not available to us for all companies, the tax returns being confidential information in the hands of the Internal Revenue Bureau. In studying the effects of the new averaging or industry-wide formula provided in House Joint Resolution 371, we had available data with respect to 38 of the larger American life insurance companies from which we have been able to work out relative tax distributions. These 38 companies constitute less than 10 percent of the total number of American life-insurance companies but they have about 80 percent of the total amount of life insurance in force among American companies. Clearly, therefore, the other 90 percent of the American companies are relatively small when measured by the amount of insurance in force.

Here are the salient facts disclosed by our study. In 1948 this group of 38 companies had approximately 97 percent of the total free investment income of all American companies. On the basis of their individual free investment income the companies in this group would have paid approximately 97 percent of the total tax of all American companies. Under the new averaging formula provided in House Joint Resolution 371, however, this group would pay only 86.3 percent of the total income taxation of the life insurance industry. Put another way, the group consisting of 90 percent or more of the companies in the business which, on the whole, are the smaller companies, had only 3 percent of the free investment income in 1948 but under the averaging formula would pay approximately 13.7 percent of the total taxes.

The Life Insurance Association of America has recently made a series of calculations which we think clearly supports the conclusions which we arrived at independently.

The Life Insurance Association study is based on the actual income tax return data of 225 companies for the taxable year 1948. Of these 225 companies, 10 are Canadian and have been deleted by us from the table set out low. The remaining 215 companies have outstanding more than 90 percent of the insurance in force in the United States. In the following table, the companies are grouped by size according to amount of assets. Column 2 of the table shows the number of companies in each group whose tax return data was analyzed. Column 3 shows the number of companies in each group which would pay more tax if their tax were computed on their own individual free investment income than they would pay if it were computed on the basis of the averaging formula contained in House Joint Resolution 371. Column 4 shows the number of companies that would pay less tax if their tax were computed on their own individual free investment income than they would pay if it were computed on the basis of the averaging formula contained in House Joint Resolution 371. Column 5 shows the number of companies, included in the number set out in column 4, which would pay no tax at all if taxable income were determined directly on the basis of each individual company's free investment income. Column 6 shows the average ratio of the aggregate actual reserve and other policyholder interest requirements for each of these groups to the aggregate net investment income for each of these groups, respectively. Column 7 shows the average ratio of the aggregate actual reserve and other policyholder interest requirements for each of these

groups (with the negatives eliminated as required by House Joint Resolution 371) to the aggregate net investment income for each of these groups, respectively. The table is as follows:

Size group (by assets in millions of dollars)	Number of companies	Companies paying more tax on individual free investment income	Companies paying less tax on individual free investment income	Companies paying no tax on individual free investment income	Average ratios—actual interest requirements to net investment income	
					Negatives not eliminated	Negatives eliminated
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Over 1,000	12	5	7	2	0.9550	0.9406
200-1,000	23	10	13	9	.9238	.9049
100-200	12	1	11	6	1.0085	.9834
50-100	24	8	16	10	.9979	.9492
20-50	52	15	37	31	1.0081	.9349
10-20	35	11	24	23	1.0113	.9203
5-10	31	11	20	12	.9908	.9100
Under 5	26	8	18	16	1.0297	.9138
Total	215	69	146	109		

It is interesting to observe from this Life Insurance Association study that of the 215 American companies included, 69 would pay more tax on the basis of their own individual free investment income than under the averaging formula, while 146 would pay less. Of the 146 there are 109 which would pay no tax at all. In other words, there are 109 companies, more than 50 percent of those analyzed, which had no free investment income in 1948 but would nevertheless have to pay a tax under the average valuation rate formula laid down in House Joint Resolution 371. In addition there are 37 other companies which would pay more tax than can be justified on the basis of their free investment income. Obviously, the number of companies which would be penalized under the averaging formula for the benefit of the 69 companies that gain is a very substantial segment of the life insurance business. The fact that proportionately more of the smaller companies than of the larger companies would be so penalized is clear from a comparison of columns 3 and 4 of the table.

The average ratios in the last two columns, No. 6 and No. 7, of the above table are also interesting. It will be seen from column 6 that for the companies with $200,000,000 or less of assets the ratio of interest actually required for contractual and statutory purposes in 1948 was very close to the amount of investment income available for those purposes; in fact, in four of the six groups the ratio was in excess of 100 percent. By elimination of the negatives, however, as required by the formula, these percentages are markedly reduced as compared to the reduction for the companies having over $200,000,000 of assets. The extent of the reductions in these ratios indicates clearly the substantial interest deficits of those companies in the smaller sized groups whose interest requirements exceeded available interest and emphasizes the serious injustice which such companies would suffer if they were forced, through the medium of the averaging formula, to pay a tax on the basis of an average ratio deduction.

In general, therefore, the data prepared by the Life Insurance Association and which appears in the preceding table shows that the averaging formula of House Joint Resolution 371 is unfair and inequitable and that, on the whole, it favors the larger companies and bears most heavily upon the smaller companies. It reveals the very striking fact that whereas on the individual company free investment-income basis more than 50 percent of the 215 companies would have no free investment income and thus pay no tax, all of those companies would nevertheless be required to pay a tax under the average valuation rate formula. Further than that, an additional 17 percent of these 215 companies would be called upon to pay a greater tax under the average valuation rate formula than they would have to pay on the individual company free investment income basis. Taking these two groups together, therefore, we can see that more than two-thirds of the 215 companies would be called upon to pay a greater tax under the average valuation rate formula than they would pay in accordance with the individual company free investment-income basis. The average valuation rate formula, therefore, would be unfair and inequitable because in general it would

require the smaller companies to pay more tax than they should and would result, in general, in the larger companies paying less tax than they should. However, if the Government were to tax directly the free investment income of each life insurance company, it would correct these injustices and, at the same time, would develop a tax equal in the aggregate to the taxes which would be realized under House Joint Resolution 371.

Company-by-company approach

We strongly urge upon your committee our conviction that much, if not most, of the difficulty for both the Government and the life insurance companies over the matter of income taxation has resulted from the artificialities and arbitrary factors introduced into the various tax formulas since 1921. We sincerely believe that the problem can be minimized and perhaps eliminated and the Government will derive continuing revenue in a satisfactory amount if the Congress will eliminate the averaging and all other artificial formulas and impose the tax on life insurance companies on the direct basis of the free investment income of each company.

Pure logic, justice to the Government and among the companies, and consistency with the theory and provisions of the general income tax law support this proposal. We do not believe that any individual company could have just cause to complain about paying taxes on its own free investment income. By this direct tax the Government would realize a full tax on the full free investment income of each company, equal in the aggregate to the taxes which would be realized under House Joint Resolution 371. This method would furnish relief to those companies whose net investment income exceeds their statutory and contractual interest requirements by only a small amount. At the same time, this method would grant relief which is needed even more by those additional companies, generally the smaller ones, which have no free investment income at all because their statutory and contractual interest requirements exceed their net investment income but who would be called upon, nevertheless, under the average valuation rate formula to pay income taxes.

The Secretary of the Treasury, although indicating a preference for the company-by-company approach as against the averaging approach, in his statement to the Committee on Ways and Means commented that the former "might tend to result in differences in tax as between companies in an essentially similar situation." Unless there were essential differences between the companies, we fail to see how any differences in tax could arise. As a matter of fact, the averaging formulas create very serious injustices in forcing payment of identical amounts of taxes by companies which superficially may seem to be substantially identical but actually are quite different. For example, two life-insurance companies may today have approximately the same amount of assets. They may earn substantially the same rate on investments. They may have about the same amount of insurance in force. Under the averaging formulas, these two companies would pay substantially identical taxes. However, the guaranteed interest obligations of the first company on outstanding policies may substantially exceed those of the other company. Each company must meet its interest obligations to which it is bound by contract and by statute. Its investment income must first be committed to the carrying out of thse interest obligations to its policyholders. Accordingly, each company has available for the payment of income taxes only what is left after these commitments have been met. This amount left in each case, of course, is the free investment income of that company. The fact that under the company-by-company free investment-income approach the first life-insurance company would pay a lower tax than the second is no more a penalty to the second company than would be true in the case of a department store selling at a lower profit mark-up and paying less income tax on the same gross sales than would be paid by another store operating on a higher mark-up. If the second life insurance company has chosen to reduce managerial responsibilities by guaranteeing a lower rate of interest to its policyholders, there is no reason why that company should now protest the imposition of a tax on its free investment income. If the first company has estimated its ability to guarantee a higher rate of interest to its policyholders, there is no reason why it, as the result of an averaging formula, should be compelled to pay tax on more than its free investment income in order to relieve the second company from a part of its proper tax burden.

In commenting further on the company-by-company approach, the Secretary of the Treasury stated, "With respect to future business, it might tend to induce the use of high-interest assumptions to reduce tax liability," but added, "safe-

guards might be devised to prevent such distortions and curb the possibility of 'assuming away' interest income by deliberately adjusting reserve interest, mortality, and expense assumptions to obtain tax advantages."

We can see no sound or practical reason why the tax formula would materially influence the decision of any life-insurance company as to its contractual reserve interest rate. Any change in the contract reserve interest rate would apply only to new policies and would, therefore, have little effect for a considerable period of time upon the average contract reserve interest rate on any company's total business. To illustrate this we might consider the experience we have had at Acacia. Prior to 1938 our policies were on a 3½ percent reserve interest rate basis. During the period from 1938 to 1947 all of the new policies we issued were on a 3 percent reserve interest rate basis. Acacia grew rapidly during that period in amount of insurance in force, with the result that by the end of 1947 more than 66 percent of our insurance in force was on the 3-percent reserve of 1947 more than 66 percent of our inusrance in force was on the 3 percent interest rate basis, leaving less than 34 percent on the 3½ percent reserve interest rate basis. Despite this rapid growth in insurance in force, however, the reserves on our 3-percent business were only 25 percent of our total reserves as of December 31, 1947, leaving, of course, the reserves on the 3½-percent business equal to 75 percent of our total reserves.

Any lower tax benefit to be derived from the adoption of a higher contractual reserve interest rate therefore would appear to be very small for many years after the adoption of the new basis. Accordingly, there would be little incentive for the management of any life-insurance company to subordinate their natural and desirable conservatism in this matter to the possibility of receiving some slight savings in tax at some time in the future.

In addition, the management of any life-insurance company in deciding on what reserve interest rate to use in its contracts, we believe, would be actuated by far more powerful considerations than possible tax advantages to be derived at some time in the future. In dealing with life-insurance contracts which may remain in force for as long as 100 years—the lifetime of the insured followed by the lifetime of the beneficiary—it is the duty of the management of the company to select a reserve interest rate basis which will be conservative enough to keep the company sound and safe and to guarantee that the payments provided for in its contracts will be made when due.

In the case of mutual life-insurance companies, at least, the management acts as trustees for the funds of their policyholders and we feel confident that you will agree that in the past they have discharged their obligations in a very conscientious manner. This trusteeship guarantees that in the future as in the past a safe and conservative basis will be used. It seems clear, therefore, in the light of the reasons outlined above, that no mutual life-insurance company would adopt a reserve interest rate purely from the standpoint of the effect it might have on the amount of its income tax.

The averaging method of establishing the taxable income of life-insurance companies is unjust. In its result, it violates the fundamental principles that taxes should be imposed according to ability to pay and without fluctuations in their application and result. Only the company-by-company approach fulfills these principles and results in a just tax for each company, taking account of the variations among the companies in responsibilities to policyholders and in operating results.

Compromise for stopgap legislation

It has been suggested that House Joint Resolution 371, as purely stopgap legislation, is a practical temporary solution of the problem under the 1942 law resulting from nonpayment of any income taxes by life-insurance companies for the taxable years 1947, 1948, and 1949, and that proposals for changing the basic method of determining the income-tax liability of the companies should properly be deferred until permanent legislation is considered. We do not believe that expediency justifies the perpetuation and, indeed, the aggravation of the injustices inherent in the averaging formula established in the 1942 law.

Practical judgment and the apparent need for prompt action, however, have dictated recognition of the opinions which have been expressed. We therefore proposed to the Committee on Ways and Means, and review here for the consideration of your committee, a possible compromise in the event that your committee considers that full exploration of the basic concepts of the tax law affecting life-insurance companies cannot now be undertaken. We wish to emphasize

that this proposal is addressed only to the stopgap legislation; that it is advanced deliberately as a compromise of strongly divergent points of view; and that it is not in any way a modification of our firm conviction that any averaging formula is markedly inequitable to a substantial number of companies and is unsound in theory and result. Our compromise, however, affords some measure of relief to the companies, generally the smaller, who suffer the most disadvantage and inequity under the averaging method of House Joint Resolution 371 and, at the same time, reduces the tax preference to the lesser number of components benefited by the provisions of House Joint Resolution 371.

