Calendar No. 279

86TH CONGRESS } SENATE { REPORT
1st Session } { No. 291

LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959

REPORT

TOGETHER WITH

SUPPLEMENTAL VIEWS

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

TO ACCOMPANY

H.R. 4245

A BILL RELATING TO THE TAXATION OF THE INCOME OF LIFE INSURANCE COMPANIES

MAY 14, 1959.—Ordered to be printed

UNITED STATES
GOVERNMENT PRINTING OFFICE
40690 WASHINGTON : 1959

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86TH CONGRESS 1st Session } SENATE { REPORT No. 291

LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959

MAY 14, 1959.—Ordered to be printed

Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 4245]

The Committee on Finance, to whom was referred the bill (H.R. 4245) relating to the taxation of the income of life insurance companies, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

H.R. 4245, the life insurance company income tax bill of 1959, provides a permanent method of taxing life insurance companies for the calendar year 1958 and subsequent years. This new treatment replaces the 1942 formula which would otherwise be applicable. The bill taxes both investment and underwriting income. The 1942 formula would tax only the former. The bill also taxes capital gains.

Your committee has in general retained the basic provisions and framework of the House bill which would provide a three-phase tax base for life insurance companies: the first is on a portion of investment income; the second is on one-half of underwriting income; and the third is on the remaining half of the underwriting income to the extent it is distributed to stockholders or certain other conditions exist. This latter, or phase 3 tax, applies only if more than the income taxed under phases 1 and 2 remaining after tax, is distributed to stockholders. Neither the House nor your committee's bill apply this phase 3 tax in 1958. Your committee's bill, however, provides a further transitional period by making the phase 3 tax generally only one-third effective in 1959 and two-thirds effective in 1960. Both the House and your committee's bill impose a separate, flat 25 percent tax on net long-term capital gains (in excess of net short-term capital losses).

Both the House and your committee's bill determine the taxable portion of the phase 1 investment income tax base on an individual company basis rather than, as does the 1942 formula, on the basis of a uniform percentage of investment income applying to the entire industry. Under your committee's amendments the taxable portion is determined by applying to life insurance reserves (adjusted) an interest rate representing the average earning rate of the company on its assets over the current and four prior years. The House bill, on the other hand, takes into account the current year's earnings rate of the individual company, but also averages with this the rate the company assumed in establishing its reserves (or the industry average assumed rate for the prior year if higher). This is one of the important differences between the House and your committee's bill.

Another of the important differences between the House bill and your committee's amendments arises in the manner of determining the portion of the investment income which is taxable to the life insurance company. The House bill determines this by subtracting from net investment income an amount determined to be needed to meet policyholder, etc., requirements. Your committee's bill, on the other hand, determines the proportion of income needed for policyholder requirements and then divides all items of income, including tax-exempt income and intercorporate dividends received, between the policyholder and life insurance company in this ratio. Thus, only the life insurance company's share of each of these items is taken into account. For example, if the ratio were 75 to 25 between the policyholders and the company, only 25 percent of the investment income would be taken into account in computing the life insurance company's taxable investment income. From this remaining 25 percent there would be deducted the portion of the tax-exempt interest and intercorporate dividends received deduction contained in this share. In addition, the bill provides that if it is established in any case that the application of the definition of taxable investment income results in the imposition of tax on any tax-exempt income, any part of the thirty fifty-seconds of any partially tax-exempt interest, or any part of the 85 percent dividends received deduction, adjustment is to be made to the extent necessary to prevent such imposition of tax.

In taxing underwriting gains—one-half currently and the other half when made available to shareholders—both the House bill and your committee's amendments impose a tax on a type of income not subject to tax under the 1942 formula or under the more recently applicable stopgap formulas.

To aid new, small, and growing businesses, the bill contains a number of special features. A full offset for underwriting losses (except for certain deductions) against taxable investment income and a special small business deduction, which under the House bill is equal to 5 percent of investment income and under your committee's bill is equal to 10 percent of investment income (in both bills, up to a maximum deduction of $25,000), are among a few of these special features. A full list appears under heading II–E below, "Reasons for the Bill."

For future years, both the House bill and your committee's amendments provide an exemption for investment income allocable to qualified pension fund reserves under the investment income tax base

of phase 1. This treatment is provided in view of the exemption presently available for pensions provided through "trusteed" plans. The exemption is made effective in three steps over the period 1959 to 1961, being one-third effective in 1959, two-thirds effective in 1960, and fully effective in 1961.

The bill as amended by your committee is expected to result in approximately $500 million in Federal income taxes being paid by life insurance companies with respect to the calendar year 1958 as contrasted to $558 million under the House bill. These figures can be compared with the $500 million which would be paid if the 1942 formula were continued, or the $319 million which would be paid if the 1955 stopgap formula were made applicable. About 69 percent of the $500 million provided under your committee's bill for 1958 will be paid by mutual insurance companies and the remaining 31 percent by stock life insurance companies. For 1959 it is expected that under the bill as amended by your committee life insurance companies will pay about $535 million in Federal income taxes, without taking into account collections to be derived from the tax under phase 3 on distributions to stockholders or the tax on capital gains.

II. REASONS FOR THE BILL

Since 1921, life insurance companies have been taxed only on their net investment income. They have been taxed, under one formula or another, on what has been considered the life insurance company's share of this income as distinct from the policyholders' share. From 1921 through 1941, the division of the net investment income between the company and the policyholders was determined by applying specified rates of interest to the reserves each company individually held for its policyholders. Since 1942, however, the policyholders' share of investment income has been determined on an industrywide, rather than individual company, basis. The formula which would apply for the calendar year 1958 and subsequent years, in the absence of any action by Congress, is the so-called 1942 formula. This is the formula which was in effect for the period 1942 through 1948. For the period 1949 through 1957, so-called stopgap formulas were applicable. The most recent of these was the 1955 stopgap formula which applied for the year 1955 and was extended to 1956 and 1957.

Your committee agrees with the report of the House committee that both the 1942 formula (which would be applicable to 1958 and subsequent years in the absence of any action to the contrary) and the 1955 formula contain serious inadequacies which it would be unfortunate to perpetuate in any permanent system for the taxation of life insurance companies. Testimony of the Assistant to the Secretary of the Treasury, appearing before your committee in its hearings on this bill, made it clear that the Treasury Department joins in this view.

The principal problems presented by the 1942 formula, and also by the 1955 stopgap formula, are outlined in headings A and B below. However, the 1955 stopgap formula in addition would result in the collection of an inadequate share of total tax revenues from life insurance companies. Under the 1955 stopgap formula, revenues of only

about $319 million would be obtained from life insurance companies with respect to the calendar year 1958, while the 1942 formula would produce tax revenues of about $500 million. Another difficulty with the arrangement for the taxation of life insurance companies which has applied in the past several years is the temporary nature of the formulas which have been made applicable since 1948. The year-by-year extension of stopgap treatment has created uncertainty as to the tax treatment of life insurance companies and these companies frequently have not known until after the end of the year in question what their Federal tax burdens would be for that year. This uncertainty can be removed only by finding a permanent means of taxing life insurance companies, and to achieve this result it was necessary to reexamine the basic problems which have arisen in connection with their taxation

A. Determining life insurance company's share of investment income

One of the major problems in the tax treatment of life insurance companies has been the determination of what constitutes the life insurance company's share of the investment income. Both the 1942 fromula and the various stopgap formulas which have been applied since 1948 have determined the policyholders' share of the investment income on an overall or industrywide basis. In these cases the policyholders' share under one formula or another has been computed for the entire industry and then this has been expressed as a percentage of net investment income of the entire industry. Each company then applied this ratio to its own investment income to determine the portion treated as belonging to the policyholders and the portion treated as taxable to the life insurance company. An industrywide ratio is an inadequate method of dividing investment income between policyholders and the company since an individual company's division of income between policyholders and the company may vary widely from the average division of investment income for the industry as a whole.

Under the 1942 formula the ratio of investment income deemed needed for the policyholders was determined by the Secretary of the Treasury in accordance with a statutory formula, based in part (35 percent) on the prior year's industry average interest requirements and in part (65 percent) on the assumption that interest requirements would equal interest at 3¼ percent of total industry reserves. Once the Secretary computed the policyholder's requirements for the entire industry, a ratio was obtained by expressing this amount as a percentage of net investment income for the entire industry. This 1942 formula, if applied for 1958, would give a ratio of 75.53 percent, which would be the percentage of net investment income deemed set aside for policyholders and not taken into account in the taxation of each life insurance company. Therefore, the life insurance company's share of the net investment income on which it would be subject to tax in 1958 under the 1942 formula would be 24.47 percent of each company's net investment income. The 1955 stopgap formula permitted companies to set aside 87½ percent of the first million dollars of net investment income to meet the needs of policyholders and 85 percent of any remaining income. Thus, under this formula, a life insurance company's share of the net investment income on which it would be taxable would be 12½ to 15 percent.

Your committee agrees with the House that both the 1942 and the 1955 formulas are undesirable as permanent solutions since they

measure the sharing of the investment income between the policyholders and the company on the basis of an overall or industrywide norm instead of on the basis of the varying portion of the investment income which individual companies may need to set aside for policyholders. In addition, your committee agrees with the House that there is no reason for setting aside 85 to 87½ percent of investment income for policyholders when a smaller proportion of the investment income adequately provides for reserve requirements.

