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TAXATION OF LIFE INSURANCE COMPANIES

APRIL 10 (legislative day, MARCH 29), 1950.—Ordered to be printed

Mr. GEORGE, from the Committee on Finance, submitted the following

REPORT

[To accompany H. J. Res. 371]

The Committee on Finance, to whom was referred the joint resolution (H. J. Res. 371) to correct the formula used in computing the income taxes of life insurance companies for 1947, 1948, and 1949, having considered the same, reports favorably thereon with amendments and recommends that the joint resolution as amended do pass.

PART I—GENERAL STATEMENT

A. 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.

House Joint Resolution 371 as it passed the House would have determined 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. Your committee's amendment applies the formula in the House bill to the years 1949 and 1950 and eliminates its application to the years 1947 and 1948.

B. 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 deduc-

tion, 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 exceeded 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.

C. THE HOUSE BILL AND THE COMMITTEE AMENDMENT

Under the House bill a formula was adopted for the years 1947, 1948, and 1949 which eliminated the arbitrary 3¼ percent fixed element, basing the reserve and other policy liability credit ratio exclusively on the average experience of the industry in the preceding year. Your committee's amendment retains this formula for the year 1949 and extends it to the year 1950.

Your committee does not believe it advisable to apply the formula retroactively to the years 1947 and 1948. The returns for those years were filed some time ago; the books of the companies have been closed; and in some cases no reserves were established to cover the Federal tax liability. Testimony before your committee disclosed that some companies had made commitments in those years relying on the fact that no Federal income tax was payable under existing law. In some cases the payment of a tax now would impose a hardship upon the policyholders.

The committee believes that the constitutionality of a tax imposed at this time on 1947 and 1948 incomes is at least debatable. From the testimony it is evident that some companies will contest the validity of such a tax. Others may be forced to do so through action of their policyholders.

Even if your committee were of the opinion that a tax now levied on 1947 and 1948 incomes would be upheld by the Supreme Court, it would still oppose retroactivity extending over such a long period of time. The committee believes that the extension of a tax to 1947 and 1948 at this late date would not be a sound and reasonable step from the standpoint of fundamental public policy which requires that a taxpayer's obligation to his Government be made definite and certain at the time the tax is due.

The House report lays great stress upon the history of the preliminary negotiations between the Treasury Department and the representatives of the two associations of life insurance companies, which have been in process ever since the autumn of 1947. However, your committee does not regard the negotiations as putting the insurance companies on notice that the Congress might adopt retroactive legislation extending as far back as 1947 and 1948. In fact some of the witnesses before your committee testified that they had no notice that such retroactive legislation was contemplated, even by the Treasury Department, until August 1949.

On the other hand, the life insurance companies have certainly been on notice that a revision of the formula was being considered by the Congress for the year 1949, at least since October 10, 1949, the date House Joint Resolution 371 was introduced in the House. This date is over 2½ months before the end of the calendar year 1949 and 5 months before the due date for filing 1949 returns.

Your committee is in agreement with the House that the legislation in question should be merely of a stopgap character. The committee bill extends this stopgap legislation to 1950 because it seems unlikely

that a permanent plan for the taxation of life insurance companies can be developed in sufficient time to be made applicable to 1950.

It is estimated that the total additional revenue to be derived from your committee's bill will be approximately \$112,000,000. Of this amount \$42,000,000 will be derived from the year 1949 and \$70,000,000 from the year 1950. Under the House bill, which applied to 1947, 1948 and 1949, the estimated yield is approximately \$98,000,000.

PART II.—DETAILED DISCUSSION OF THE TECHNICAL PROVISIONS OF THE JOINT RESOLUTION

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 a 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 1949, and 1950, it does make two changes in such formula for taxable years beginning in 1949 and 1950. Both changes result in a smaller numerator, in the computation of the ratio referred to in the preceding paragraph, 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 (i) 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 1948 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 1949. 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 1948 and (ii) the average rate of interest assumed in 1948 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 1949 or 1950, 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, 1948. 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 1950, 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 1949. By applying the resolution only to the year 1949, the committee bill makes sections 2 and 3 unnecessary.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the joint resolution, as reported, 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):

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 1949 AND 1950.*—*In the case of the taxes imposed for a taxable year beginning in 1949 or 1950, 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.

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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).