The compromise formula which we have developed recognizes both the principle of imposing taxes on free investment income in the hands of companies having such income and the principle that each company shall pay some income tax. Because our proposed compromise gives recognition to these two principles, we believe that its result in any given tax year will be fairer to both the Government and the life-insurance companies than will House Joint Resolution 371. We want especially to point out that under our compromise suggestion, as compared with the average valuation rate formula, the total taxes payable to the Government for each taxable year would be closer to the aggregate revenue which would be realized from a tax applying directly to the free investment income of the individual companies. Our compromise formula would reduce the effect of the 1-year lag under the average valuation rate formula. Finally, and of substantial importance, under this proposal the distribution of the tax burden will be more equitable among the individual companies.

Our suggested compromise, in bare outline, provides for each individual company computing its tax, at the normal corporate income-tax rates, first, on its own free investment income for the taxable year and, second, according to the average valuation rate formula. The amount of tax payable by the company would be equal to one-half of the sum of these two taxes.

Basically, this formula gives 50 percent weight to the individual experience of each company and 50 percent weight to the average experience of the industry. To illustrate the result, let us assume a company with $10,000,000 of net investment income and $9,000,000 of policyholder interest reserve requirements in 1949. For this company the individual interest requirement is 90 percent of its net investment earnings. If this company were taxed at the normal corporate rates directly on its free investment income of $1,000,000, the tax would amount to $380,000. Under the average valuation rate formula, however, based on the 1948 industry-wide results, this company would report only $645,000 as taxable net income, on which its tax, at the normal corporate rates, would be $245,100. If our compromise formula were adopted, giving 50 percent weight to the individual experience of this company and 50 percent to the average valuation rate formula, the tax to be paid by this company would be one-half of the sum of $380,000 and $245,100 or $312,550. On the other hand, let us consider a company also with net investment income of $10,000,000 but with policyholder interest requirements of more than $10,000,000 in 1949. On the basis of its individual experience this company would pay no tax. On the basis of the average valuation rate formula, however, based on the 1948 industry-wide results, this company would pay $245,100 in taxes, the same as the first company. If the compromise proposed by us were adopted, the second company would pay $122,550 or, in other words, one-half of the amount according to the average valuation rate formula.

The compromise proposed by Acacia would result in general in distributing the total tax more equitably among the companies, with particular benefit to the smaller-sized life-insurance companies. For example, our study of the 38 companies referred to above indicated that the smaller companies, 98 percent of all the companies, in 1948 had 3 percent of the free investment income but would pay 13.7 percent of the taxes under House Joint Resolution 371. Under our proposed compromise formula, these companies would pay 7.4 percent of the total taxes. On the other hand, the 38 companies who, although they had 97 percent of the total free investment income in 1948, would pay only 86.3 percent of the total taxes under House Joint Resolution 371, would, under the Acacia compromise proposal, pay 92.6 percent of the total taxes. It follows from these figures that the Acacia proposal provides for a more equitable distribution among individual companies of the total income tax than does the average valuation rate formula. This is especially true with respect to the distribution between the large companies and the small companies.

TOTAL NET INCOME APPROACH

There is another and substantially different approach to the problem of taxing the income of life-insurance companies which we think should be brought to the attention of your committee in order that you may have before you the full picture of developments to date with respect to this problem.

The Secretary of the Treasury has discussed with the Committee on Ways and Means the possibility of imposing a tax at regular corporate income tax rates on the basis of the total net income of the company. As outlined by him, this total net income would consist of the total receipts of the company including premiums, investment income, and other income, if any, less all expenses, payments to policyholders, policy reserve requirements, and dividends to policyholders under participating policies. As we understand it, the tax basis under this method in the case of stock companies would be stockholders' dividends plus all net additions to earned surplus and, in the case of mutual companies, would consist of all net additions to surplus funds. In the case of both the stock companies and the mutual companies, surplus funds would include all special or contingency reserves which are in the nature of surplus.

Earlier in this statement we discussed at quite some length the fact that in a mutual life-insurance company the portion of the insurance premiums which may be allocated to surplus and to special or contingency reserves do not lose their character as deposits by the policyholders, since they are still held for the benefit of the policyholders and are owned by them. With respect to mutual companies the net income approach discussed by the Secretary of the Treasury is based on the assumption that the premium deposits of the policyholders are income to the company as an entity distinct from the policyholders who compose the company. This assumption is at variance with the facts and with the recognition that the Congress has consistently given to the nature of premium deposits in the tax laws enacted since the year 1921. Without repeating the reasons which we have heretofore given in detail, we again call to your attention the fact that free investment income is the only true income of a mutual life-insurance company and that accordingly the total net-income base as proposed by the Secretary of the Treasury would not be a proper basis for the taxation of mutual life-insurance companies.

In stating our position with respect to a sound and equitable basis for taxing mutual life-insurance companies, we have made no reference to what we consider would be a sound and fair basis for taxing stock life-insurance companies whose net earnings, reflected in dividends to stockholders and in additions to surplus, including special and contingency reserves, are the private gain and personal profit of the stockholders. With respect to the stock companies, we can see no sound or valid reason why some type of net income approach would not be an appropriate method for taxing such companies. It seems to us that it would be difficult for the stock companies themselves to contend otherwise in the face of the fact that in 1947 and 1948 alone, for which years they paid no income taxes, the stock companies distributed to their stockholders more than $70,000,000 in dividends and increased their surplus funds, including special and contingency reserves, by approximately $150,000,000.

As Secretary Snyder pointed out in his statement before the Committee on Ways and Means, the problem of how to tax life-insurance companies has been a difficult one "partly because of the unique and complex nature of the business and partly because of the structure of the industry, comprising both stock and mutual elements." It is our conclusion, as a result of our study, that probably one of the principal reasons for the difficulties the Congress has had in developing satisfactory tax legislation for life-insurance companies has been the use of the same tax base for both mutual and stock life-insurance companies. As we have heretofore pointed out, there are such fundamental differences between stock and mutual companies that it would be sound and proper to employ different bases for taxing the two types of companies using the free investment income as the tax base for the mutual life-insurance companies and the total net income as the tax base for the stock life-insurance companies.

CONCLUSIONS

In making this presentation to your committee, Acacia is not attempting to express the viewpoint of any other life-insurance company. Our comments and observations regarding the fundamental differences between mutual and stock life-insurance companies have been expressed as the basis for our conclusions

which we submit in the hope that they may be of help to your committee in resolving this complex problem in a manner that will be just and equitable to all concerned. Our conclusions may be summarized as follows:

1. Free investment income is the only sound and proper tax base for mutual life-insurance companies.
2. The tax should be imposed on the basis of each mutual company's individual free investment income and without averaging or any other artificial or arbitrary formula.
3. The total net-income basis is not a sound and proper basis for the taxation of mutual life-insurance companies.
4. Some form of total net-income basis would seem to be sound and appropriate for taxing stock life-insurance companies, taking into consideration the fact that the stock life-insurance companies are owned and operated for the private profit of their stockholders.
5. If a compromise is indicated for purposes of the stopgap legislation (H. J. Res. 371), the Acacia compromise proposal is a reasonable basis of diminishing the inequities of the averaging formula, affording some relief to the companies sustaining an inequitable and unwarranted tax burden from the averaging method, and reducing the preference of the fewer companies who shift their proper tax burden to others as the result of the averaging method.

Our observations and conclusions have been based on an objective effort to apply the three basic principles set forth in the opening of this statement. Our conclusions do not stem from a desire to avoid the payment of just taxes. We are desirous, as we know you are, that such taxes as may be imposed by the Congress will be sound in principle and fair and equitable in practice. Our studies and research have led us to the conclusions set forth above and accordingly we respectfully commend them to your consideration.

We sincerely appreciate the opportunity your committee has given us to express our views in connection with this very important subject.

Respectfully yours,

WM. MONTGOMERY,
President, Acacia Mutual Life Insurance Co.

Mr. SCHMUCK. Thank you, sir.

I think it is proper to emphasize at the outset that our opposition to the pending bill is not motivated by a desire to avoid or evade the payment of proper taxes. We have had a consistent position with respect to the averaging formula which underlies this legislation since 1942. That position has been based essentially on three fundamental principles which we think should be implicit in any proper tax legislation: first, that the life-insurance industry as a whole should pay income taxes in an aggregate amount fair to the industry and to the Government: second, that there should be a fair and equitable distribution of the aggregate taxes among the individual companies; and, third, that any tax basis or formula should give recognition to the statutory and contractual obligations of each individual company for adding interest to its policy reserves.

We want to address ourselves primarily to the basic concept of the formula or method which is to be used for the taxation of life-insurance companies.

In 1942, there crept into the tax law this averaging concept. Essentially the law taxing life-insurance companies is a tax aimed at the net taxable, or what we might call the free investment income of life-insurance companies.

May I define that. We take our gross investment income; from that we deduct our investment expenses. Then we are allowed an additional deduction for the interest that we must accumulate in our reserves under the statutes and under our contracts, and the interest that we are otherwise obligated to apply to our policyholders and their beneficiaries.

The focal point of the differences lies with respect to the method of calculating this reserve and other policy holder interest deductions.

The proponents of the bill now pending before your committee argue for the so-called industry-wide or, in a more expansive moment, the global approach, in which everything is tossed into a pot—the investment income of the companies, on the one hand, their requirements, on the other hand, and average is taken of the whole thing. And then each company in computing its income tax uses that same average to determine what its deductions shall be.

On the other side, we have maintained consistently and do maintain now that this is an arbitrary and artificial method of determining a tax deduction, that it is unsound in its conception, and that it is unfair and inequitable in its results. We believe that a simple direct deduction taken by each company on the basis of its own requirements is the only sound and fair method of allowing that deduction, and thereby determing taxable income of the company.

That is certainly consonant with all other provisions of the tax law. We are the only business subjected to this method of arbitrarily determining what our taxable income shall be. In its result, we believe that our proposal is much more fair than the so-called averaging method, because it permits each company to determine its taxable income on the basis of its own experience, and thereby pay a tax which will fluctuate according to the ability of such company to earn free investment income.

Senator BUTLER. What variation would there be, then, in that deduction if you did away with the uniform deduction? What would be the variation among all companies?

Mr. SCHMUCK. The variation, sir, would take account of what each individual company requires under its contracts for its policyholders. Maybe I can illustrate it.

The way this pending bill works is this: Let us assume there are three companies that make up the whole life-insurance business. Let us assume that each one has $10,000,000 of net investment income after expenses. Then we will assume that company A needs $6,000,000 for its policyholder requirements. Company B needs $9,000,000, and company C, let us assume, needs $12,000,000. If those companies were reporting on an individual basis, company A would have $4,000,000 of free investment income which should be properly subjected to tax. Company B would have $1,000,000 subject to tax, and company C would have none. What they do under this averaging formula is, they first take the $12,000,000 that company C needed, and reduce it to $10,000,000, because they say you cannot have more than 10 over 10 entering into this so-called average.

Then, having reduced that, they add the income, making $30,000,000 of investment that they had. They add the deductions as adjusted, making $25,000,000, and they say, "Now, each one of you companies may take 83⅓ percent deduction for your interest requirements." As a result of that, all three of those companies in this illustration would report 1⅔ million dollars of income for tax and all three of the companies would pay a tax on that 1⅔ million dollars despite the variations in their actual operating results. I do not know whether that illustration clearly answers the Senator's question. I hope it has.

Senator BUTLER. My question was, If you had made any estimate as to what the variation might be for all of the companies, what would be the range, the lowest deduction, and the highest deduction, of all companies?

Mr. SCHMUCK. I can tell you the high deduction, Senator, would be over 100 percent for many of the companies, because they simply are not earning their interest requirements today.

There was a study made of 215 American companies, and of the 215 companies, 109 were not earning their interest requirements in 1948. This study covered that year. And those 109 companies had a deduction in excess of 100 percent on their own operating experience. What the low is, I cannot tell you. We cannot get access to all of the income tax data. That is of course confidential information. It would run, I suppose, as low as 80 percent, maybe lower than that in the case of individual companies.

Senator BUTLER. An insurance contract is somewhat similar to an annuity contract, and an annuity contract whether taken with one company or another will pay about the same rate, that is, the cost of the annuity is about the same, regardless of what company you take it with.

Mr. SCHMUCK. With some variations, sir.

Senator BUTLER. Very little variation.

Mr. SCHMUCK. Yes, sir, relatively speaking perhaps very little. It can amount to a great deal in the aggregate.

Senator BUTLER. The variation then in this item you are covering at the moment, would that not automatically fall into about that same category, and the variation be very slight?