To meet this problem, your committee's bill, like the House bill, determines the portion of investment income to be set aside for policyholders on an individual company basis. However, the formula used in your committee's bill differs from that in the bill as passed by the House. Your committee's amendments determine the portion of the investment income which represents the policyholder's share by applying a company's average rate of earnings in the current year and 4 prior years to the reserves it set up for the policyholders, adjusted to the level they would have been had they been set up on the basis of this earnings rate. The House bill makes use of the earnings rate in a similar fashion (but only the current year's earnings rate, not the average rate for 5 years). However, this is only weighted 50 percent in the computation under the House bill. Equal importance is given under the House bill to the assumed rate of each individual company (or the industry average assumed rate, if this is higher) on which the existing reserves are based. Your committee concluded, after considering the matter very carefully, that it was not desirable to make use of assumed rates, either the company's own individual rate or the industry average, in determining the policyholder's share of the investment income. These assumed rates not only vary from company to company but also can be either increased or reduced by individual companies as they see fit. Moreover, testimony before your committee indicated that permitting the use of the industry average assumed rate for some companies gives such companies an advantage over their competitors who under the House bill use their own assumed rate.

Your committee concluded that it was appropriate to determine the reserve interest rate used in determining the policyholders' share of the investment income on the basis of each company's average investment earnings rate because of the view that the competitive pressures within the industry will in the long run force various companies to build into their price structure for their policies a credit for interest on something like this basis.

Your committee's amendments also differ from the House bill in that under the amendments there is a determination on one hand of the policyholders' share of the investment income and the life insurance company's share on the other hand. The procedure (which is described more fully in the general explanation of the bill below) in general terms first determines policyholders' requirements and then expresses this as a percentage of investment yield (gross investment income less investment expenses). This percentage is then applied to each and every item of income and expense in determining the policyholders' share, including such items as tax-exempt interest, intercorporate dividends received, etc. Conversely, the difference between this percentage and 100 percent is applied to each and every item of income and expense in determining the life insurance company's share,

and it is only such share of the various income and expense items which is taken into account in determining the company's share of taxable investment income. The House bill, on the other hand, does not follow the procedure of dividing the investment income between the policyholders and the life insurance company. Instead, it first determines net investment income and then allows a deduction of a specific amount for policy and other contract liability requirements. This deduction under the House bill is then reduced by the portion of any tax-exempt income, partially tax-exempt income, and intercorporate dividends received (which were allowed as deductions in full in arriving at net investment income) which under the House bill are determined as being properly allocable to policy and other contract liability requirements rather than to taxable investment income. Your committee believes that the division of income and expense items between the policyholders and the insurance company, with only the latter being taken into account for tax purposes, is a much better concept to follow. It also makes it clear that items which are properly exempt or deductible, such as tax-exempt State and municipal bond interest, partially tax-exempt Federal bond interest, and 85 percent of intercorporate dividends received, are properly divided between the policyholders and the life insurance company and that as far as the latter is concerned, namely, the only portion included in the tax base, full allowance is made for these items. The bill also provides that if it is established in any case that the application of the definition of taxable investment income results in the imposition of tax on any tax-exempt income, any part of the thirty fifty-seconds of any partially tax-exempt interest, or any part of the 85 percent dividends received deduction, adjustment is to be made to the extent necessary to prevent such an imposition of tax. The above discussion of this problem is in terms of the revision of the bill made with respect to the investment income tax base. The bill also makes similar revisions in the phase-2 tax base which takes into account investment income as well as underwriting gains.

B. Taxing underwriting gains

Perhaps the most significant defect in the various formulas which have been employed since 1921 in the taxation of life insurance companies is the fact that all of them have been based only on investment income and, therefore, have omitted from the tax base significant elements of income and loss. This omitted segment, for convenience, may be called "underwriting" income or loss. Under both the House bill and your committee's bill, this underwriting income (or loss) is measured as the difference between the gain or loss from total operations of the company and the taxable portion of its investment income. By and large, this income arises from premium charges which are in excess of the charges required to meet that part of the claims of policyholders and their beneficiaries which is not covered by the portion of the investment income set aside for policyholders. This element of underwriting gain is referred to as mortality gains. Another element of underwriting income or loss may arise because the amount included in the premium to cover expenses of the policy is either larger or smaller than the actual expenses incurred during the life of a policy. This element of underwriting gain or loss is frequently referred to as loading income or loss.

Where there is this underwriting gain arising from premium charges in excess of amounts ultimately required to meet claims and expenses, and the excess is paid out to stockholders, it would appear that there is income which is properly classified as corporate income for tax purposes. Similarly, where this underwriting income is held in surplus, these savings are substantially equivalent in effect to surplus derived through any retained earnings. Moreover, since 1921, there has been a steadily increasing tendency within the industry to stress policies which involve relatively little of the investment element and a larger portion of the pure insurance element. In such cases the income is largely underwriting income. It has developed that many companies known as specialty companies, issuing a relatively large number of policies without a significant investment element, have been taxable on income which is only a small fraction of the total income they report on their own books. On the other hand, it also has developed that many insurance companies have shown a loss on their total operations, yet have still been subject to Federal income tax on the basis of a formula which looked only at their investment activity and not at their total activity.

Although it is believed desirable to subject this underwriting income to tax, it is stated that because of the long-term nature of insurance contracts it is difficult, if not impossible, to determine the true income of life insurance companies otherwise than by ascertaining over a long period of time the income derived from a contract or block of contracts. Because of this, the bill as amended by your committee, like the bill as passed by the House, does not attempt to tax on an annual basis all of what might appear to be income. In both the House and your committee's bill, half of the underwriting income is taxed as it accrues each year. The other half of the underwriting income is taxed when it is paid out in a distribution to shareholders after the taxed income has been distributed, or when it is voluntarily segregated and held for the benefit of the shareholders. This other half of the underwriting income also is taxed if the cumulative amount exceeds certain prescribed limits or if for a specified period of time the company ceases to be a life insurance company.

Although for many companies taking underwriting gains or losses into account means a larger tax base, for many other companies, particularly small, new and growing life insurance companies, having underwriting losses rather than gains, the inclusion of this underwriting element in the tax base means a lesser, rather than a greater tax. The small, new, and growing life insurance companies are particularly likely to have underwriting losses because of the initial costs which they incur (such as agents' commissions) in placing new policies on their books. Both the House and your committee's bill are particularly liberal in these cases since they allow the offset of these underwriting losses in full against taxable investment income (subject to certain restrictions as to the deduction of policyholder dividends, etc.) and do not require the 50 percent reduction in such losses which would be made if they were gains.

C. Exemption of income on pension plan reserves

In determining the share of the investment income to be attributed to the policyholders and, therefore, not subject to taxation with respect to the life insurance company, one element taken into account

both under your committee's bill and in the bill as passed by the House is the investment income earned in connection with reserves accumulated for qualified employer pension and profit-sharing plans. In determining this element, which is not to be taken into account in determining the tax base of the life insurance company, both versions of the bill provide that an amount is to be attributed to the policyholders equal to the current earnings of the company on its book reserves held for qualified pension and profit-sharing plans. To the extent that the insurance company holds additional amounts of surplus to cover its contingencies under these qualified plans, the investment income on the surplus will still be subject to tax at the corporate rates in the hands of the company. This will also be true to the extent that such income enters into the underwriting income tax base and is not paid out in the form of policyholder dividends. Likewise, a tax will still be imposed at the company level to the extent of any capital gain tax attributable to this income.

The favorable treatment for qualified pension and profit-sharing business is believed desirable in view of the fact that investment earnings of a qualified pension or profit-sharing trust are completely exempt from tax while they are accumulated in the trust. Generally speaking it is the smaller employers who are forced to set up insured pension plans rather than trusteed pension plans, because of the greater risk and higher ratio of expenses connected with the operation of a small trust. A higher tax on similar earnings in the hands of insurance companies than is provided in the case of trusteed plans therefore is generally discriminatory against small businesses. This accounts for the treatment provided by both the House bill and your committee's bill. However, this favorable treatment is not made fully applicable until 1961. During 1959 this special pension treatment will be applicable to one-third of the company's pension reserves and in 1960 it will be applicable with respect to two-thirds of such reserves. Thus, life insurance companies not already in this business will have an opportunity to expand their sales of this type of business during this interval before the special pension treatment becomes fully applicable.

D. Capital gains and losses

In the past, capital gains have not been taxed to life insurance companies (on their life insurance business) and capital losses have not been available as offsets against ordinary income in any respect. Both the House bill and your committee's bill correct this omission of prior law by taxing capital gains for the calendar year 1959 and subsequent years. However, under the bill net long-term capital gains (in excess of net short-term capital losses) are taxed at a flat 25 percent rate, and because of complexities which would be involved no alternative tax computation is provided. In order to prevent the imposition of a tax with respect to appreciation in value which has occurred prior to 1959, the bill provides that capital gains (but not capital losses) are to be determined by using the regular cost or other basis for the property or their fair market value on December 31, 1958, whichever is higher. Net short-term capital gains (in excess of net long-term capital losses) are included in the regular investment income and underwriting gain for tax bases for years beginning after December 31, 1958.