Mr. SCHMUCK. Not necessarily, and that goes back to the interest guaranty that is contained in the contracts. Some companies for many, many years have operated on a 2 or 2¼ or 2½ percent guaranteed interest rate. That means that they guarantee to their policyholders that interest, let us say, at 2½ percent will be added to the reserve each year. Other companies, for reasons that the management deemed wise have guaranteed 3 or 3½ percent to their policyholders. Half a percent or 1 percent spread in that situation means a great deal in terms of money, and obviously the interest requirements of the 3 or 3½ percent company are considerably greater per thousand dollars of insurance than that of 2 or 2½ percent companies.

Senator BUTLER. All right.

Mr. SCHMUCK. The averaging formula we believe is not only discriminatory in its result as among the companies, we think it is unfair to the Government. We think it has been ever since 1942, and demonstrably so.

If the concept of this tax is to reach the free investment income over and above what is required for policyholders' reserves, and with that concept we completely agree, then it seems to us that in fairness to the Government all free investment income should be taxed. That has never happened under this averaging formula.

First of all, there is a lag in the operation of the formula, 1-year lag. Actually you apply the 1947 average percentage to the 1948 results to determine the tax that is going to be paid in 1949. That lag has an effect on the amount of tax paid.

Secondly, up to the present time as the result of the arbitrary factor that was introduced into the formula in 1942, the taxable income that has actually been reached has never begun to reach the true free investment income. The proof of that is the fact that we paid no taxes for '47 and '48; for '49 we would not pay under the existing law, although in those years the net investment income in the hands of individual companies, if taxed directly, would have produced taxes in excess of $90,000,000 for those 3 years.

The bill that is pending here is nothing but the modification of the 1942 law on the specific point of how to determine the averaging method. The proponents of this bill have made the statement that it is fair and it is equitable in the way that it distributes the tax among the companies. .

We examined their statements in an effort to determine the basis for that conclusion. We found a basis set forth in the testimony of one of the witnesses before your committee, and I quote him, that the formula "is grounded upon the sound and reasonable assumption that in the long run companies require about the same percentage of net investment income to maintain their reserves."

We believe that that assumption is completely inaccurate, and certainly a most dangerous basis upon which to pass important tax legislation which in the long run can affect the solvency of life-insurance companies.

But let us assume that that statement is true. Let us assume that over the long period each individual company in the life-insurance business does require the same percentage of its investment income for its policyholder requirements. If that is true, then certainly over the long run each individual company must average out, and if that is so, we can see no basis for objecting to putting this tax on a company-by-company basis, which will take account of the fluctuations of the individual company year by year, but, on the assumption, over the long run must average out.

On the other hand, if that assumption is not correct, then certainly there is very serious danger of consequences to individual companies, that I am sure are not intended by this Congress, but which could result from an arbitrary averaging method such as is projected in the pending bill.

This pending measure, as does any averaging formula in our opinion, gives very serious tax preferences to some companies. We made an analysis of 38 companies on their 1948 experience. These 38 companies have in excess of 80 percent of the total amount of life insurance in force among all of the more than 600 American companies. Obviously, the remaining 570 companies are relatively small. We found that these 38 companies in the year 1948 had 97 percent of the free-investment income of the entire industry, and were they taxed directly on that income, they would of course pay 97 percent of the tax for the entire industry.

As the result of this averaging formula, they shift a part of the burden that they should properly bear so that these other companies, instead of paying 3 percent of the tax, would be paying under this formula 13.7 percent of the tax. And that difference of 10 percent for the year 1948 in terms of dollars means a considerable burden upon these smaller companies, a burden that we do not think is proper or equitable.

The Life Insurance Association of America made a study, the one that I have referred to, of the 215 companies, which we think clearly bears out the inequitable result that we insist is in this averaging formula. The study is discussed at some length at pages 8 and 9 of the statement that we have filed. That study discloses that under this averaging formula 109 companies which had no free investment income in 1948, would pay a tax. There are 46 additional companies which would be paying more tax than they should pay on their own individual basis. Sixty-nine companies gain a tax advantage as opposed to paying on their individual basis, and thereby of course shift a part of their tax burden over to the other companies.

We think that the figures that the LIAA has compiled clearly support our conclusion as to the inequity of the pending bill.

You may properly ask, as a matter of fact it has been asked here, why if this is true are the companies going along with this averaging formula.

In the first place, we think there is a basis for challenging the statement that has been made here that 95 percent of the companies are supporting the bill. The two associations between them represent, or include in their membership, only 225 companies. That is substantially less than 50 percent of the 609 companies in the business. The meetings that they have held on this tax problem have never been attended at any one time by more than 95 companies and there have been substantial differences among them.

The statement appears in filed records that the membership of the two associations have among them 95 percent of the assets of the business, or that they have 90 or 95 percent of the insurance in force in the business, and those statements are undoubtedly accurate, but we submit are far cry from covering 95 percent of the companies in the business.

As to why companies are supporting this, we believe it is a combination of fear and inadequate information. We think the fear in large part has been generated by the constant repetition of the statement that the companies will take this bill or make up their minds they are going to get something worse.

We think the inadequate information is a natural result. The small companies simply do not have the facilities for boring into the technicalities of as complex a matter as the proper basis of taxation of life-insurance companies.

Be that as it may, and whatever may be the support for this bill and the opposition to this bill—and the opposition is substantial, Mr. Parkinson rattled off a number of companies who oppose this bill—the fact remains that the bill, if it is unsound in concept, and if it is inequitable in result, is not one that should be established in the law either temporarily or permanently as a basis for taxation which is going to affect all of the policyholders of this country.

We believe that the inequities of this bill will be cured if our tax is put on the simple direct basis of taxing each company on its own results without any averaging or the introduction of any other arbitrary data.

We also believe and think we can demonstrate that the Government will derive greater revenue from a tax so based.

Senator MILLIKIN. What is the present basis of taxation?

Mr. SCHMUCK. The present basis, sir, is a so-called averaging formula. Do you want me to discuss the 1942 law, or the present bill?

Senator MILLIKIN. I am not talking about the present bill. How are you taxed at the present time, company by company?

Mr. SCHMUCK. We are taxed on an averaging basis.

Senator MILLIKIN. That is all I wanted to know.

Mr. SCHMUCK. Yes, sir.

Mr. McAndless, when he testified before you, filed an exhibit to his statement. In that exhibit he set up two columns which purported to compare the tax revenue to the Government under the bill pending before the committee and under what he described as a company-by-company basis.

I understand that Mr. McAndless has since filed a corrected exhibit A to his statement.

We have prepared, and I ask permission to introduce into the record at this point, a table setting forth in summary form both of the figures used by Mr. McAndless in his original and in his corrected statement, and a summary of what we believe, and I think have established, are the accurate tax revenues that would be derived for the year 1948 on the averaging formula as opposed to the company-by-company approach that we advocate.

Senator MILLIKIN. Would you mind an interruption?

Mr. SCHMUCK. Not at all.

Senator MILLIKIN. I would like permission to ask someone from the Treasury as to the theory of the present averaging method as distinguished from a company-by-company approach. Who is there here from the Treasury?

Give your name to the reporter, please?

Mr. C. M. LEWIS (Office of Tax Legislative Counsel, Treasury Department). The theory of the averaging method as distinguished from the company-by-company method, sir? I would say that I think Mr. Schmuck has brought out rather clearly that the company-by-company method would look to the actual free investment income of each company, year by year, and impose a corporate tax on that amount. The averaging method would take the experience of a group of companies.

Senator MILLIKIN. I understand the difference between the two. I want to get at the "why"; why average instead of working on the company-by-company basis?

Mr. LEWIS. I think the reason that was developed in 1942, sir, at the time that the averaging proposal was advanced by the industry, was that the company-by-company system as applied to two comparable companies, comparable in size, in assets, in size of business, and in business importance, might yield materially different taxes for a given year.

One company, for example, might have taken higher investment assumptions on their reserves, as compared to the other company, which might have taken conservative assumptions.

Senator MILLIKIN. Within limits, why should they not be permitted to do that?

Mr. LEWIS. They should, sir, from an investment-income standpoint. On the other hand, looked at as companies doing a comparable business, the company with the higher assumption might have made up

for the risk which it assumed in terms of a different mortality table, or in terms of some other type of compensation, so that the net outcome from a business standpoint of the operations of the two companies might be essentially similar, but, looked at solely from the investment-income standpoint, given an equal rate of return under the business conditions of that year, the company with the investment income high assumption would conceivably have failed to meet its obligation out of investment income; the company with the very conservative low-interest assumption would have more than met its obligation.

Senator MILLIKIN. You have all of those factors, I suggest, in any line of business.

Mr. LEWIS. Yes, sir.

Senator MILLIKIN. You have conservatively managed businesses, recklessly managed businesses, businesses managed in between. But we do not apply a fixed yardstick——

Mr. LEWIS. No, sir.

Senator MILLIKIN. To other types of business. I am trying to see why we pick out this field for an averaging process when we do not apply it to other business. You and I might be in the same kind of manufacturing enterprises across the street from each other, and the net-tax result to the Government might be very, very different. We might have gross sales of the same amount but different expenses, different deductions, all sorts of differences that would lead to different tax rates. The Treasury, therefore, does not look at those two differing results and say we have to inject uniformity in here, and start in on an averaging process. I am not arguing against the averaging process. I want to know the "why" of it.

Mr. LEWIS. I think that your example, sir, of the two comparable businesses across the street will be very helpful in pointing this up. We will assume that those two business organizations in their over-all operations produce the same profit for the shareholders so that in terms of conservatism or in other words, of business operation, they are equivalent in terms of their over-all result. The usual tax on corporations, of course, takes into consideration their total operation, and you end up with a taxable net income which reflects the total operation.

Senator MILLIKIN. That includes deduction of expenses, and the expense deductions of any two corporations would not be precisely even even though their gross would be the same.

Mr. LEWIS. Exactly the same. One company may operate in one way so its deductions of one type may far exceed the deductions of that type of the other company, but the other company will make up in terms of another type of deduction, so they end up the same. In the taxation of life-insurance companies, well, I will stick to the business corporation example. If for those two companies you said that, for tax purposes, you would only look to one segment of their operation; for example, say, they were making three products, each one of them making the same three products, and you said that, for tax purposes, you would look only to product A of each of the companies.

Senator MILLIKIN. If I said that, I did not explain myself clearly. Let us assume they make one product and let us assume that they make precisely the same product. Let us assume that their gross is exactly the same, all three assumptions being unrealistic, but let us assume them.

One company has, for example, twice the expense of another company. Therefore, your end taxable result is different.

Mr. LEWIS. Quite right, sir.

Senator MILLIKIN. Why do not we work out an averaging process for that kind of venture?

Mr. LEWIS. No; it would be completely unrealistic, sir.

Senator MILLIKIN. I think so, too. I want to find out why it is realistic in the case of insurance companies.

Mr. LEWIS. It was for purposes of illustrating the answer to that point that I was assuming the three products.

Senator MILLIKIN. Let us assume the three, then.

Mr. LEWIS. If I may, I think it will illustrate that.

Senator MILLIKIN. I thought you attributed that to me.

Mr. LEWIS. I think it will illustrate one aspect of this problem. Both of those two manufacturing companies make three products, baby carriages, shoes, and some industrial equipment. If for tax purposes you look only to the baby-carriage operation of the two companies, one company may do very poorly on its baby carriages, and very, very well on its shoes. The other company may do extremely well on its baby carriages and very poorly on its shoes. So that, averaging the over-all results of both companies for the year, they have the same net income under ordinary corporation income tax concepts, but if the tax base is restricted to baby carriages for the two companies, one company will come up with no taxable income at all and the other company will come up with an extraordinarily substantial taxable income.

In a sense, the analogy of course is not perfect by any means, but in a sense the analogy is in the limitation of the tax base in the case of life-insurance companies to their net investment income as distinguished from profits which they may make because of favorable mortality experience or profits which they may make in administrative savings (whether or not those profits are distributed back to the policyholders is another question entirely), their net investment income as distinguished from those other two large groups of business considerations which enter into the carrying on of life insurance.

Senator MILLIKIN. What remains for that purpose after you get through with the other costs and disbursements of the business?

Mr. LEWIS. The net investment income is defined as the dividends, interest, and rents received, less investment expenses, sort of brokerage commissions, since the investment operations are isolated and considered by themselves.

Senator HOEY. Does it not take into consideration this favorable condition that might exist on account of mortality and those other things?

Mr. LEWIS. That is right.

Senator HOEY. How long has that policy been in effect?

Mr. LEWIS. Since 1921. Prior to 1921 the taxation of life-insurance companies took into consideration total income and total outgo, which automatically included all of these other elements. At that time the complications of administering the law as it was then drawn, which was merely a modification of the general corporate provisions in wording because the problem had not been fully analyzed, were such that the system just broke down and did not work and was unproductive at the time.

Senator HOEY. Does this average policy take into consideration the income from all of these sources and an adjustment of the over all?

Mr. LEWIS. No, sir. Since 1921, the tax base for life-insurance companies has been net investment income only; in other words, dividends, interest, and rents received on their asset reserves.

Senator TAFT. Is not the whole basis of income taxation the principle of ability to pay? Is not that the whole basis both of corporate and individual income tax?

Mr. LEWIS. Yes.

Senator TAFT. Is not that the whole basis of taxation of profits, if any at all, the comparative ability to pay?

Mr. LEWIS. I would not have phrased it that way myself.

Senator TAFT. I mean, here is a corporation which makes no profit, and another corporation in the same business pays tremendous tax because it is able to do it. There is no other reason, is there, particularly? They are doing the same business. Assume two companies doing the same business, one has no net income, one has a big profit. We tax the second one. On what principle? On the principle of ability to pay, is it not?

Mr. LEWIS. To elaborate the thought I would describe the graduated individual rates as related more to ability to pay; on the other hand, the corporate flat rate I would describe as a payment on account of profits, which in a sense is ability to pay, but it is a slightly different sense, but you are right.

Senator TAFT. The minute you average, do you not knock out any possible basis of ability to pay? You eliminate that?

Mr. LEWIS. Yes.

Senator TAFT. So why tax them on net income? If you are going to take the other basis, it would be in accordance with the size of the business. States tax life-insurance companies on the basis of premiums or something of the kind, percentage of premiums.

Mr. LEWIS. That is right.

Senator TAFT. Simpler form of approach would be to try to adjust this ability-to-pay business to something where it has no relation at all after you have changed it all around this way.

Mr. LEWIS. Exactly.

Senator TAFT. Is not that a simpler way?

Mr. LEWIS. That was the basis of the Treasury's opposition in 1942.

Senator MARTIN. Did you assert that this theory was advanced by the life-insurance companies themselves, this averaging theory?

Mr. LEWIS. As I understand it; yes, sir.

Senator MARTIN. Thank you.

Mr. LEWIS. I would add in all fairness that as the result of all of the discussions, as Mr. Kirby pointed out, the Treasury finally went along with the thing, since it was in its final enactment a great improvement over the previous law.

Senator MILLIKIN. Administratively it was more convenient.

Mr. LEWIS. I am not so sure about that, sir.

Senator MILLIKIN. Does it not require a whole lot less scrutiny of the whole business operation?

Mr. LEWIS. I would not say so, sir; no.

Senator MYERS. Did I understand you to say the average formula was opposed by the Treasury Department in 1942?

Mr. LEWIS. As I understand it; yes, sir; the Treasury originally submitted its own proposal which was for a company-by-company method of taxation. When that reached the Congress, the industry took the position that the industry-wide method was preferable, and the thing went on from there with the Treasury finally going along.

Senator MYERS. The industry itself proposed the industry-wide average formula; it has done that?

Mr. LEWIS. As I understand it; yes, sir.

Senator BYRD. Will you elaborate a little on why the Treasury supports this bill when it has opposed the principle in the past, why the Treasury presents this?

Mr. LEWIS. Yes, sir. The 1942 formula. If I may, could I add one further thought which I think will complete my answer to Senator Millikin's question based on the baby-carriage example. In the baby-carriage example, with one company having no baby-carriage profits, and the other one having extraordinarily substantial baby-carriage profits, the taxation company by company of those profits results in a heavy tax on company B, and no tax on company A when the two companies are right across the street, and end up the year with the same business profit. The concept of the averaging formula generally is an effort not completely successful, but still as compared to that result quite successful, to make the resulting tax actually paid by each company roughly proportionate to its over-all business importance.

So that under the averaging method those two companies even with a tax base restricted to baby carriages would pay roughly the same tax. The averaging system is not 100 percent successful, but it is directed at that problem.

Senator MILLIKIN. I am trying to get at the soundness of the theory. Why under the normal taxing concepts should both of those companies pay the same?

Mr. LEWIS. We think, if I may say so personally, and I am not in a position really to speak authoritatively for the Treasury, we think the concept is essentially unsound.

Senator MILLIKIN. Thank you.

Senator BYRD. Will you answer my question?

Senator MILLIKIN. The concept of averaging?

Mr. LEWIS. Yes.

Senator BYRD. Why it is, then, you favor a bill, the concept of which you think is unsound?

Mr. LEWIS. For this reason, sir. The averaging formula which was enacted in 1942, the formula that was worked out, included this fixed element of 3¼ percent. In a sense you might say that it got in there by accident. The 3¼ percent weighted 65 percent, formed an organic part of the Treasury proposal in 1942. The reason for the use of a fixed element in the Treasury's company-by-company proposal in 1942 was, given the limited tax base, to compensate for the fact that some companies used a high interest rate, which they offset by mortality savings, the risk on which they offset by mortality savings, while some companies used a low rate and took more risk on mortality savings.

It was an effort to equalize on an individual company basis for the fact that there was a limited tax base. When the industry-wide method was adopted that reason ceased to have any meaning at all. Looked at in retrospect, I have always assumed personally that in the rush

of getting the thing onto paper and drafted, the Treasury's 3¼ percent weighted 65 and the experience of each company weighted 35 percent was translated to meet this new averaging pattern. It has no organic reason for existence given an averaging pattern. So much in theory. It never should have been there. In practice it has resulted, of course, because of changing economic conditions, in the fact that the compaies have not had to pay any tax on their life-insurance business in 1947, 1948, presumably 1949, with a decreasing yield from what it should have been back in 1946.

Now the reason for the Treasury's support of this proposal is as follows: The Treasury, the President, and the Secretary, as you know, are interested now in revising the over-all system of taxing life-insurance companies. They have been interested in such a change since particularly the autumn of 1947, at which time it became apparent that this averaging system certainly in the way it was drafted was breaking down.

With respect to the problems involved, Mr. Parkinson said:

Well, the problems can be resolved in 25 minutes if put in the hands of technicians.

The problems unfortunately are not problems for the technician: of deciding the method on which life-insurance companies should be taxed, whether there should be a limited tax base, whether there should be a complete tax base, whether there should be averaging for the industry, whether there should be a company-by-company method. The report of the Committee on Ways and Means points to these very basic questions which affect this mammoth industry and which require the utmost consideration by everybody concerned so that no resulting inequity can be done to such an important enterprise.

In other words, the difficulty—I think Senator Taft referred to this aspect of the problem at the previous hearing—the difficulty of evaluating and reaching an agreement on a revision, a reapproach to the question of taxing life-insurance companies in the light of our 25 years of experience is an extraordinarily difficult one. The conferences between the industry and the Treasury to a large extent were devoted to that problem and went on for 2 years. In the meantime, another year clicked by without any tax under present law.

Late last spring and last summer as another year started looming up, it became apparent that something ought to be done to stop this flow of taxless years while this basic question was under discussion, and at that time the question of so-called stopgap legislation just to hold the dike while the big broad question was under consideration was first adopted as a workable premise both by the industry and by the Treasury. The give and take as to the nature of what that stopgap legislation should be is outlined in the appendix to the report of the Committee on Ways and Means. It ultimately resulted in a proposal by the Secretary last August for the imposition of a Secretary's ratio, that is a technical thing the way the formula is worked out, given the present system, pegged at a figure which would produce an equitable tax for the taxable years 1948–49. That was to yield $90,000,000 total.

After consideration of the matter by the subcommittee of the Committee on Ways and Means, the form of this stopgap problem changed, and took the form of the proposed resolution which you have before

you, which is, instead of pegging the Secretary's ratio to a fixed figure, more closely related to a substantive tax solution in that it looks to the average interest experience of the industry. It has been made applicable to all 3 years, since those were the 3 years when no tax at all was paid.

In other words, the subcommittee's shift from a pegged figure to a semisubstantive approach justifies in a sense going back the extra year, because it is as though the thing had always been there, and in a sense, furthermore, gives expression to what should have been the nature of the enactment in 1942, given the averaging assumption.

But to answer your question in a sentence, the Treasury supports the proposal as the best type of stopgap solution; it is in support of a stopgap solution to put a stop to this clicking away of taxless years under an admittedly erroneous formula, in that it contains the fixed element, while the basic problem of permanent legislation is seriously considered with a view to arriving at a result which is just as sound as it possibly can be.

Senator TAFT. In this discussion with the insurance companies, have you considered abandoning entirely the idea of net income and complicated concepts and simply basing the tax on volume of business, on the gross volume?

Mr. LEWIS. No, sir.

Senator TAFT. Has that been discussed at all?

Mr. LEWIS. I do not think so, sir, because I think that neither the Treasury nor the industry would give serious consideration to a tax admittedly of that nature. Both the Treasury and the industry, I think, are interested in trying to get a tax which is an income tax as being the fairest and most equitable.

Senator TAFT. I do not see how you can use the word "fair" when you average. When you use averaging, the word "fair" goes out the window, and also the whole concept of ability to pay. That is the thing I have not been able to understand.

Senator MILLIKIN. If you base a flat tax on the gross amount of the policies obviously you are averaging in effect, because that does not take in account the expenses of the various companies.

Mr. LEWIS. Exactly, sir.

Senator TAFT. Ought they not to be free in a way in their investment policy for the best interests of the taxpayer, free from the consideration of tax questions which are involved in that figure?

Mr. LEWIS. Yes, sir. The best way to be free is an income tax related to an over-all profit after the business operation.

Senator TAFT. I do not see that at all.

Mr. LEWIS. I agree with you on the averaging.

Senator TAFT. I disagree with that. The moment you tax net income, you affect materially the investment policies of any companies that are interested in that income.

Senator MYERS. Do I understand it was the Department's thought that the averaging was not the proper formula, but nevertheless the net-income investment approach was the best formula, and you might treat each individual company rather than averaging over-all of the companies?

Mr. LEWIS. Yes, sir; since 1921.

Senator MYERS. I mean the net-income investment theory differs from the theory proposed by Senator Taft, does it not?

Mr. LEWIS. Yes.

Senator TAFT. I did not want to propose it.

Senator MYERS. I mean suggested, not proposed.

Mr. LEWIS. In 1921, the restriction of the tax base to net investment income against which, of course, is allowed this extraordinarily substantial deduction, and quite properly so, for the business commitment to the policyholder for setting aside interest, was largely a Treasury proposal. Dr. Adams was an expert who handled problems of life-insurance companies, as well as other types of insurance companies, their taxation, and, given the experience and the knowledge of that time, it was his firm recommendation that the tax base be limited to net investment income, and the tax was imposed on a company-by-company basis.

The Treasury in 1942 continued on that theory and modified the technical formula being used and recommended a tax base restricted to net investment income, the tax to be imposed on a company-by-company basis.

Senator MYERS. Do I understand that the entire industry is in favor of the net investment income theory? The present witness is objecting not to the net investment income theory, but to the averaging theory, although he believes the net investment theory should be applied to individual companies, rather than averaging over the entire industry. I understand that is the position of the present witness. I may be mistaken.

Mr. SCHMUCK. That is correct, sir.

Senator MYERS. But the theory of net investment income is supported by the entire industry, is it not?

Mr. LEWIS. I would say so.

Senator MYERS. And by every company within the industry?

Mr. LEWIS. I would say so, although that question has not been presented for legislative purposes.

Senator MYERS. I understand.

Mr. LEWIS. And consequently it has not gotten their considered reactions.

Senator MYERS. The only difference is whether it should be averaged or applied company by company.

Mr. LEWIS. Yes, sir. Certainly in connection—well, yes, sir.

That problem has been sidestepped by this stopgap legislation which would just close the door, given the present system, while that further question was under consideration.

Senator MILLIKIN. I did not intend such a lengthy interruption by asking my question. Using my small slingshot, I did not expect so many birds to come out of the bush. I am sorry to have interrupted you.

Mr. SCHMUCK. I think the Senator flushed a good covey.

I think it was a most helpful interruption, and if I may continue to interrupt this presentation, I would like to refer to one thing which partially supports what we have just heard, and in part I am afraid contradicts one statement.

Since this resolution was passed in the House, there have been hearings before the Committee on Ways and Means on so-called permanent legislation. The Secretary of the Treasury in person testified at those hearings. A substantial part of his presentation dealt with this subject of taxation of life-insurance companies. In support of one thing that Mr. Lewis said, this statement appears in exhibit 3 to the Secretary's formal statement at that time:

I consider the industry-wide average which has been used since 1942 a most inequitable basis for permanent legislation.