E. Special features for small and new businesses

The bill as passed by the House contained a number of features designed to especially benefit small and new life insurance companies. Amendments made by your committee have expanded these benefits still further. Although the bill, both in the form in which it passed the House and as amended by your committee, increases the tax burdens of life insurance companies substantially, your committee has been careful to ascertain that this increase in tax burdens will not impede the growth of small and new life insurance companies. In addition to the 30 percent tax rate which applies under existing law to the first $25,000 of income for corporations generally, the bill as amended by your committee contains the following eight features especially designed to benefit small and new businesses:

1. In the computation of the tax base a special deduction is allowed for 10 percent of the investment yield (gross investment income less investment expenses) up to a maximum of $25,000. A similar deduction was allowed under the House bill except that the deduction was 5 percent instead of 10 percent.

2. Both the House bill and your committee's bill provide that in determining the policyholder's share of the investment income a downward adjustment is to be made to the policyholder reserves to the extent the interest rate used is above the company's assumed rate. Both the House bill and your committee's amendments provide that the downward adjustment in reserves is to be determined by adjusting them downward 10 percent for every 1 percent the interest rate used is above the individual company's assumed rate. Because the business of small, new companies has not matured, this formula is much more generous in their case than for the well-established companies.

3. Where there is a loss from underwriting operations, both the bill as passed by the House and as amended by your committee provide that this loss (but with certain limitations as to the deduction of policyholder dividends, the special deduction for nonparticipating policies, and the 2-percent deduction for group insurance) may be offset in full against the investment income tax base even though, if there were a gain from the underwriting operations, only half of this would be taxed currently. This is likely to be more beneficial to small and new businesses than to their well-established competitors because such companies generally are incurring large expenses (such as agents' commissions) in attempting to expand the business on their books.

4. Generally, policyholder dividends, the deduction for 10 percent of additions to certain reserves on nonparticipating contracts (or 3 percent of premiums on these policies) and the deduction for 2 percent of premium receipts from group insurance are not available as deductions to the extent that they may result in an underwriting loss and thus generally may not be offset against the investment income tax base. However, your committee has amended the House bill in this respect to permit the deduction of such items where they result in an underwriting loss up to a maximum of $250,000. This will be of primary benefit to the smaller companies.

5. Your committee has amended the bill to provide that net operations losses may be carried forward from the years 1955, 1956, and 1957 instead of from 1958 forward. New and small business are the

companies more likely to have had losses during this period and therefore will be the primary beneficiaries of this amendment.

6. Your committee has amended the bill to provide a 10-year carryforward of net operations losses incurred by new businesses in the first 5 years of their existence.

7. In the case of the half of underwriting gains which is not taxed currently, the bill as passed by the House requires a payment of tax if the cumulative amount with respect to which the tax was deferred equals more than 25 percent of life insurance reserves (or 60 percent of premiums). The limitation with respect to reserves was decreased by your committee from 25 percent to 15 percent, but your committee added, as an alternative, a ceiling of 25 percent of additions to reserves since 1958. This new alternative will benefit new and small businesses relative to those who already had well-established reserves prior to 1959.

8. The House and your committee's bill provide that those establishing their reserves on a "preliminary term" basis may nevertheless for tax purposes convert this to the more liberal "net level premiums" basis. This is of primary importance to the smaller companies since it is such companies which predominantly are the users of the preliminary term method.

F. Relative treatment of mutual and stock companies

A special problem is presented in the case of life insurance companies by the fact that a large portion of the life insurance business is carried on by mutual companies. The comparative taxation of mutual and stock companies is, of course, generally a difficult problem, but is magnified in the case of life insurance companies by the fact that mutual insurance companies for the most part represent the larger insurance companies, currently accounting for 63 percent of the life insurance in force and 75 percent of the total assets of the life insurance industry. Here the basic question is whether amounts which are distributed back to the policyholders as dividends are properly a part of the life insurance company's tax base.

The treatment accorded policyholder dividends in large measure will account for the relative distribution of tax burden between mutual and stock companies. If the tax with respect to life insurance companies were based exclusively upon gains from operations (including but not limited to investment income) and full deduction were allowed for policyholder dividends, based on 1958 data, stock companies would pay approximately 42 percent of the total tax burden and mutual insurance companies the remaining 58 percent. On the other hand, if the tax base of insurance companies is investment income only, and there is no allowance for policyholder dividends (such as under either the 1942 formula or the 1955 stopgap formula), stock life insurance companies, again based on 1958 data, would pay approximately 25 percent of the total tax burden and mutual insurance companies the remaining 75 percent. The bill as reported by your committee, like the bill as passed by the House, in effect combines these two basic tax methods. Under your committee's bill stock life insurance companies for 1958 will pay approximately 31 percent of the total tax burden, while mutual insurance companies will pay the remaining 69 percent. Under the House bill the distribution of the tax burden was only slightly different. The slight shift of burden under your committee's action is due primarily to an amendment it made easing

the burden of all companies under the investment income base. Since mutual companies pay a larger portion of the tax on investment income than stock companies, this has the effect of shifting slightly the percentage distribution of the total tax burden between these two groups of companies.

Both the House and your committee have been concerned with the competitive problem between stock and mutual companies and several features of the bill deal with this problem. Under both the House bill and your committee's bill, the life insurance company's entire share of investment income is subject to tax without the allowance of any reductions for policyholder dividend distributions (with a limited exception under your committee's bill for small mutual companies where there are underwriting losses). On the other hand, only half of the underwriting gain, computed by allowing the deduction of dividends to policyholders, is taxed currently. Taxing both mutual and stock insurance companies on their full share of investment income in effect means that this income is taxed to the companies whether or not it is distributed as dividends to policyholders. Moreover, your committee's bill provides that although, generally, underwriting losses can offset investment income otherwise subject to tax, underwriting losses attributable to policyholder dividends (and certain other compensating deductions for stock companies) cannot be offset against the investment income tax base except in the case of a limited offset provided for small mutual companies. This restriction is provided so that policyholder dividends will not create more than a limited underwriting loss which may be offset against taxable investment income. Thus, it will not generally be possible for mutual companies to reduce their investment income tax base by distributions to policyholders. In general, mutual companies will pay a tax on their share of investment income whether or not it is distributed to policyholders.

In addition to limiting the extent to which policyholder dividends may create underwriting losses which may be offset against the investment income base, the underwriting income tax base itself is modified to reduce the relative impact of policyholder dividend distributions. Thus, a special 10 percent deduction is allowed with respect to the reserves on nonparticipating life insurance business (or, alternatively, a deduction of 3 percent of the premiums on these policies). This deduction is designed to compensate stock life insurance companies for the fact that they do not have the "cushion" of redundant premiums (which, if the business does not go well, a mutual company can use to offset losses but otherwise are subsequently paid back as policyholder dividends).

G. Revenue effect

Table 1 shows the revenues which will be derived from the bill as amended by your committee for 1958 as compared with the amount which would be derived under the bill as passed by the House, and as compared with revenues under the 1942 formula and under the 1955 stopgap formula. The taxes imposed with respect to life insurance companies under the bill as amended by your committee with respect to 1958 are expected to result in the receipt of approximately $500 million, or about the same as under the 1942 formula. This is about $58 million less than would be derived under the House bill, primarily because of the amendment adopted by your committee

substituting for the deduction rate under the House bill an earnings rate based upon the average interest earned in the current and last 4 years. The $500 million expected to be derived under your committee's bill in 1958 is substantially larger than the $319 million which it is expected would be derived under the 1955 stopgap formula if that were made applicable. The table also shows the relative distribution of the tax burden between mutual and stock companies.

TABLE 1.—*Estimated total revenue to be derived for 1958 from life insurance companies under the bill as amended by your committee, under the bill as passed by the House, under the 1942 formula, and under the 1955 formula; and distributions of these revenues between stock and mutual insurance companies*

[Amounts in millions of dollars]

	Total receipts	Mutual companies		Stock companies	
		Amount	Percent	Amount	Percent
1942 formula	$500	$375	75	$125	25
1955 formula	319	239	75	80	25
The House bill:					
Phase 1	518	386	74.5	132	25.5
Phase 2	40	1	2.5	39	97.5
Total under the House bill	558	387	69.3	171	30.7
The bill as amended by your committee:					
Phase 1	460	345	75	115	25
Phase 2	40	(1)	(1)	40	100
Total under the bill as amended by your committee	500	345	69	155	31

[1] Negligible.

For 1959, under your committee's amendments, taxes imposed with respect to life insurance companies are expected to result in collections of about $535 million without taking into account increases arising from the capital gains tax and the tax under phase 3, both of which become effective in whole or in part for the first time with respect to that year. At the present time there is no suitable basis for making an estimate as to revenues to be derived from these two special features. The estimate for 1959 liabilities of insurance companies, on the one hand, includes a revenue reduction of roughly $20 million, attributable to the pension plan exemption which becomes one-third effective for that year. On the other hand, the 1959 estimates include increases which are expected to bring about a net increase of nearly $30 million. Most of this increase represents a higher earning rate which is anticipated for the industry, coupled with a further expansion in the amount of life insurance business. Another factor in this increase is certain accounting adjustments which are expected to result in an increase in revenues of about $5 million in each of the 10 years immediately ahead.

III. EXPLANATION OF BILL

Under both the House and your committee's versions of the life insurance company tax bill of 1959, a three-phase procedure is provided for the taxation of life insurance companies.

The phase 1 portion of the tax base represents the life insurance company's share of the investment income less investment expenses. The life insurance company's share of this income is the portion of each item not set aside for the policyholders.