It is our opinion that expediency does not make it any less inequitable for stopgap or temporary legislation, and personally we believe it is an inconsistent position to support the averaging for one purpose and oppose it as the Secretary of the Treasury did for another purpose.

The contradictory element that perhaps is not entirely contradictory with what has been said here is that in that presentation the Secretary of the Treasury did make reference, sir, to this idea of taxing the over-all income of the companies. I think that is another question. It is one we can pursue at some time at some length. There certainly is opposition on the part of at least the mutual companies to a taxation on the over-all basis. We feel that the nature of our premium deposit is such that it is not income to the companies; it is a capital deposit by the policyholder which is at all times held for the policyholder. There is no proprietary interest in a mutual company.

No matter what form that premium deposit winds up in, in our opinion it is not income. We feel that for mutuals the only income is this investment income. The only true income as such. With respect to stock companies, you have substantially that situation up to a point. Beyond that point the situation differs because when all of the funds paid into a stock company have been applied for policy purposes, and then participating dividends, if there are participating policies issued by that company, at that point you have the funds going into either dividends to stockholders or surplus, which can be distributed to stockholders either as dividends or as stock dividends and transferred to the capital account. There may be a justifiable basis for a distinction as between the mutual and stock companies.

Senator TAFT. What proportion today are mutuals and what are stock?

Mr. SCHMUCK. By number, the stock companies far exceed the mutuals. I think it is generally considered that there are about 100 mutual companies, and about 500 stock companies. I will check that and make sure that it is correct for the record if the Senator desires. By insurance in force, volume of business, somewhere between 75 and 80 percent of the insurance in force has been issued by the mutual companies and the balance by the larger number of stock companies.

I have very little more to go, sir. If I may finish putting these point into the record, I had asked if the chairman will recall permission to place in the record this comparative table of Federal income tax results for the year 1948.

Senator BYRD. That will be placed in the record at this point.

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(The table referred to follows:)

Comparison of Federal income-tax results, taxable year 1948, based on data prepared by Life Insurance Association of America

[In thousands]

Size group by assets Dec. 31, 1948	McAndless' computations (exhibit A)				Actual figures	
	Original exhibit A		Corrected exhibit A			
	38-percent tax on average valuation formula with lag ignored	38-percent tax on weighted valuation rate basis (alleged company-by-company basis)	38-percent tax on average valuation formula as set out in H. J. Res. 371	38-percent tax on weighted valuation rate basis (alleged company-by-company basis)	38-percent tax on average valuation formula as set out in H. J. Res. 371	38-percent tax on actual company-by-company basis
(1)	(2)	(3)	(4)	(5)	(6)	(7)
A (over 1,000 million)	$27,273	$19,298	$20,965	$14,755	$20,965	$23,937
B (200 to 1,000 million)	6,112	9,220	4,611	7,341	4,611	8,100
A plus B	33,385	28,518	25,576	22,096	25,576	32,037
C (100 to 200 million)[1]	1,117	949			863	297
D (50 to 100 million)	1,256	1,800			975	986
E (20 to 50 million)	1,258	1,711			984	1,160
F (10 to 20 million)	400	590			320	388
G (5 to 10 million)	200	331			166	212
H (under 5 million)	102	136			88	105
C through H	4,333	5,517			3,396	3,148
All groups	37,718	34,035			28,972	35,185

[1] Figures below this point not covered by Mr. McAndless, but included in other LIAA studies.

Mr. SCHMUCK. What we had in mind in preparing this table, and the reason why we have asked that it be put into the record, is the question of revenue to the Government, which will be derived under the averaging formula as opposed to the company-by-company basis, which we recommend.

At the same time we would like to clarify, for the information of the committee, what we mean by a company-by-company basis, as opposed to what is meant by Mr. McAndless when he refers to a company-by-company formula in his exhibit.

That difference is what accounts for the difference in the results. What Mr. McAndless has meant by company-by-company basis or formula is nothing but a modification of the averaging system. He took 35 percent of the company's own experience. Then he took 65 percent of the average for the business, and he applied the result to each company and said that was a company-by-company approach.

Well, to use that is almost the perfect definition of the industry-wide approach as it has been in force since 1942.

By the company-by-company approach we mean just what we have said—each company reporting its income, each company reporting its own expenses, each company reporting its own interest requirements for policy reserves and for other purposes, and reporting the balance as its taxable income and paying a tax on it.

On that approach, and this is shown in the last two columns of the table, the industry-wide or the House Joint Resolution 371 formula, would produce for the year 1948 an aggregate of a little under

$29,000,000 of tax. The direct company approach would produce a little over $35,000,000 of tax revenue. That would be distributed among the companies on the basis of their free income and therefore on the basis of their ability to pay taxes. By the same token, we believe that it is the $35,000,000 and not the $29,000,000 which the Government is entitled to receive from our industry for the year 1948, and it has been these averaging variations that have resulted in the Government never receiving a tax at any time since 1942 on the full free-investment income.

Senator TAFT. Do you have on what you call company-to-company basis, information as to the tax that would have been paid right along?

Mr. SCHMUCK. Yes; there would have been a tax paid in each year. The tax that would have been paid for the year 1948 would have been this $35,000,000 figure. The taxes for the years 1947, 1948, and 1949, we estimate would have exceeded $90,000,000.

Senator HOEY. How long has this averaging policy over the industry been in effect?

Mr. SCHMUCK. Since 1942, sir.

Senator HOEY. This bill would merely continue that for these 3 years with the exception of changing the formula?

Mr. SCHMUCK. It continues the principle; yes, sir.

Senator HOEY. The only difference is it changes the formula?

Mr. SCHMUCK. Yes, sir.

Senator HOEY. That was agreed to by those who did agree to it on the basis that under the old formula they would pay no tax at all for these 3 years and this formula is changed so that they pay the amount specified for that period?

Mr. SCHMUCK. I think that is true, Senator. I think they backed into it. They figured out what the free investment income would have been—at least this could have been the way: figure out what it was, and then how to get at it, and this variation does get at that figure.

Senator BYRD. You are not objecting to the retroactive taxation? You are objecting to the method of it.

Mr. SCHMUCK. Senator, we have never taken a strong position with respect to the retroactive feature of the bill. We do not believe that as the management of a mutual life-insurance company we have the right to say that we support or favor a retroactive bill. On the other hand, in view of the fact that, as has been brought out here, there was free investment income in those years, and but for the arbitrary formula that amount would have been taxed, we must concede some merit to the Treasury's argument. I think in the final analysis we would prefer to leave with the Members of the Congress the question of what precedent may be established by the passage of a retroactive bill, and whether the disturbance of the business community, and perhaps all taxpayers, is justified in view of the over-all situation.

Senator MILLIKIN. I suggest that it is more than a question for Congress. I suggest perhaps the basic question is what right is there in an insurance company to spend the assets of the insurance company, when it does not have to spend them under law.

Mr. SCHMUCK. We do not believe that we have the right to agree to this, sir, nor do we believe that we have the right to pay out the

money unless the Congress has ordered it, and the courts have declared that the law is a proper one.

Senator MILLIKIN. I do not know of any higher form of trusteeship than the management of an insurance company.

Mr. SCHMUCK. We certainly agree with that.

Senator MILLIKIN. When a trustee starts spending his trust moneys to meet obligations which do not exist, I suggest that he is in a very perilous field.

Mr. SCHMUCK. Yes, sir.

Senator MARTIN. I would like to suggest, further, what Senator Millikin says, and that particularly applies to a mutual company, because everything that that company has really belongs to the stockholders after the various legal expenses have been met.

Mr. SCHMUCK. Yes, sir; that is certainly true—belongs to the policyholders.

Senator MARTIN. Belongs to the policyholders.

Mr. SCHMUCK. That is right. That is why we say we do not feel we would have the right, even if disposed to do it, to say that we can support the retroactive features of this bill.

There is one other consideration that I might advance in that connection, and that is the first knowledge that we had in our company that the Treasury was proposing retroactive legislation was in July of 1949; contrary to some of the statements that have been made here, we, and I believe a very substantial number of other companies, had not established reserves for taxes for the years 1947 and 1948, and we did not do so until December of 1949.

Senator MILLIKIN. May we draw from that observation that if there is to be any retroactive tax, it should be limited to current taxable year?

Mr. SCHMUCK. The year 1949, sir.

Senator MILLIKIN. Yes.

Mr. SCHMUCK. I do not think we considered that retroactive. We have not yet filed our tax returns for the year 1949.

Senator MILLIKIN. That is what I say.

Senator MARTIN. If this question is improper, why, we will strike it out. Have you set up anything on your books to take care of the taxes retroactive for, we will say, 1947 and 1948?

Mr. SCHMUCK. We set that up, sir, as of December 31, 1949, because the first information that we had was in July of 1949, and as a result, the end of the year, when we set up our reserve accounts, was the first opportunity to do so.

Senator HOEY. Coming back to this average matter again, you say this act was passed in 1942. From 1921 to 1942, what policy prevailed as to the taxes that were levied? Was it the average on the industry?

Mr. SCHMUCK. No, sir. Each company at that time was given a flat percentage deduction. The 1921 law allowed a flat deduction of 4 percent of mean reserves. That was adjusted downward to 3¾ percent in 1932, and continued at that flat rate until the 1942 Revenue Act.

Senator HOEY. Thank you, sir.

Senator BYRD. Is there anything further? We have several other witnesses.

Mr. SCHMUCK. I appreciate that, sir.

Senator TAFT. If we decide on some basis for temporary taxation, do you see any particular reason why we should not make it permanent?

Mr. SCHMUCK. No, sir.

Senator TAFT. Are not the same principles largely applying unless we contemplate a complete change in the method that might take time, otherwise if we say it is fair for 1947 and 1948 and 1949, why do we not say it is fair for all purposes?

Mr. SCHMUCK. I agree with that, Senator. I think that this situation has become very, very confused, and unnecessarily so. It seems to me that if the members of this committee can satisfy themselves that they have reached a sound basis for taxation, that should be legislation that is placed on the books until it is established that it is not sound legislation or some other change is required.

As I said before, I do not believe that expediency is a reason for approving any bill, and it seems to us that the primary argument in favor of this bill pending before the committee up to this time has been expediency.

Senator MILLIKIN. There is an austere, Spartanlike quality to your logic which does not always control legislation. What I am driving at is, supposing that we should conclude, and I have not the slightest idea what we will conclude, but supposing we would conclude that we would not carry any tax back beyond the beginning of the tax year of 1949; would that be so illogical that it would be unacceptable to you?

Mr. SCHMUCK. Do you mean that no bill that would pass, that would be approved by this committee, would go back beyond 1949, Senator?

Senator MILLIKIN. That is right.

Mr. SCHMUCK. We certainly would not consider that illogical, sir.

Senator MILLIKIN. And supposing we gave a very short prospective life to such a bill, so as to give time to come up with something that is sound, would that be unduly offensive to you?

Mr. SCHMUCK. No, sir; that is a matter of judgment. We believe that permanent legislation is possible. We do not think that the situation is as confusing as it has been made to appear, but that is a question of judgment, sir.

Senator MILLIKIN. There has to be time for it, and I do not think that there is time for it this session, and so it might wind up, some of us might conclude that perhaps we could run this back to the beginning of the taxable year 1949, and run it along for a further short period in order to give those interested a chance to work out a sounder system.

Mr. SCHMUCK. We can certainly see the basis for that reasoning, and the basis for, I hope, an honest difference of opinion on it.

Senator BYRD. Thank you.

The next witness is Mr. John A. Lloyd, vice president of the Union Central Life Insurance Co., of Cincinnati, Ohio.

STATEMENT OF JOHN A. LLOYD, VICE PRESIDENT, THE UNION CENTRAL LIFE INSURANCE CO., CINCINNATI, OHIO

Mr. LLOYD. Mr. Chairman and gentlemen of the committee, our company is but one of many companies which are opposed to House Joint Resolution 371.

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We are opposed to its enactment for the following reasons:

1. Because it levies taxes retroactively, a practice which we believe to be unfair and unjustified and to be fraught with danger to all individuals and to all business.

2. Because the proposed legislation levies taxes upon the basis of an artificial, unfair, and discriminative formula for which, in our opinion, there is no justification.

3. Because it is temporary stopgap legislation and as such is not in the best interest either of the life-insurance business or of the Federal Government.

We respectfully suggest to your committee that it now write a permanent tax bill levying taxes upon the net investment income of each life insurance company.

I think it should be stated in the beginning that our company believes Congress should enact a new statute levying taxes upon the net investment incomes of life insurance companies; that we do not oppose such taxation, but seek to have a better method adopted. We have always believed that the present statute is unfair, unwise, discriminatory, and contrary to the best interests of policyholders and companies and that it would ultimately militate against the Federal Government.

We believe in the principle that life insurance companies should pay taxes upon their net investment income as being the soundest method of taxing such companies. We do, however, severely criticize the so-called global base formula employed in House Joint Resolution 371 and the formula in the present law, and we welcome the fact that Congress is now enacting new legislation as offering hope that the present statute will be corrected. It seemed to us, back in 1942, when the present law was enacted, that if the downward trend in interest rates which then was evident, continued, the time would come when the law would produce no taxes. That situation has now come to pass.

We, therefore, urge that this committee enact new legislation correcting the errors of the past and providing a fair and practicable basis upon which life insurance companies can pay taxes.

Now to go back to our three reasons for opposition to this bill:

1. We are opposed to House Joint Resolution 371 because it levies taxes retroactively. We submit that there is no justification for going back to the years 1947 and 1948. The fact that the formula in the present law produced no taxable net income in 1947 and 1948 is not in any way the fault of the business of life insurance.

The reasons lie in (*a*) the impracticability of the formula in the statute and (*b*) declining interest yield, the effect of which is felt not only by all life insurance companies, but by all other investors, corporate and individual as well.

Senator MILLIKIN. Might I interrupt merely to ask whether your company is a mutual or a stock company?

Mr. LLOYD. Our company is a stock company in the process of being mutualized. About two-thirds of the stock has been turned in for purposes of mutualization, and the other third we are now in the process of getting in.

The effect of House Joint Resolution 371, so far as a large number of life insurance companies is concerned, is much the same as if the

Treasury looked over an individual business taxpayer and said: "That business had a big income back in 1947. It is true that it cost it more to operate than it took in, but since it took in a lot of money we ought to get some of it even though the business had a deficit," and so they come to Congress and ask for a statute to go back to that particular year and on an utterly artificial basis attempt to tax that business by calling its deficit "net income."

I will leave the legal argument to the lawyers, being content to state to this committee that, in our opinion, retroactive taxation is contrary to the public interest because it opens up the broadest avenues for the punitive abuse of the taxing power. Retroactive taxation could be used for the harassment or curtailment or for even the destruction of business or for the punishment of citizens or corporations. Now we know this committee would never use it that way, but this committee will be succeeded, years from now, by others which might. Congress should protect all, great and small alike, from such injustice.

Aside from the injustice of retroactive taxation, we would like to cite another specific reason why it should not be applied to life-insurance companies. The books of the life-insurance companies are closed for 1947 and 1948 and it is not possible to go into those two back years without serious consequences. All transactions of those years are completed. Income and expenses are determined and cannot be changed. Dividends to policyholders have been voted, the policyholders and the State insurance departments have been so notified and the money set aside for this purpose has been paid out to the policyholders. The policy reserves as required by law have been set up and the amount of surplus for the protection of policyholders has been determined, also as required by law. Each company has filed its statement with the various State departments of insurance and these statements have been audited, approved, accepted, and published by the various State departments. Every person who has become a policyholder of a life-insurance company in the succeeding years has become such on the basis of the financial structure certified to and approved by the various State insurance departments for the years gone by.

If Congress were to pass House Joint Resolution 371 the only place a company could get the money to pay such taxes would be out of surplus funds which are needed for the security of policyholders. There is no other place to get the money. These surplus funds constitute much needed protection to policyholders. The very fact that investment income is low makes these funds all the more important as safeguards for the future.

Nearly 80,000,000 Americans own life-insurance policies. They have a right to believe that the surplus funds set aside for the protection of their policy contracts will be held sacred to that purpose. They have a right to rely upon the strength of the companies in which they are insured as that strength is revealed in their filed and published statements. If a retroactive tax is levied it will come out of the funds upon which policyholders rely as the cushion of safety above the minimum reserve required by State laws. I submit that it would be morally wrong to take it from such a source.

2. House Joint Resolution 371 levies a tax upon an artificial "global base" formula for which, we believe, there is no justification and which

has the effect of making companies which, in fact, have no taxable net income pay heavy taxes, while it lessens the taxes paid by companies which do have taxable net income.

I am sure the committee is familiar with the "global base" formula provided in this resolution. It produces unjustifiable results, as does the formula in the present law. It is our opinion that the present law has been injurious to the structure of American life insurance. Because of the artificial formula, many life-insurance companies, while they have no taxable net income in fact, have been required to pay unreasonably heavy taxes and sizable sums of money thus have been paid out which should have been used either to strengthen the policy reserves directly or to add to surplus for the ultimate strengthening of reserve requirements.

This unsound formula has a paralyzing effect upon a company's power to develop actual net investment income, because it slows the ability of a company which is not earning its required rate of interest to develop the surplus funds upon which it ultimately can earn the needed rate.

If it were not for the operation of the arbitrary formula in the present law, the Federal Government would be getting taxes from life insurance companies in spite of low interest yield.

While most of the life insurance in force in this country is still upon a 3½ to 3 percent interest assumption base, in recent years the companies have adopted more realistic interest assumptions. The rate now used by various companies varies from 2¾ to 2 percent. While a few companies made the change earlier, for the most part it occurred during the years 1947 and 1948 and followed the enactment of new mortality and nonforfeiture value statutes by the States during those years. It requires time for a sufficient volume of business requiring lower yields to be placed on the books to reduce the aggregate yield to an earnable rate.

But the result of this change from the old interest requirements of 3½ and 3 percent which the companies cannot earn to the more realistic assumptions which they can earn, is that, barring further radical reduction in interest rates, all companies will, within a reasonably short time, be earning their required interest and will be developing actual net investment income which should be made subject to income taxation.

Senator MILLIKIN. Mr. Chairman, might I ask a question, please?

I wonder if I could impose on you by requesting that you amplify your statement:

> It requires time for a sufficient volume of business requiring lower yield to be placed on the books to reduce the aggregate yield to an earnable rate.

Can you illustrate that?

Mr. LLOYD. Yes. Let me give you an illustration of a company which has on its books business upon which it assumed it could earn 4 percent, business upon which it assumed it could earn 3½ percent, and business upon which it assumed it could earn 3 percent.

Senator TAFT. When you say "business," you mean outstanding policies?

Mr. LLOYD. That is right, Senator. Yes; I mean policies in force, policies which it sold, having figured a premium which would produce a deposit with the company, which, invested at that given rate of

interest, would pay out the policy contract, would produce the reserve necessary to pay it out.

Now, that company, which, if you will observe, I said had 4 percent business, 3½ percent business, 3 percent business—that company, let us say, has had an average interest requirement of 3.20 percent, because of this aggregate business in three brackets. It has been earning 2.95. It began to issue policies at the beginning of 1948—and I pick that year because that is the year when the big change-over occurred in the life-insurance business—it began to issue policies on a 2¼ percent basis. And having looked over the investment picture as far as it could see into the future, it said, "We think we can assume that we will earn 2¼ percent." That is a safe assumption. So it then filed with all the State departments policy forms providing for the assumption of 2¼ percent interest, and it began to sell those policies.

Senator TAFT. That raises the premium of those policies. Those policyholders have to pay more, then, from that time on?

Mr. LLOYD. That is right; the new 2¼ percent policyholders have to pay enough dollars so that those dollars invested at 2¼ percent can produce the desired result.

Well, now, to dilute—and that is a word that is familiar to us, and which I think is easily comprehended—to dilute the higher interest assumption of the older reserves requires a great many millions of 2¼ percent business. And that flow of new business is now coming in.

Senator MILLIKIN. The new business has to pay, let us call it, the losses of the old business, due to the decline in interest rates, does it not?

Mr. LLOYD. To a certain extent. I wouldn't call it losses, but to a certain extent that has always been true since the beginning. When they had 4 percent, 3½ percent, and 3 percent, each time that change was made it was because they couldn't earn with safety the prior assumed interest.

Senator MILLIKIN. So in calculating your new rate you take into account—let us put it that way—the difficulties arising out of the old assumptions that governed the old policies?

Mr. LLOYD. No; Senator, we don't do that. But it has the effect of leveling it off; although in calculating the premium rates we do not take that into account.

Senator TAFT. To a certain extent your investment income also is only diluted gradually to a lower rate. Is that not true? You have certain investments which continue to carry the same old rate.

Mr. LLOYD. Are you talking about our company, Senator? No.

Senator TAFT. No; I do not mean especially your company. Is it not true in general?

Mr. LLOYD. We say this should be on a company-by-company basis, because there are no two life-insurance companies alike anywhere in the world. They are all different. And the differences are pretty sizable. For instance, in our company we have mortgages on which we earn average rate of about 3.65 after we pay the cost of putting the mortgages on the books and servicing. We have 56 pieces of real estate which we are in the process of disposing of, having taken them over in foreclosure actions. Our earnings on those, I guess, would run to about 7 percent. Then we have some contract sales upon which we will average about 3.60 percent. The rest of our investment portfolio

is all in bonds, and it has all been put on the books since 1932. And the average yield on that is 2.65.

Senator BYRD. What kind of bonds? Would you explain that, briefly?

Mr. LLOYD. Well, we have about 410 millions in bonds. That is a round figure. Maybe it is about 407. I don't want to be held to that. A hundred and some million of that are United States Government bonds which we bought during the war. I cannot give you the average yield on that, but of course the top is 2½ percent, and they run down to less yield. Then we buy utilities, industrials, some Canadians, some rails. That is the spread of our bond portfolio.

Senator BYRD. What about deeds of trust on real estate?

Mr. LLOYD. You refer to what out in Ohio we call ground-rent trusts?

Senator BYRD. No; I mean a straight loan on a farm, for example.

Mr. LLOYD. Oh, mortgage loans?

Senator BYRD. Mortgage loans.

Mr. LLOYD. Yes; have about 117 millions in mortgages. More than 60 percent of those are FHA's.

Senator BYRD. What is the average interest rate?

Mr. LLOYD. I think it is about 3.65. It is right in there. I would have to check it, but I think that is about what it is. So that last year the aggregate average yield was 297, I think, in our company.

Senator MILLIKIN. As to those bonds that you bought in 1932, you bought good municipals at 2 and 2½ percent?

Mr. LLOYD. We have about 5 million of them left, Senator. As one time we were pretty heavy holders of municipals, and we sold the account out down to about 5 millions and reinvested it in mortgages and other forms of investment.

Senator MILLIKIN. I was just making the point that as those earlier bonds mature, you either take your cash or they are refunded into a bond that carries a much lower rate of interest.

Mr. LLOYD. That is right. As the old investments go out, we have to take less yield on the new ones, which is why we bring the policy interest assumption down.

As I said, all companies will, within a reasonably short time, be earning their required interest and will be developing actual net investment income which should be made subject to income taxation.

It is our opinion that no artificial formula should be used, but that the tax should be levied upon the result of the actual operation of each company. This we believe to be fair and just. The results in taxes collected will be approximately the same as the formula produces and will be equitably developed. I think Mr. Schmuck testified that the Government would get more in taxes from the company-by-company base than from the other, if I remember his figure. This suggestion adheres strictly to the sound principle of taxation based upon ability to pay. We urge the adoption of the individual company basis.

If, however, your committee should decide to adopt an artificial formula—which, we again wish to counsel you, is unwise—there are at least two such now worked out which are much more realistic, practical, and just than the one in House Joint Resolution 371 or than the one in the present law. The proponents of both these new formulas will make them available to the committee.

3. Stopgap legislation, except in an emergency, is bad legislation and this truth is particularly applicable to the business of life insurance. Life insurance is a long-time enterprise. The management of life-insurance companies must plan not in terms of years, but of generations. It must continually look as far into the future as it is possible to see clearly, and to provide for such contingencies as it can find within its long vision. It should have as definite knowledge of foreseeable factors as is possible and taxation is one of those factors which can be provided for permanently or at least for the foreseeable future. That being true, we believe it should be so provided.

We submit to your committee that there is no emergency which makes stopgap legislation necessary and that that being true, Congress should eschew temporary legislation and, in the interest both of good business and good government, now enact a permanent tax bill.

There is no mystery about the business of life insurance. It has no secrets. It is anxious to have a new income-tax law and to cooperate with Congress to secure once. It is just as easy to write a permanent law as it is to write a so-called stopgap measure.

In conclusion may I voice our appreciation of this opportunity to express our views on this important measure and reiterate our belief that your committee can write a fair, workable, permanent bill in a very short time and we earnestly hope that you will do so. You will find within the life-insurance business a willingness to cooperate with you in this endeavor.

Senator BYRD. Any other questions?

Thank you very much, Mr. Lloyd.

Mr. LLOYD. Thank you, Mr. Chairman.

Senator BYRD. The next witness is Mr. Ellsworth C. Alvord.