The phase 2 portion of the tax base represents 50 percent of the excess of total net income from all sources ("gain from operations") over taxable investment income. This excess is referred to here as underwriting gain. In general terms this underwriting gain consists of mortality and loading savings; that is, savings resulting from fewer deaths per thousand at various age groups than were assumed in establishing premiums and reserves, and any reduced expenses of servicing policies and expenses incurred in "putting policies on the books below estimates made in fixing premiums." This "underwriting income" also includes a portion of investment income which is not taxed under phase 1 (attributable to the difference between using the company's own required rate rather than its average earning rate as in phase 1). Nevertheless the mortality and loading savings are the important aspects of this phase 2 tax base. If there is an underwriting gain from these sources, half of this income is added to the phase 1 tax base.

However, if there is an underwriting loss, the entire loss is deducted from the taxable investment income as otherwise determined under phase 1. Expressed differently, this means that the combined tax base under phases 1 and 2 is not to exceed the overall gain from operations (the sum of any gains derived from the combination of taxable investment income and underwriting operations). An underwriting loss (as determined by the company) is not viewed as an underwriting loss which can reduce the tax base, however, to the extent that it consists of policyholder dividends in excess of $250,000. (Also, in this $250,000 maximum are the 10 percent deduction for nonparticipating policies, or the 3 percent on premiums from such policies and the 2 percent deduction for group insurance, discussed under B below.)

The phase 3 portion of the tax base is designed to give assurance that underwriting gains made available to shareholders will be subject to the full payment of tax. Thus, this phase is concerned with that part of underwriting income which under phase 2 is not added to the tax base, including the 10, or 3, percent and the 2 percent deductions. This amount which has not previously been taxed is added to the tax base of the insurance company when there is distributed to shareholders a part of that income (less the tax on it), when the accumulated untaxed income exceeds certain limitations, when the company elects to be taxed on that income, or when for a specified period of time the company no longer qualifies as an insurance company. Generally, however, distributions first may be made to the shareholder with respect to the amounts which have been taxed currently without subjecting the company to a phase 3 tax.

The portions of the tax base determined under the three phases are added together and the regular 52 percent corporate rate is applied (with the 30 percent rate applying to the first $25,000 of taxable in-

come). In addition, a separate 25 percent tax is imposed with respect to net long-term capital gains (in excess of net short-term capital losses).

Some provisions of the bill come into effect gradually. The bill provides that the phase 1 tax base is to apply for 1958 and subsequent years. The phase 2 tax base also is to apply for 1958 and subsequent years, but under your committee's amendments relief under this phase is to be provided for the year 1958. For any company whose phase 2 tax base for that year exceeds its phase 1 tax base (that is, where the "gain from operations" is more than twice the "taxable investment income") the phase 2 tax base is to be reduced by 10 percent of this excess. The capital gains tax applies with respect to the calendar year 1959 and subsequent years. The phase 3 tax base is one-third effective for the calendar year 1959, two-thirds effective for the calendar year 1960, and fully effective thereafter. The exemption for qualified pension plan reserves under phase 1 also is made available over a 3-year period, being one-third effective in 1959, two-thirds effective in 1960, and fully effective thereafter.

A. Phase 1.—Taxable investment income

1. *General explanation.*—Phase 1 first provides that the policyholder's share of every item of investment yield is not to be taken into account in computing the taxable investment income of the life insurance company. Investment yield is gross investment income, less investment expenses, but includes tax-exempt interest, partially tax-exempt interest, and dividends received. Thus, only the life insurance company's share of each of these items is to be taken into account in computing taxable investment income. The policyholder's share of each of these items is determined by dividing the policy and other contract liability requirements by the investment yield. The insurance company's share is the remaining portion.

2. *Gross investment income.*—The first step is to determine gross investment income. Gross investment income, under both the House and your committee's version of the bill consists of interest, dividends, rents, royalties, etc., net short-term capital gains (after 1958), and income from the operation of a trade or business (other than from the insurance business itself).

3. *Investment yield.*—Under your committee's amendments, the next step is to determine investment yield. Investment yield is gross investment income, less investment and similar expenses. As under the House bill, your committee's bill, in allowing the deduction of investment expenses, makes provision for a more adequate allowance for mortgage fees and services (including mortgage origination fees) than previously has been provided. The other "similar expenses" which under both the House bill and your committee's bill are deductible are real estate expense, depreciation, depletion, and trade or business deductions but only to the extent these deductions relate to the investment income and not to income of the insurance business as such. Other items, which under the House bill were allowed as deductions in arriving at investment income namely, tax-free interest, thirty fifty-seconds of partially tax-free interest, 85 percent of intercorporate dividends received, and the small business deduction are provided for elsewhere under your committee's bill.

4. *Policy and other contract liability requirements.*—After determining investment yield, the next step is to determine the policyholders' share

of this yield which is not taken into account. The remainder is the life insurance company's share which is taken into account. This sharing between the policyholder and the life insurance company is determined by the percentage relationship of the "policy and other contract liability requirements" to the investment yield. These requirements are similar to what is referred to as the "policy and other contract liability deduction" under the House bill, although your committee has made certain substantive changes. As in the House bill, the policy and other contract liability requirements consist of the sum of three items: Certain investment earnings not taken into account in taxing the life insurance company because they are allocated to the life insurance reserves for policyholders; the investment earnings attributable to pension plan reserves; and the interest paid on such things as supplementary contracts and dividend accumulations, and on indebtedness generally.

One of the principal changes made by your committee's amendment of the House bill relates to the method of determining the amount of investment income set aside with respect to life insurance reserves. Your committee's amendments provide that the interest rate to be applied in determining this amount is to be the average rate of interest earned on assets (other than those used in carrying on the insurance trade or business) in the current and 4 prior taxable years. The House bill also used the earnings rate for the current year but did not depend entirely on this. Under the House bill the "deduction rate" was halfway between the current earnings rate and an assumed rate (either that of the individual company or that of the industry for the prior year, whichever was higher). The House bill also differed from your committee amendments in that the earnings rate used was only that of the current year rather than the 5-year average provided by your committee's amendments.

Your committee decided to use only the earnings rate because, as was pointed out in its hearings, there are certain problems in the use of an assumed rate. For example, allowing a company to use its own assumed rate to some extent still makes it possible for a company to vary its own tax burdens by making liberal or conservative evaluations as to its reserve needs. On the other hand, allowing a company to use an industry average assumed rate means to some extent that the arbitrariness of an industrywide formula such as was used in the laws applicable from 1942 to 1955 would still remain as a factor. Also, complaints were made in your committee's hearings that the industrywide average unduly favored certain large companies which used a low rate of interest in establishing their reserves. These companies would be able to obtain a larger deduction under phase two by reason of larger additions to reserves, yet could not be limited in phase one to the corresponding smaller interest additions, since they could use the higher industry average assumed rate. Your committee concluded, however, that rather than use the earnings rate of a single year, it would be more appropriate to use a 5-year average to prevent sharp rises or declines in this rate.

As under the House bill, once the interest rate is determined, the next step is to determine the adjustment in the life insurance reserves. This is computed by taking the difference between the interest rate to be used in computing the policy requirements and the rate assumed by the company in establishing its own reserves. Then, based upon

a rule demonstrated by industry experience, the reserves of the company are adjusted downward by 10 percent for every 1 percent by which the average earnings rate (or deduction rate under the House bill) exceeds the company's own assumed rate (or vice versa). The policy and other contract liability requirements then are determined by multiplying the life insurance reserves as so adjusted by the average earnings rate (deduction rate under the House bill). The adjustment is made to life insurance reserves to restate, in effect, the reserves as they would have been if the average earnings rate of the company (or deduction rate under the House bill) had been used by the company in establishing these reserves.

The amount set aside and not taken into account with respect to pension plans is substantially the same as under the House bill. The amount set aside for this purpose is the average pension plan reserves multiplied by the current earnings rate. The set-aside of this amount with respect to pension plan reserves is designed to remove discrimination against pension plans of small employers who are likely to be insured through insurance companies. At the present time where an employer is large enough to establish a trusteed pension plan, entirely separate from the insurance company, investment income received by such a trust (in the case of a qualified pension plan) is free of income tax. Not taxing investment income attributable to qualified pension plan reserves, therefore, equates with this the treatment provided the smaller employers who establish plans through insurance companies because they cannot afford to establish separate trusteed pension plans. No set-aside is provided for, however, with respect to earnings on the portion of surplus attributable to pension fund business, nor, under phase 2, is any special deduction provided with respect to pension plans. (However, in phase 2 a deduction is in effect obtained to the extent that amounts are paid out with respect to the pension plans as dividends to policyholders.) In the case of the separate capital gains tax, no special deduction is permitted with respect to pension plan reserves since this is a low-rate tax applying without special allocations. As indicated above, this treatment for pension plan reserves is available for reserves related to qualified pension plans meeting the tests as to nondiscrimination provided in section 401 and following. In addition, under your committee's amendments this is to be available with respect to reserves relating to annuities for employees of an organization which qualifies for exemption under section 501(c)(3) as an educational, charitable, or religious organization.

The special amount set aside with respect to qualified pension plan reserves does not become fully effective until the calendar year 1961. In 1958 no special set-aside is provided; in 1959 the special rules are to be applicable to one-third of the pension fund reserves; and in 1960 to two-thirds of those reserves.