STATEMENT OF ELLSWORTH C. ALVORD, ATTORNEY, WASHINGTON, D. C.

Mr. ALVORD. Mr. Chairman and gentleman of the committee, my name is Ellsworth C. Alvord, a practicing attorney in Washington, D. C. I am appearing solely on my personal behalf and primarily to make clear the position I took recently before the Committee on Ways and Means of the House of Representatives.

I am, as you gentlemen know, also chairman of the committee on Federal finance of the United States Chamber of Commerce. It is difficult for one occupying such a position to appear in an individual capacity.

The committee on Federal finance of the chamber of commerce has taken no position whatsoever with respect to the pending resolution and, so far as I know, it has never taken a position with respect to the taxation of life-insurance companies. That problem has normally been left to the associations representing the life-insurance companies.

I have, as you gentlemen know, for many, many years opposed retroactive legislation. It was necessary for me to discuss the joint resolution now pending before you when I appeared before the Committee on Ways and Means, because the problem of taxing life-insurance companies was before that committee in connection with the recommendations of the Secretary of the Treasury.

I also want to make it very clear that I am not opposing the life-insurance industry. I am not opposing various formulas that have been worked out. I am not opposing the officials of the Treasury Department. And certainly I am not opposing any of the Members of Congress, and particularly the members of the subcommittee under the very able leadership of Mr. Lynch, who worked out the pending so-called stopgap legislation.

Before the Committee on Ways and Means I did urge the adoption of a permanent policy for the taxation of life-insurance companies. I again urge that this be done.

You members of the committee now have the problem fairly well in mind. The statute with respect to the taxing of life-insurance companies appears somewhat complicated. The specific problem, however, is quite easy to state. I would oppose any change in the taxation of life-insurance companies only upon their investment income. I am sorry that Senator Taft disappeared, because——

Senator MILLIKIN. He is just returning now.

Mr. ALVORD. Senator, I was just about to mention the tax you proposed on premiums, and I am very glad you came back.

Senator TAFT. I said, in effect, that if you are going to average, why do you not abandon the whole theory of ability to pay, and therefore why not take a simple one on gross income rather than an average?

Mr. ALVORD. I will come to that in just a minute, sir.

Senator TAFT. That was the suggestion I made.

Mr. ALVORD. The point I wanted to make is that I think the sound basis for taxing life-insurance companies is a basis based upon their so-called net investment income; that is, their dividends, rents, interest, minus expenses in connection with those three items.

Now, our problem is: What kind of a deduction are we going to allow for contributions to reserves? As you know, the problem is based on the fact that life insurance for many, many years has been sold on a fixed-premium basis. That fixed premium was determined by the insurance companies under the various applicable laws, tables, and computations, so that if I were to pay $100 a year, based on the assumptions which they made, including earnings on my payment and the assumption of mortality, I would pay in enough at $100 a year over my lifetime to pay my beneficiaries the amount of insurance which I have contracted for.

The sole problem has to do with: How to compute the contributions to the reserves which are necessary in the case of my policy and every other policy in order that the company will have enough money to pay my beneficiaries when I die?

There has been a great deal of discussion on the individual company basis. I will give you the problems rather than the policy.

In 1921, when the basic policy of taxing only net-investment income was adopted. Dr. Adams was then representing the Treasury. I am not ashamed to admit that my memory goes back that far quite readily. It was decided that 4 percent of the reserves of the company would be a proper deduction. That 4 percent was established, I think, by Dr. Adams very largely on the averaging doctrine. It was felt that companies as a whole should contribute 4 percent of their reserves to their reserves in order to maintain the soundness of their policies.

That 4 percent was reduced somewhat by the Revenue Acts of 1932 and 1938; and then we come to the 1942 act, where the so-called global principle—I don't think it departed too much from the basic principle of the 1921 act—said, "We will take only 65 percent of a 3¼-percent rate and use that weighted against 35 percent of each company's average, the average of each company's average experience.

The only difficulty with the individual-company approach that I see—and perhaps this will answer your question, Senator Millikin, is that as Mr. Lloyd has just told you, each company in the life-insurance business is different. Their outstanding contracts are different. Their earnings are different. And their reserve requirements are different. Those variations, an infinite number of variations, plus the fact that an individual company policy would give—and I say this without criticism in the slightest—would give to the various insurance companies a chance to do a little jiggling and juggling.

Senator MILLIKIN. That is true of all business.

Mr. ALVORD. That is true, sir.

Those were the two reasons why something other than an individual-company basis was adopted. I personally would have no objection to the individual-company basis if we were sure that the variations and the opportunities for jiggling and juggling would not throw it out of gear.

It was those two factors, I think, which compelled the adoption of what is called the global basis, which, so far as I know, is a pretty sound basis. That says, as you know, in practical effect, "We will take the average requirements for contributions to reserve over the entire industry, rather than the company-by-company method." That means that the variations in the individual companies must be disregarded, which is unfair to some of the individual companies and too fair to others, and it also prevents any jiggling with the valuation of reserves.

The only actual difficulty that I know of with the 1942 act is that the Treasury cheap-money policy cut the earnings of life-insurance companies down so that they were not earning enough under that formula to contribute to the reserves and have anything left. That is the basic and only difficulty.

So far as I can see, and I don't pose as an expert on insurance taxation in the slightest—there has been very little legislation on it—the pending resolution might perhaps be used as a basis for permanent legislation. It certainly might be used as a basis for legislation for current years until a more permanent policy can be worked out. I am expressing no opinion upon that. I give a great deal of credit to the members of the industry, who attempted to work out a fairly sound stopgap policy, and to the Committee on Ways and Means for effecting the agreements. That stopgap legislation might be perfectly all right for '49 and '50, perfectly all right until, if it is unsound in policy, a sounder policy can be established by the Congress. If the pending resolution should not be acceptable as permanent legislation, then certainly a sound policy can be determined without undue delay.

I would earnestly recommend that that sound policy, of course, be established in cooperation with the industry, and probably with the Treasury changing their attitude somewhat so that they are not attempting to tax something which is not income. That is the basic difficulty. The Treasury is shooting at something which isn't income,

and the life insurance companies are attempting to compromise so that that principle of taxation will not be enacted into law.

I recommend strongly against the retroactive application of any increase in tax, including the resolution before you, to 1947 and '48. I do that both on the question of policy and on the question of constitutional law. On the question of policy I think I have practically every member of this committee with me in prior legislation. You will recall that Senator Connally and Senator La Follette and Senator Taft specifically objected to a 1943 formula designed to correct a mistake in the 1942 act, to be made applicable to '42. And, generally speaking, the Congress has done its best to prevent the retroactive imposition of increased taxes.

Prior to the adoption of the withholding principle in 1943, it was quite common for the Congress to enact, during the calendar year, increased taxes applicable to the entire calendar year, and to fiscal years falling within that calendar year. Very, very seldom, in only one case that I know of, has the Congress passed retroactive legislation in a subsequent year applicable to the prior year. That was the Revenue Act of 1918, which I think was enacted on the 24th day of February 1919, and made applicable to 1918. The constitutionality of that was assumed, and I would agree with and accept that assumption.

I would certainly agree with the Secretary of the Treasury and with the industry with respect to retroactivity. The position that the Secretary of the Treasury has pointed out in his letter to Chairman Doughton of October 10, 1947, is quoted on page 18 of the House committee report. And I agree with the industry, as pointed out in two letters, one dated September 16, 1949 and another dated July 29, 1949, quoted at length in full at pages 16 and 13 of the House committee report, respectively.

There you find a restatement of the very soundly established policy against the retroactive imposition of increased taxes. That policy certainly would apply to the imposition of taxes for 1947 and 1948; certainly where, as I was informed before I appeared before the Committee on Ways and Means, there was substantial objection on the part of individual taxpayers. It might be that a unanimous agreement somehow could be worked out which would be binding—though I know of no such method—under which certain people would agree to pay retroactive taxes.

Senator MILLIKIN. Mr. Chairman, I suggest that it is a very vicious policy. It is even more vicious by agreement than without agreement.

Mr. ALVORD. That may be, sir.

Senator MILLIKIN. Because you are opening the door so that the Treasury—and I am not talking about the present Treasury but any Treasury—might look back and say, "Oh, we have not realized enough money out of this industry in the last 10 years." Then they would say, "Now, let us get together and agree on a retroactive tax." Well, why does the fellow agree on a retroactive tax? He agrees on a retroactive tax because of the implied threat that "if we cannot get it retroactively, you are going to have to pay it in future."

Mr. ALVORD. That, I suspect, might be true, Senator, and my guess is that back in the background of this thing is somebody's determination that $90,000,000 ought to be raised. Now, just how anybody

reached that $90,000,000, I am not certain. I suspect it was done probably by the Treasury's taking the Secretary's 0.92 figure, which was about the ratio back in 1943 and 1944, and saying, "That is what we should have allowed."

Senator TAFT. $30,000,000 a year is about what they paid for the previous 5 years.

Mr. ALVORD. I suppose it would work out to be just about the 0.92 figure; yes.

I also point out the very serious constitutional questions involved. As you know, if we are taxing income, we must comply with the sixteenth amendment to the Constitution, or we bump into the provisions of section 8 of article I and the provisions of section 9 of article I, which require uniformity and apportionment.

Under the sixteenth amendment, Congress is given power to tax income, from whatever sources derived. It is pretty generally agreed that sometime there comes a time when that which was income no longer is income. The Supreme Court has never passed on that. I would suppose probably for tax purposes it might well be fixed as the time on which the tax returns are filed. If that is true, then, certainly, as to 1947 and 1948, there is not only a very grave constitutional issue involved but, in my opinion, it would be unconstitutional and would be held unconstitutional. I agree with Senator Millikin that the persons responsible for the payment of the tax would have to protect themselves by claims for refund, and we would have several years of litigation. That same picture, you will recall, was involved in the National Life Insurance case, and after several years of litigation the Treasury was forced to pay out every penny they had collected when they attempted to impose a tax on tax-free income. So that under the sixteenth amendment the only power you have is to tax income. It seems to me that the financial position of all companies—of all taxpayers—with respect to 1947 and 1948, has so changed that that which was income in those years is no longer income.

A second problem is the due-process problem under the fifth amendment, which is correspondingly the same problem as the due-process problem under the fourteenth amendment.

Certain cases have been cited to support retroactivity. The first one, upon which great emphasis is laid, is the so-called windfall tax, which you gentlemen will remember, was enacted in 1936. The situation there was that the Supreme Court, on January 6 of 1936, held the so-called processing taxes under the Agricultural Adjustment Act unconstitutional. Then came the Revenue Act of 1936, which was enacted June 23, 1936, which imposed an 80-percent tax upon income attributable to the shifting of excise taxes—which, of course, included the excise tax under the Agricultural Adjustment Act, and was designed primarily to do that; and 80 percent upon the income resulting from reimbursement of the excise tax which had been passed on to someone else; and also 80 percent upon income resulting from refunds under the Agricultural Adjustment Act unconstitutional excise taxes.

I think you will recall, gentlemen, that the constitutionality of that provision was subject to serious question by this committee. It was fought out in the courts. It got no higher, so far as I know, than the circuit court of appeals. The case which is frequently cited and which is cited by Judge Lynch in his memorandum filed with you, is the White Packing Co. case against Robertson ((CCA, 4th) 89 Fed.

2d 775). That case is quite easy to understand. It was a bill to enjoin the collection of this so-called 80-percent tax. The lower court held, on three grounds, that a bill to enjoin would not apply, would not be granted, first because of section 3224, which says you can't enjoin the collection of a tax, and then on two other technical grounds which I won't discuss. It got up to the circuit court, and the plaintiff, seeking the injunction, attempted to get the case remanded to the district court so that it could put evidence on the hardships, their inability to pay, the costs, and so forth, of computing the tax. The circuit court of appeals said:

> Nothing doing. We won't grant you the injunction. We think the lower court was right. Furthermore, we think that the statute is constitutional. Therefore, even if you put in all this evidence and prove your point, which we doubt you could do, it won't do you any good.

The point that they make in their decision is not that the tax was retroactive but that the tax imposed was a tax based upon income which, for the first time during the year in which the 1936 act was enacted, became the income of the processor.

It had not been the income of the processor. He had passed the tax on. He had gained the increased price as the result of the tax. With the unconstitutionality of the tax established, he was then going to try to get the money back, or somebody was going to try to get it back, from the Treasury. He would be unjustly enriched, to the extent that he had passed the tax on. And it was only to that extent that he was being taxed. My recollection is that there was some $850,000,000 involved. The 1936 act also stopped quite effectively the getting of the refunds.

Commenting on the constitutionality of the act, the court said:

> Here the tax is imposed on income which has recently been earned * * * and which has come into the possession of the taxpayer during the year in which the tax is imposed.