The amount taken into account in determining policy and other contract liability requirements with respect to interest paid is the same under your committee's amendments as under the House bill with the exception of one provision added by your committee. Deductions in this case are allowed for interest paid on indebtedness, discounts on prepaid premiums to the extent of the accrual during the year, and interest paid on insurance or annuity contracts for which no provision is made in the life insurance reserves. This latter category includes interest paid on supplementary contracts and policyholder dividends which the policyholders have allowed to accumulate

in the company. In addition, your committee has added a provision to make it clear that interest added by a life insurance company to special contingency reserves required by section 8(d) of the Federal Employees Group Life Insurance Act of 1954 are to be included in this category. All of the interest payments included under this provision are similar in nature to the deduction for interest paid or credited on deposits by a bank and therefore properly are not taken into account in determining the income of the life insurance company making the payment.

The sum of the three amounts referred to above—namely, the amount set aside with respect to earnings on life insurance reserves, the amount set aside with respect to earnings on pension plan reserves, and the amount set aside with respect to interest paid—constitute the policy and other contract liability requirements.

5. *Taxable investment income.*—Under your committee's amendments the taxable investment income of a life insurance company is the life insurance company's share of each item of investment yield, with certain reductions. The life insurance company's share of investment yield is the amount remaining after setting aside the policyholder's share of investment yield. The policyholder's share of the investment yield is the percentage of this investment yield represented by the policy and other contract liability requirements. Thus, the insurance company's share of the investment yield is the difference between this percentage and 100 percent.

Included in this investment yield which is divided between the policyholder and the life insurance company is tax-exempt interest on State and municipal bonds, partially tax-exempt Federal bond interest, and 85 percent of dividends received with respect to which a deduction is available. To arrive at taxable investment income of the life insurance company, its share of investment yield is reduced by its share of this tax-exempt interest, partially tax-exempt interest, and 85 percent dividends received deduction. The purpose of your committee in providing this treatment is to exempt a life insurance company from tax on any tax-exempt interest, on thirty fifty-seconds of partially tax-exempt interest, and on 85 percent of dividends received. To give further assurance that no tax is to be imposed on tax-exempt interest and the other items, your committee has added a special paragraph to the bill providing that if the application of the definition of taxable investment income does result in the imposition of tax on tax-exempt interest, on the thirty fifty-seconds of partially tax-exempt interest, or on the 85 percent of dividends received, adjustment is to be made to the extent necessary to prevent any such imposition of tax.

A further deduction allowed in arriving at taxable investment income is the so-called small business deduction. Under your committee's bill this is 10 percent of investment yield but not more than $25,000. Under the House bill a special small business deduction was allowed equal to 5 percent of a company's net investment income up to a ceiling of $25,000. The small business deduction is patterned after the 2½ percent differential provided on the first $1 million of net investment income under the 1955 stopgap formula. The substitution of the 5 percent by the House bill for the 2½ percent increased the relief for small companies which do not reach the $25,000 ceiling,

and the additional increase of this percentage to 10 percent which was made by your committee still further increases the relief for such small companies. By retaining the $25,000 ceiling, the additional relief provided by your committee is entirely confined to the smaller life insurance companies.

6. *Summary of changes made in phase 1 by your committee's amendments.*—The principal changes made by your committee in the phase 1 tax base already have been described above. They can be summarized, however, as follows:

(*a*) The House bill determined the net investment income of the company as being the whole of the gross investment income less all the exempt interest, the deduction for partially exempt interest, and the entire deduction for dividends received. From this a deduction was allowed for policy and other contract liabilities. Under the House bill, however, this deduction was reduced to the extent that this deduction was attributable to the already deducted tax-exempt interest, partially tax-exempt interest, and intercorporate dividends received. Under your committee's amendments, on the other hand, there is a determination of the life insurance company's share of the investment income less investment expenses. Then this is reduced by the life insurance company's share of tax-exempt interest, thirty fifty-seconds of the partially tax-exempt interest, and 85 percent of the intercorporate dividends received. In addition, your committee's bill by a special proviso makes it clear that in no case is any tax to be imposed on tax-exempt interest, on the thirty fifty-seconds of partially tax-exempt interest, or on the 85 percent of the dividends received.

(*b*) Your committee's amendments determine the life insurance reserve requirements by employing a 5-year average earnings rate rather than by using a deduction rate which is halfway between the current earnings rate and the company's own assumed rate (or the industry assumed rate for the prior year, if higher).

(*c*) Pension reserves, the earnings on which are in effect excluded from tax, under your committee's amendments are defined as including not only reserves for qualified pension plans, but also reserves for annuities of educational, charitable, and religious organizations described in section 501(c)(3) of the code.

(*d*) Under your committee amendments the interest paid, included in the policy and other contract liability requirements, is defined as including interest paid on special contingency reserves provided for under the Federal Employees Group Life Insurance Act of 1954.

7. *Example of phase 1 tax computation.*—The computation of taxable investment income under the House bill and under the bill as amended by your committee can be illustrated by the following example. Assume the following with respect to a life insurance company:

Assets	$1,000,000
Reserves	$900,000
Investment yield (or net investment income before small business deduction under the House bill)	$40,000
Company's current earnings rate ... percent	4
Company's average earnings rate (for the current and 4 prior years) ... percent	3.75
Company's assumed rate ... do	2.5
Industry average assumed rate in prior year ... do	3

Under your committee's amendments the average earnings rate of 3.75 percent would be used in determining the policy and other contract liability requirements. Under the bill (both the House bill and the bill as amended by your committee) for every 1 percent of increase in the interest rate used, over the company's own assumed rate, the reserve is adjusted downward by 10 percent. Since here the 3.75 percent average earnings rate is 1.25 percentage points above the company's assumed rate of 2.5 percent, the reserve is adjusted downward by 12.5 percent. Thus, the $900,000 of reserves is reduced for purposes of this computation to $787,500. As a result, the reserve requirements in this case would be $787,500 multiplied by 3.75 percent or $29,531. Assuming that there was no "interest paid" and no pension trust reserves this $29,531 is the policy and other contract liability requirement. The next step is to express this requirement of $29,531 as a percentage of the $40,000 of investment yield. This is 73.8 percent of investment yield and, therefore, the life insurance company's share of the investment yield is 26.2 percent. That percentage of the investment yield (26.2 percent of $40,000) is $10,469. From that amount would be deducted the life insurance company's share of any tax-exempt interest, its share of 85 percent of any dividends received, and its share of thirty fifty-seconds of any partially tax-exempt interest, together with the small-business deduction of 10 percent (with a maximum deduction of $25,000) of investment yield. Thus, if $400 of the investment yield were tax-exempt interest, the company would be entitled to a further deduction of its share (26.2 percent) of this $400 or $105 (or a greater amount if this is not sufficient to prevent the imposition of any tax on tax-exempt interest). In addition, there would be the small-business deduction which is 10 percent of $40,000 or $4,000. Taking $4,105 from the company's share of investment yield results in a phase 1 tax base of $6,364.

Under the House bill, given the above assumptions, the "deduction rate" of the company would be 3½ percent (halfway between the company's current earnings rate of 4 percent and the industry average assumed rate of 3 percent, since the latter is higher than the company's own assumed rate). As under the House bill, the company's reserves are adjusted downward 10 percent for every 1 percent of difference between the company's own assumed rate and the rate of interest used. Since here the deduction rate is 1 percentage point above the company's own assumed rate, the reserve is adjusted downward by 10 percent, i.e., the reserve is adjusted downward from $900,000 to $810,000. As a result the reserve deduction in this case would be $28,350 ($810,000 multiplied by 3.5 percent). As stated in the assumptions, the net investment income is $40,000 before the small business deduction; reducing the $40,000 by the small business deduction (5 percent of $40,000 or $2,000) leaves $38,000 of net investment income. Deducting the policy and other contract liability deduction of $28,350 from this (assuming no deductions for interest paid or pension plan reserves) leaves a taxable investment income of $9,650.

The above illustration was based upon the assumption of no tax-exempt income. If, however, $400 of the company's income were tax-exempt interest, the company would be entitled to a further deduction of $400, but its policy and other contract liability deduction would be cut back by the amount of $400 multiplied by $\frac{\$28,350}{40,000}$

The amount of this cutback would be $283.50, leaving a net reduction in the tax base on account of this tax-exempt interest of $116, offset by a decrease of $20 in the small business deduction.[1] Thus, the taxable investment income would be $9,650 minus $96, or $9,554.

B. Phase 2.—Gains or losses from operations

1. *General explanation.*—The computation of gains and losses from operations is designed to arrive at the total income of the life insurance company. Thus, it includes receipts from all sources, including the life insurance company's share of investment income and also income derived from the operation of the insurance business itself. Against this are allowed the appropriate deductions, including those relating to the operation of a life insurance business and also deductions for special contingencies deemed necessary for life insurance companies. The amount obtained after subtracting from gross receipts the various deductions is known as gain (or loss) from operations. If the result is a gain from operations, the next step is to deduct taxable investment income as computed under phase 1, since this amount is already included in the life insurance company's tax base. The amount remaining is here referred to as underwriting gain since it in large part consists of mortality and loading savings. The mortality savings are those accruing from the fact that the deaths have not occurred as assumed in establishing the life insurance premiums and reserves. Loading savings are attributable to lower than estimated expenses for placing policies on the books and servicing them from that time on. In addition, however, what is here called underwriting income may also include minor amounts of investment income, since under phase 2 the life insurance company's share of the investment yield taken into account is determined on the basis of the company's own assumptions as to the interest required to be added to reserves rather than on the basis of the interest which would be added to reserves if based upon the 5-year average of the company's earnings rate.