The court also cited a Supreme Court case (*U. S.* v. *Hudson* (299 U. S. 498)) which sustained the constitutionality of the Silver Purchase Act, which was enacted June 19, 1934, and was made retroactive 35 days.

Consequently the White Packing Co. case, if a precedent for anything in the field of constitutional law, is a precedent for the position that I am taking: That some time income ceases to be income; that Congress cannot under the sixteenth amendment impose a tax upon the income which has ceased to be income; and that it is dangerous for Congress to attempt to impose any retroactive increase in income taxes beyond the beginning of the calendar year in which the increase is enacted. Only once since the adoption of the sixteenth amendment, following the Supreme Court decision that an income tax was a direct tax and therefore must meet the requirements of article 1 to which I have referred, and since the decision of the Supreme Court that the fifth amendment is applicable to laws imposing retroactive taxes—only once has Congress attempted to impose a tax upon income of the preceding year. That was the Revenue Act of 1918 which, as I have said, was enacted on February 24, 1919, and which was applicable to the calendar year 1918.

It is my opinion that Congress may now impose increased taxes for the calendar year 1949, as proposed in the pending resolution. I

think that 1949 incomes have not yet passed beyond the realm of "income." And I think that the circumstances surrounding the enactment of the proposed increase take it out of the fifth amendment.

Other cases have been cited as sustaining the validity of a retroactive income tax enacted by the Congress. One is *Welch* v. *Henry* (305 U. S. 134). This is the so-called Wisconsin case. In 1935 the Wisconsin Legislature amended its tax laws so that a portion of the exemption of income from corporate dividends in the hands of individuals was removed. It made that act applicable to 1933 incomes. Justice Stone wrote the opinion in that case and said specifically that, there being no meeting of the legislature in 1934 (the Wisconsin Legislature met in regular session only every 2 years) the 1935 legislature was the first one which had any opportunity to deal with the problem of increased revenues and, so far as the due-process clause of the fourteenth amendment is concerned, it was not unreasonable of the Wisconsin Legislature to go back to 1933, the first taxable year open since the legislature had adjourned in 1933. The sixteenth amendment was, of course, not involved. The issue arose solely under the fourteenth amendment. The last paragraph of Justice Stone's decision is interesting:

While the Supreme Court of Wisconsin thought that the present tax might "approach or reach the limit of permissible retroactivity" we cannot say that it exceeds it.

I also point out to you that this was a 5-to-3 decision.

Numerous examples of the retroactive imposition of taxes by the Congress have been referred to. For example, Justice Brandeis in his dissenting opinion in *Untermyer* v. *Anderson* (276 U. S. 440) cites a long list of statutes purporting to impose retroactive taxes. An examination of each one of them reveals that each (with the exception of the Revenue Act of 1918, to which I have referred) was enacted prior to the sixteenth amendment—so that the sixteenth amendment issue which I have discussed was not involved—and prior to the decision of the Supreme Court holding that the due-process clause of the fifth amendment was applicable to the retroactive imposition of taxes by the Congress.

In conclusion, it is my opinion that the joint resolution now pending before you would be unconstitutional in its attempted increase of taxes for the years 1947 and 1948.

Mr. Chairman, if I have time, I would like to, in revising my testimony, perhaps submit a more detailed memorandum.

Senator BYRD. Very well.

Mr. ALVORD. I will be very happy to answer any questions.

Senator BYRD. Thank you very much.

If there is nothing else to come before the committee today, the committee stands in recess.

(The following material was submitted for insertion in the record:)

STATEMENT OF ROSWELL MAGILL, CRAVATH, SWAINE & MOORE, NEW YORK 5, N. Y.

When the bill now before the Committee on Finance, House Joint Resolution 371, was being considered by a subcommittee of the Committee on Ways and Means last October, I wrote Senator George and Mr. Doughton in opposition to the bill. Senator George has invited me to appear before the Committee on Finance at this time. Since my engagements in New York City make it impossible for me to come, I would like to submit the following short statement of my views.

Since I am a trustee of the Mutual Life Insurance Co. of New York, I have been interested in the discussions during the past 6 months of new methods for the taxation of life-insurance companies. Some of the published statements have seemed to me erroneous in the inference that life-insurance companies are avoiding Federal income taxes. It is my understanding that the reason life-insurance companies have not owed income taxes for several years is that under the taxing formula put into the law in 1942 with Treasury approval such insurance companies have had no taxable income. Interest rates have fallen so much below their level in 1942 and below the level at which taxes would be payable that no taxes are due under the law.

Reports of the hearings on House Joint Resolution 371 before the subcommittee of the Committee on Ways and Means trouble me, because the emphasis seemed to be not on the preparation of a method of taxation that will be fundamentally sound but of one which will yield the Treasury a total of $90,000,000. So far as I am aware, no data has been presented to show whether a fair system of taxation of life-insurance companies will yield $50,000,000 or $90,000,000 or some other sum.

House Joint Resolution 371 seems to me to contain two major defects: First, the bill makes the new taxes retroactive to 1947, 1948, and 1949. Companies have certainly closed their accounts for all 3 years; have published their audited annual statements; and have credited "dividends" to their policyholders on the basis of their reported earnings in reduction of premium payments. Under the tax law as it stood throughout 1947, 1948, and 1949, the companies were not liable to any income taxes. To collect an income tax today for those past years is grossly inequitable. For one thing, such taxes presumably will be collected in part from men who were not even policyholders in the companies in 1947, 1948, and 1949, since the tax will have to be paid from 1950 earnings or from surplus in which a 1950 policyholder has a pro rata interest. Moreover, House Joint Resolution 371 would introduce a most undesirable precedent in support of other forms of retroactive taxation. Throughout our recent history, Congress has set its face against taxation retroactive back of the year of enactment; and there are several recent instances of the defeat of tax legislation in Congress on the basis of its retroactivity.

Second, the life-insurance companies are obligated to their policyholders under State laws to maintain reserves to enable them to meet their contractual liabilities to such policyholders. No company has any income until these liabilities are met. Therefore, no company should be taxable by virtue of a formula which purports to determine its taxable income on the basis of some average without regard to the company's individual contractual obligations. The fact is, of course, that with current very low earnings closely regulated and determined by Government agencies life-insurance companies are not earning much if anything in excess of their contractual reserve obligations to their policyholders. It is for that reason that the 1942 formula does not produce revenue to the Treasury.

I am by no means an insurance expert. I do know, however, that there are large companies and small companies, stock companies and mutual companies. To try to deal fairly with them all on the basis of a single magic formula that does not take account of their individual situations is quite impossible. To impose a tax on them in 1950 in respect of their 1947, 1948, and 1949 incomes is most unjust to the millions of policyholders who will have to bear the retroactive taxes. The taxation of life-insurance companies, like the taxation of corporations generally, should be dealt with by a tax-law prospective in operation based on a careful study of the peculiar facts and circumstances of the life-insurance industry.

THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES,
New York, March 30, 1950.

Hon. WALTER F. GEORGE,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: I understand that Mr. Alvord, in testifying before the Finance Committee yesterday, stated that a permanent solution for the taxation of life-insurance companies that would be fair and equitable from all standpoints could be worked out without unreasonable delay.

We in the Equitable agree thoroughly with Mr. Alvord and, as a matter of fact, our actuarial department is well along the road toward such a solution. The proposal upon which they have been working is now in the process of being

checked against figures that have been furnished vountarily by a considerable number of companies who have also been advised of the details of the proposal.

Basically, it involves starting with the net investment income of each company and arriving at a deduction of an amount necessary to maintain its reserves which will be fair both from the standpoint of the company and the Treasury. The taxable income of each company can then be readily determined without resorting to the artificial and unrealistic formula now in the law which in effect assumes that every company's interest requirements are in the same ratio to its investment income. We believe that it is a comparatively simple matter to arrive at a proper deduction which will be workable and have sufficient flexibility so that it will not be necessary to revise the formula every few years.

Our actuaries will be available at any time to confer with representatives of the Joint Committee on Internal Revenue Taxation or of the Treasury and discuss the details of the proposal. Naturally, the views and comments of any other members of the life-insurance industry will be welcomed, and unquestionably their representatives should be invited to attend such a conference.

Faithfully yours,

THOMAS I. PARKINSON, *President.*

THE MUTUAL LIFE INSURANCE CO. OF NEW YORK,
New York 5, N. Y., March 24, 1950.

Hon. WALTER F. GEORGE,
Chairman of the Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR GEORGE: I have been informed that the Senate Finance Committee will hold an additional hearing on the question of retroactive taxation of life-insurance companies on Wednesday, March 29, and it has been suggested that the committee might have some interest in the views of this company as contained in our one hundred and seventh annual report to policyholders. Accordingly, in order that we may assist in affording the committee as wide an expression of views as may be practicable, I enclose a copy of our annual report for 1949 and ask that the part thereof entitled Opposition to New Federal Income Taxes, commencing on page 6 and ending on page 8, be entered in the record.

This expresses the views which we have consistently held and expressed on the subject of retroactive taxation, although recognizing that the industry through its associations, of which we are members, have expressed contrary views.

Respectfully yours,

LOUIS W. DAWSON, *President.*

OPPOSITION TO NEW FEDERAL INCOME TAXES

Congress now has under consideration a bill providing for the payment of new Federal income taxes by life insurance companies. This bill, if passed, would tax the companies, not only on their 1949 operations, but retroactively for 1948 and 1947. On this basis the Federal income taxes to be paid by the Mutual Life in 1950 would be about 3.4 million dollars. This is, of course, a tax on the Company's policyholders that increases the cost of their life-insurance protection. On such a basis, payment of income taxes in 1950 by all life-insurance companies combined would amount to about $90,000,000.

The Mutual Life has fought this proposal aggressively—in hearings at Washington, and at meetings with other life-insurance companies. Our opposition has been based on the fact that the Treasury seeks to levy a triple tax for the year 1949 through the device of retroactive taxation. We believe this is unwarranted and without precedent.

Life companies have always been subject to income taxes, but since 1921 Congress has recognized that the only real income of such a company is in its income from investments. It has also recognized the principle that some deduction, for tax purposes, should be allowed to life companies for that portion of their income that they are required to add to their policy reserves, which the law requires them to maintain.

In 1942 a new formula for income taxation of life companies was adopted, based on these principles. It was implicit in that formula that if the rate of investment earnings fell below a certain point there would be no taxable income, and therefore no tax would be payable.

Since 1942 the general level of investment yields has declined, largely as a result of the Government's own monetary policies. By 1947, investment yields had fallen so low that, under the formula, the life insurance companies had no taxable income. The same condition existed in 1948. Although the life-insurance companies raised the question with the Treasury Department in 1947, no change was made in the law in either 1947 or 1948.

Now, 3 years later, and after the companies have conducted their usual financial transactions and have closed their books each year, the Government representatives want to tax them on a retroactive basis. Such payments for 1947 and 1948 cannot come out of income. They must be a charge against surplus.

Retroactive taxation is a matter of concern, not only to life insurance companies, but to all corporate taxpayers. Indeed, it may well set a precedent that will affect all individual taxpayers. If the principle of retroactive taxation is once established, no one will be safe against a redefinition of his past tax liabilities.

We are equally concerned with the evident desire of the Treasury Department to develop a new formula of taxation for life-insurance companies which will tax such companies—and thus their policyholders—much more heavily. This will constitute a tax on thrift and good citizenship, and the only substantial defense against such a move is the voice of the policyholder himself.

BARNETT, BUGG & LEE,
Monroeville, Ala., March 14, 1950.

Hon. WALTER F. GEORGE,
United States Senate, Washington, D. C.

DEAR SENATOR: I am taking the liberty of writing you, since you are chairman of the Finance Committee of the Senate.

The bill now pending in Congress, referred to as the Lynch bill and dealing with the matter of revising the income tax laws as affecting insurance companies and making those revisions retroactive for some years, has served to bring our attention to the whole idea of retroactive tax legislation.

It may be that Congress has the power to revise tax laws and give them retroactive application. If so it occurs to me that common justice as between the Government and its citizens calls loudly for something to be done that would give a reasonable measure of finality to tax obligations.

My first thought is perhaps it would be feasible to incorporate in income tax legislation provisions to the effect that the law as it stands at the end of the tax year shall constitute a contract between the government and its citizens; and that any legislation that would attempt to change the liability in any manner with retroactive application after the end of the tax year should be construed as impairing a contract, which is forbidden by the Constitution.

I would be glad to have your idea on this subject.

Yours very truly,

A. C. LEE.

(Whereupon, at 11:59 a. m., Wednesday, March 29, 1950, the hearing was closed.)

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