After determining the underwriting gain, one-half of this amount is then added to the taxable investment income to obtain the combined tax base under phases 1 and 2. This 50 percent reduction in underwriting gains is made because it is difficult to establish with certainty the actual annual income of a life insurance company. It has been pointed out that because of the long-term nature of life insurance contracts, amounts which may appear as income in the current year, and as proper additions to surplus, may as a result of subsequent events be needed to fulfill life insurance contracts. Because of this difficulty in arriving at true underwriting gains on an annual basis, both the House bill and your committee's bill provide for the taxation of only 50 percent of this gain on a current basis.

The above discussion has dealt with the cases where there are underwriting gains. However, if there are underwriting losses (i.e., either the gain from operations is smaller than the taxable investment income or there is a loss from operations) the tax treatment varies. In this case the total tax base under phases 1 and 2 is to be the taxable investment income less 100 percent of any underwriting loss (or,

[1] Under the House bill the small business deduction is a percentage of net investment income after deduction of tax-exempt interest, etc. Therefore, assuming $400 of the $40,000 to be tax-exempt income reduces the small business deduction from $2,000 to $1,980.

stated differently, the amount of the gain from operations). It will be noted that in this case the underwriting loss is allowed in full as an offset against taxable investment income, even though, had there been a gain, only 50 percent of the underwriting gain would have been taken into account. The full offset of losses in this case is allowed so that companies with underwriting losses can obtain the tax benefit of these losses immediately rather than subsequently when, in the case of a stock company, reduced distributions are made to shareholders.

The tax base where the gain from operations is less than the taxable investment income (or where there is a loss from operations) can be viewed as substituting for the regular phase 1 and phase 2 tax bases the single item of gain from operations.

2. *Gross receipts.*—The first step is to determine gross receipts. Gross receipts for this purpose include premiums and other considerations on insurance and annuity contracts and also considerations for supplementary contracts. These premiums are reduced for return premiums and premiums arising out of reinsurance ceded. A second item in gross receipts is any decrease in life insurance reserves representing the release of funds formerly set aside for policyholders but no longer required for this purpose. A third category is the life insurance company's share of investment yield, and a fourth is other income received.

The investment income included under your committee's amendments is the life insurance company's share of investment yield (gross investment income less investment expenses). The life insurance company's share of the investment yield, for purposes of the phase 2 tax base, is the ratio of its own required interest to investment yield. Required interest represents the interest addition to reserves actually made by the company. Thus, it is the rate of interest assumed by the taxpayer in calculating its reserves multiplied by the average of its life insurance reserves for the year. The ratio used in phase 2 in determining the policyholders' and life insurance company's shares of investment yield differs from the ratio used in phase 1 in that the phase 1 computation makes use of the average earnings rate, thereby increasing somewhat the policyholders' share relative to what it is in phase 2, where the actual interest added to reserves is used. In the House bill there is no such specific deduction for required interest under phase 2 but instead this is taken into account in the deduction for increases in reserves. As under the phase 1 tax base, tax-exempt interest, thirty fifty-seconds of partially tax-exempt interest and 85 percent of intercorporate dividends received, to the extent of the life insurance company's share, are allowed as deductions in determining the life insurance company's share of investment yield included in the phase 2 tax base. Also allowed as a deduction from this income is the same small business deduction for which provision is made in phase 1.

3. *Deductions for claims, expenses, and additions to reserves.*—The deductions allowed against the gross receipts described above include claims and benefits paid to policyholders and their beneficiaries, expenses of operating the insurance business, and investment expenses, if any, to the extent not allowed in computing investment yield.

The deductions also include increases in life insurance reserves (and unearned premiums and unpaid losses and amounts necessary to satisfy

insurance or annuity contracts which do not involve life, health, or accident contingencies) but only to the extent of the excess of these additions over the required interest. Leaving required interest out of addition to reserves is a variation from the treatment provided in the House bill. Under your committee's amendments the required interest is omitted here because it is represented by the exclusion of that portion of the investment yield set aside for policyholders.

4. *Deduction for policyholder dividends.*—In the case of participating policies (insurance written on a mutual basis) deductions are allowed for dividend payments or rate credits to policyholders. Under the House bill these dividend payments, although allowed as deductions in computing the phase 2 tax base, were not allowed to reduce taxable investment income under phase 1 or to create a net operations loss which could be carried over and applied in reduction of underwriting gains of another year. Under your committee's bill these dividends (plus certain other deductions described below) are allowed as offsets against the phase 1 tax base, or are allowed to create an underwriting loss for tax purposes, up to the extent of $250,000. Your committee realized that to permit these dividends to offset in full the phase 1 tax base would in effect allow mutual companies to distribute their investment income as dividends without payment of tax. On the other hand, it recognized that smaller mutual companies paying what are recognized as ordinary policyholder dividends may, nevertheless, incur underwriting losses if they attempt to expand their operations. It was the problem faced by these smaller mutual companies that led your committee to the conclusion that policyholder dividends should be allowed as deductions, to a limited extent, in determining any underwriting loss to be offset against the phase 1 taxable investment income.

5. *Deduction for nonparticipating policies.*—Policyholder dividends in part reflect the fact that mutual insurance is usually written on a higher initial premium basis than nonparticipating insurance, and thus the premiums returned as policyholder dividends, in part, can be viewed as a return of redundant premium charges. However, such amounts provide a "cushion" for mutual insurance companies which can be used to meet various contingencies. To have funds equivalent to a mutual company's redundant premiums, stock companies must maintain relatively larger surplus and capital accounts, and in their case the surplus generally must be provided out of taxable income. To compensate for this, the House bill allows a deduction for nonparticipating insurance equal to 10 percent of the increase in life insurance reserves attributable to nonparticipating life insurance (not including annuities). Your committee has recognized the validity of the reasons for providing such a deduction and has therefore continued it in your committee's version of the bill. However, basing this addition, as does the House bill, only upon additions to life insurance reserves does not take account of the mortality risk factor present in policies involving only small reserves. To overcome this deficiency, your committee's amendments provide that a special 3 percent deduction based on premiums is to apply, instead of the 10 percent deduction, where it results in a larger deduction. This is a deduction equal to 3 percent of the premiums for the current year attributable to nonparticipating policies (other than group or annuity contracts) issued or renewed for a period of 5 years or more.

As in the case of policyholder dividends, the 10 percent or 3 percent deduction for nonparticipating policies may enter into an underwriting loss, and thereby reduce taxable investment income, only to the extent of the $250,000 limit referred to above in the case of policyholder dividends.

6. *Deduction for group insurance.*—A special deduction is also allowed under both the House bill and your committee's bill for group life, accident, and health insurance, equal to 2 percent of the premium income from this type of insurance until the cumulative amount of these deductions equals 50 percent of the current year's premium income from this source. This special deduction, which is patterned after the reserve requirement of two States, is designed to compensate for the fact that in group insurance there is less than the usual diversification of risk. This deduction, except to the extent of the $250,000 referred to above, may not be an underwriting loss offset against taxable investment income.

7. *Net operations loss deduction.*—The House bill provides a net operations loss deduction which is similar to the net operating loss deduction available to corporations generally. As in the case of the net operating loss deduction generally available, under the House bill this operations loss deduction may be carried back 3 years or forward 5 years. Under the House bill these loss carryforwards are available only for 1958 and subsequent years. Your committee has in general accepted the net operations loss deduction provided by the House bill but has made two extensions in its application. It has provided that a new company, for losses incurred in any of its first 5 years as an insurance company, is to have a 10-year carryforward of losses, rather than the usual 5-year carryforward. Your committee made this change because of its special interest in helping new companies in getting started. Also, your committee recognized that for such companies the net operations loss 3-year carryback provides very little assistance, since such companies are unlikely to have income in their early years to which they can carry back losses. Thus, in effect, they would have available to them (without this amendment) only the 5-year carryforward. A company is not considered as "new" for this provision if at any time during the loss year it was a "nonqualified" corporation within the meaning of the bill.

8. *Special limitation on phase 2 tax in 1958.*—In view of the fact that the tax on underwriting gains is entirely a new tax for life insurance companies, your committee has added a special provision limiting the additional tax which may arise as a result of taxing underwriting gains for the first time. It has added a proviso to the effect that for the calendar year 1958 if the half of the underwriting gain taxed currently (phase 2 tax base) exceeds the taxable investment income (phase 1 tax base) the amount of underwriting gain taxed currently is to be reduced by 10 percent of the amount by which this exceeds the taxable investment income. This will ameliorate the initial impact of this phase 2 tax.

9. *Summary of changes made in phase 2 by your committee's amendments.*—The principal changes made by your committee in the phase 2 tax base have been described above. They can be summarized, however, as follows:

(*a*) The House bill included investment income in its entirety (after the exclusion or deduction of tax-exempt interest, etc.) as one of the

receipt items to be taken into account. The House bill then provided for the deduction of required interest as a part of the deduction for additions to reserves, and finally reduced deductions generally for the portion of this required interest which represented tax-exempt interest, partially tax-exempt interest, and 85 percent of intercorporate dividends received. Your committee's amendments, on the other hand, determine the portion of the investment income which represents the policyholders' share, based upon the relationship of required interest to investment yield, and does not take this portion of investment yield into account in computing the phase 2 tax base. Thus, if there is tax-exempt interest, etc., the life insurance company's share is deducted from the life insurance company's share of investment yield, which is one of the items in the phase 2 tax base. The additions to reserves therefore relate only to the premium additions to reserves. Your committee's bill also provides that if it is established that the determination of gain from operations, as described in the bill, results in the imposition of any tax on tax-exempt interest, on thirty fifty-seconds of partially tax-exempt interest, or on 85 percent of the dividends received, adjustment is to be made to the extent necessary to prevent the imposition of any such tax.

(*b*) An alternative is provided by your committee's amendments to the 10 percent deduction for additions to reserves in the case of nonparticipating policies. It is provided that, instead of this 10 percent deduction, companies are to deduct 3 percent of premiums from nonparticipating contracts issued for a period of 5 years or more, if that amount is larger than 10 percent of reserves.

(*c*) The House bill provides that policyholder dividends, the 10 percent deduction for additions to reserves in the case of nonparticipating policies, and the 2 percent deduction for premiums in the case of group insurance may not be deducted to the extent they create or add to an underwriting loss which would offset the phase 1 tax base. Your committee's amendments allow these items (or the 3 percent deduction provided as an alternative to the 10 percent deduction) to create or add to an underwriting loss which may be offset against the phase 1 tax base up to a limit of $250,000.

(*d*) The House bill in computing net gain or loss from operations allows the deduction of losses from operations carried forward or back from other years. However, under the House bill no loss may be carried forward for any year prior to 1958. Your committee's bill permits losses to be carried forward to 1958 and subsequent years from 1955, 1956, and 1957 to the extent that they are not offset by income in that 3-year period.

(*e*) The House bill permits net operations losses to be carried back 3 years or forward 5 years. Your committee's bill in the case of a new business (in its first 5 years of operations as an insurance company) permits a 10-year carryforward.

(*f*) Your committee's amendments provide that if the phase 2 tax base for the calendar year 1958 (one-half of the underwriting gains) exceeds the phase 1 taxable investment income base, this phase 2 base is to be reduced by 10 percent of this excess.

10. *Example of phase 2 tax computation.*—The manner in which gains from operations are taken into account in arriving at an insurance company's tax base under your committee's amendments can be illustrated by continuing the same example presented in connection with

phase 1. It is necessary, however, to assume one additional fact, namely, the gains from operations. In one example these are assumed to amount to $45,000, and then in another example, to show the effect of an underwriting loss, they are assumed to amount to $5,000.

In the example where gains from operations are $45,000, the taxable investment income of $6,364 would be deducted, leaving an underwriting gain of $38,636. One-half of this, or $19,318, is added to the tax base under phase 1.

On the other hand, where the gain from operations amounts to only $5,000, since there was a taxable investment income of $6,364, there would be an underwriting loss of $1,364. Deducting this from the phase 1 base of $6,364 leaves a tax base of $5,000, which is the overall gain from operations. The bill achieves this result by providing that where the gain from operations ($5,000 in the example) is less than the taxable investment income ($6,364), the combined tax base under phases 1 and 2 is to be the gain from operations ($5,000).

If the company referred to in the example above had been a mutual insurance company, which paid policyholder dividends of, say, $10,000, the result would be the same under your committee's amendments but different under the House bill. The policyholder dividends deductible (together with the 10, or 3, percent and 2 percent deductions) would be allowed to enter into an underwriting loss to the extent of $250,000 under your committee's amendments, but not at all under the House bill. Thus, under your committee's amendments the results for the mutual company in the above example would be the same as shown above, but under the House bill the deductible policyholder dividends (as well as the 10, or 3, percent and 2 percent deductions) would be limited to the amount of the underwriting gains as otherwise computed, so that the policyholder dividends would be denied as deductions to the extent of the $1,364 of underwriting loss. This would have meant under the House bill that the entire life insurance company's share of the investment income—namely, $6,364—would have remained subject to tax with no offset being available as a result of the underwriting loss.

C. Phase 3—Tax on distribution, etc.

1. *General explanation.*—As previously indicated, only one-half of the underwriting gains are taxed currently under phase 2 because of the difficulty of determining on an annual basis the true income of a life insurance company. However, where a life insurance company has distributed dividends to stockholders which are in excess of the previously taxed income, it becomes clear that the company itself has made a determination that additional amounts constitute income which was not required to be retained to fulfill the policyholders' contracts. Therefore, phase 3 of the bill in general provides that income distributed by life insurance companies to stockholders in excess of the amounts already taxed on a current basis is to be included in the regular income tax base of the life insurance company at the time of the distribution. This tax may also become due if the company voluntarily elects to be taxed on the previously untaxed income, if the cumulative amount of the tax deferred income exceeds certain prescribed limits, or if for a specified period of time the company no longer qualifies as an insurance company or as a life insurance company.

Under the House bill this phase 3 addition to the tax was to be fully effective for 1959 and subsequent years. Your committee decided,

however, that since this represented a new tax, more time should be given insurance companies to adjust to it. For that reason your committee's amendments make this tax one-third effective in 1959, two-thirds effective in 1960, and fully effective in 1961. This tax relief under phase 3 for 1959 and 1960, however, is to be available only in the case of actual distributions and not under any of the other circumstances which may result in the imposition of a phase 3 tax.

2. *Operation of shareholders and policyholders accounts.*—The phase 3 portion of the tax base of life insurance companies under both the House bill and your committee's bill is provided for by establishing two special surplus accounts for tax purposes. The purpose of these accounts is to determine priorities between amounts on which the tax has been paid, and amounts on which the tax has been deferred but comes due at time of distribution. One of these accounts, called the shareholders surplus account, is a record of all tax paid amounts (remaining after payment of taxes). Under the House bill this account is established for calendar years beginning on or after January 1, 1959. Your committee, however, has amended this to establish this particular account as of January 1, 1958. Thus, each year from 1958 (1959 under the House bill) on, any amounts taxed under phase 1, 2, or 3, or as long-term capital gains, which remain after payment of Federal tax, are added to this account. In addition, certain intentionally nontaxed amounts are also added to this account. These include the small business deduction, the full amount of any tax-exempt interest, the entire thirty fifty-seconds of partially tax-exempt interest, and all of the 85 percent of intercorporate dividends received. Distributions are first treated as being paid out of this account to the extent of any cumulative balance in it, and since the amounts in this account represent amounts on which the tax has already been paid, such distributions do not result in any further tax to the life insurance company.

The effect of the amendment made by your committee establishing this account for 1958 and subsequent years, instead of for 1959 and subsequent years, is to permit life insurance companies to distribute amounts with respect to which they paid tax for 1958, without first having to pay tax on amounts earned in 1959 (and possibly subsequent years) on which the tax had been deferred. This seems desirable in view of the fact that companies could not plan their 1958 distributions with knowledge as to the tax effect of any phase 3 tax.

Both the House bill and your committee's bill also provide a second surplus account called the policyholders surplus account. Into this account is placed the half of the underwriting profits which are not taxed on a current basis. Your committee has also amended the bill to add to this account the amounts deducted with respect to nonparticipating policies (either the 10 percent of additions to reserves or the 3 percent of premiums) and also the amount equivalent to 2 percent of premiums on group insurance. The effect of placing these amounts in this account is to impose a tax on these amounts at any time they are withdrawn from the life insurance company, or when any of the other circumstances occur which result in the imposition of a phase 3 tax. Your committee approves of the allowance of these deductions and believes that they provide a desirable "cushion" for special contingencies which may arise in the case of the policies involved. However, your committee concludes that if the insurance company itself decides to distribute these amounts to stockholders it has demonstrated that this "cushion" is no longer needed.

A dividend distribution will reduce this policyholder surplus account only if there is no balance remaining in the shareholders surplus account, although certain other circumstances (described below) may also terminate the tax deferral for amounts in this account. When there is any such distribution, however, a portion of the policyholders surplus is subject to tax and constitutes the third-phase portion of the life insurance company's tax base. The amount so determined is added to any tax base determined under phases 1 and 2 before applying the regular corporate tax rate. Where an amount is distributed from the policyholders surplus account, the amount included in the tax base and the amount considered as withdrawn from the account, however, not only includes the amount paid to the shareholder but also the related tax payable to the Federal Government. Thus, generally, a $48 distribution from this account to shareholders will result in $100 being included in the phase 3 tax base and a $100 withdrawal from the policyholders' account, $48 of this amount being distributed to the shareholders and $52 representing Federal income tax. As indicated above, however, only after the shareholders surplus account is reduced to zero are distributions considered as being made from this policyholders surplus account. Distributions in excess of the balances in these two accounts do not entail any tax consequences to the company.

3. *Termination of tax deferral.*—The procedure outlines above in general illustrates the operation of the shareholders and policyholders surplus accounts where there is a distribution. However, the bill also provides several special rules which have the effect of terminating the tax deferral. First, under both the House bill and your committee's bill, the life insurance companies are given an annual election to transfer amounts from the policyholders account. Where they do so they must include the amount so transferred in their tax base, the shareholders surplus account then being increased by that amount less the tax.

Second, the House bill provided that the balance in the policyholders surplus account could not exceed 25 percent of life insurance reserves or 60 percent of net premiums received in the current year, whichever is the higher. When the cumulative balance exceeded the higher of these two limits, the excess over the higher limit was subjected to tax. Your committee has accepted the concept of a ceiling on the policyholders surplus account but has provided somewhat different limitations from those specified in the House bill. Thus, under your committee's amendments, the maximum amount in the policyholders surplus account may not exceed the highest of the following:

(*a*) 15 percent of total life insurance reserves, or

(*b*) 25 percent of the cumulative additions to life insurance reserves since 1958, or

(*c*) 50 percent of the net premiums received during the year.

This modification was made by your committee in order to place relatively more emphasis on increases in reserves since 1958. It is believed that this will be relatively more favorable for the new and expanding companies.

Third, the House bill provided that any amount in the policyholders surplus account was to become taxable as of the end of the prior year, if a company ceased to be a life insurance company (unless the carryover provisions of sec. 381(c)(22) were applicable to its suc-

cessor). Your committee has in general retained this provision but has liberalized it somewhat by providing that the tax deferral is not to be terminated in the case of an insurance company which no longer qualifies as a life insurance company unless for 2 years it does not so qualify. This makes allowance for the fact that an insurance company through accidental circumstances, such as the cancellation of a large group policy, may temporarily and unintentionally be disqualified as a life insurance company, with the result that its full deferred tax becomes due.

Fourth, both the House and your committee's bill provide that payments of debt, attributable to distributions to shareholders after February 9, 1959, the date of introduction of this bill, are to be treated as distributions out of shareholders or policyholders surplus accounts in the same manner as in the case of cash distributions.

4. *Summary of changes made in phase 3 by your committee's amendments.*—The principal changes made by your committee in the phase 3 tax base have been described above. They can be summarized, however, as follows:

(*a*) The House bill would have made the phase 3 tax applicable with respect to 1959 and subsequent years. Your committee's bill makes the phase 3 tax one-third effective with respect to 1959, two-thirds effective with respect to 1960, and fully effective thereafter. These tax reductions in the case of the phase 3 tax base, however, are to be available only in the case of actual distributions.

(*b*) Your committee has provided that the deduction for nonparticipating policies (either 10 percent of additions to reserves or 3 percent of premiums for policies of 5 years or more), and the deduction for group insurance (2 percent of premiums) are to be treated as items to be added to the policyholders surplus account, with the result that they will result in the imposition of tax if distributed to shareholders.

(*c*) Under the House bill all aspects of the phase 3 tax base would have been made applicable for the first time with respect to 1959 earnings. Under your committee's amendments, however, the shareholders surplus account is to be established as of January 1, 1958, with the result that taxed earnings in 1958, to the extent they are not distributed in that year, can in subsequent years be distributed without payment of tax on policyholders surplus.

(*d*) Under the House bill, earnings may not be retained in the policyholders account in a tax-deferred status if the cumulative amount exceeds 25 percent of life insurance reserves or 60 percent of premium income for the current year. Your committee has modified this provision to provide that earnings may not be retained in the policyholders account to the extent they exceed the highest of (1) 15 percent of total life insurance reserves, or (2) 25 percent of life insurance reserves cumulated since 1958, or (3) 50 percent of premium income in the current taxable year.

(*e*) Under the House bill any amount in the policyholders surplus account with respect to which the tax has been deferred becomes taxable (as of the end of the prior year) in any year in which the company involved does not qualify as a life insurance company. Your committee has modified this to provide that this tax is to be due (at the end of the prior year) only if the company involved is not an insurance company for 1 year and is not a life insurance company in either of 2 successive years.

5. *Example of phase 3 tax computation.*—The operation of phase 3 can be illustrated by continuing the example already used in explaining the phase 1 and phase 2 tax base. In one of the examples it was assumed that the company had a taxable investment income of $6,364 and that the taxable half of its underwriting gains amounted to $19,318, indicating a combined phase 1 and phase 2 tax base of $25,682. At the regular corporate rate, this would result in a tax of $7,855.

Under phase 3 the portion of the combined phase 1 and phase 2 tax base remaining after the payment of tax ($25,682 minus $7,855 equals $17,827) would be entered in the shareholders surplus account. In addition, the small business deduction of $4,000 and the tax-exempt interest of $400 would be added, resulting in a balance in this account of $22,227. At the same time an entry would be made in the policyholders surplus account representing the half of the underwriting gains not taxed currently, in this case $19,318, plus (under your committee's bill) the deduction taken for nonparticipating policies of, let us say, $4,000. So long as distributions do not exceed the balance in the shareholder's surplus account of $22,227, there would be no phase 3 tax. However, if additional amounts are distributed, the tax base (when phase 3 is fully effective) would be increased up to the balance in the policyholder's account, namely, $23,318. Thus, if the distributions in this case amounted to $27,027, the shareholders surplus account (balance of $22,227) would first be reduced to zero. The $4,800 still remaining would reduce the policyholders surplus account. However, a tax also must be paid, and this too comes from the policyholders account. Since the tax base under phases 1 and 2 is in excess of $25,000 in this example, the withdrawal and the tax on this withdrawal are subject to a 52-percent rate. Therefore, in this case, there would be a reduction of $10,000 in the policyholders account, $5,200 representing Federal income taxes, and $4,800 the distribution to stockholders.

D. Special provisions included in House bill

In addition to the basic provisions outlined above, there are a number of special provisions which merit comment. These include both special provisions in the House bill, which your committee has either continued unchanged or modified, and also additional special provisions which your committee concluded represented desirable amendments. The special provisions of the House bill (whether or not modified) are discussed here. The new special provisions added by your committee are discussed in E below.

1. *Capital gains and losses.*—Both the House and your committee's bill provide that net capital gains are to be taxed, beginning with the calendar year 1959. Capital gains (but not capital losses) are to be determined by using the cost or other basis of the properties involved as generally computed under the Internal Revenue Code, or their fair market value on December 31, 1958, whichever is higher. The tax rate is a flat 25 percent tax on these long-term gains (the excess of the net long-term capital gain over the net short-term capital loss). This differs from the treatment provided in the case of ordinary corporations in that this 25 percent tax is not an alternative tax but the only method of computation provided. This omission of any alternative method of computation avoids the complexity of providing for the inclusion of capital gains in the regular tax base, which in

this case consists of three different phases. Capital gains are to be based on values as of December 31, 1958, because such gains previously have not been usually subject to tax in the case of life insurance companies, and imposing a tax with respect to appreciation prior to that date would in effect be taxing some life insurance companies on capital gains which would not have been taxed if they had been realized.

The category of property "used in the trade or business" which, if sold at an aggregate loss, results in an ordinary loss and which, if sold at an aggregate gain, results in a capital gain, in the case of life insurance companies is limited to depreciable assets used in carrying on the insurance business. To avoid complexity, assets used in any other trade or business in which an insurance company may be engaged (such as the renting of real estate, or in the operation of a farm which has been obtained by the insurance company through the foreclosure of a mortgage) are treated as capital assets and result in capital gain or loss upon sale.

Your committee has retained the basic capital gains provisions of the House bill but has made two relatively minor modifications in the treatment provided by the House bill. First, it is provided in the case of transactions, such as installment sales, where the transaction occurred before the effective date of the capital gains provision, namely, before January 1, 1959, no capital gains tax is to apply merely because payment is received after that date.

Second, your committee has provided that where a life insurance company sells all of its business of one particular type, such as an entire industrial life insurance department, in either a single transaction or series of related transactions to another company (or companies) the transaction is to be treated as a sale of a capital asset if the transaction occurred in 1958. Since capital gains under the bill are taxable in 1958, this in effect means that for 1958 such a transaction is not to have any tax effect. By making this amendment, however, your committee intends no inference to be drawn as to the treatment of similar transactions in subsequent years. Where a company did in 1958 sell all of its insurance contracts of one particular type, your committee believed that it would be unfair to retroactively impose a tax in such a case, since this is the type of transaction a company would have been likely not to have made had it had any knowledge that any sizable tax was applicable.

2. *Dividends received credit and exclusion.*—Under present law dividends received by individual shareholders from life insurance companies are not eligible either for the 4 percent dividends received credit or the $50 exclusion available in the case of dividends received from ordinary corporations. This credit and exclusion in the past have been denied on the grounds that the tax paid by life insurance companies was minimal and, therefore, that there was no significant amount of double taxation if such dividend payments were fully included in the income of the dividend recipient. However, in view of the fact that both the House and your committee's bills substantially increase the tax burdens of life insurance companies, it now appears appropriate to allow the dividend credit and exclusion with respect to their dividends. Appropriate amendments are included in both the House and your committee's bills to achieve this result.

3. *Election for life insurance reserves computed on preliminary term basis.*—Some life insurance companies compute their life insurance

reserves on what is called a preliminary term basis. The effect of this is to take the full agents' commissions (which are larger in the initial period of a life insurance contract) out of amounts which would otherwise be added to reserves during the first year of a contract and to add correspondingly larger amounts to reserves in later years. The effect of this is to work a hardship on insurance companies using preliminary term reserves as compared with those which use ordinary reserves, since the policy and other contract liability requirements which determine the policyholders' and life insurance company's shares of investment income depend on the size of the reserves. Moreover, premium additions to reserves, deductible under phase 2, also would in some cases be smaller. To avoid this result, life insurance companies which have computed their reserves on a preliminary term basis are permitted to recompute their reserves on a net level premium basis. This can be done either by an exact revaluation of the reserves to a net level premium basis or by approximating this result under a formula set forth in the bill.

The House bill provides that the election to take the exact revaluation method or the approximate revaluation method is a binding election once made and must be adhered to unless a change is approved by the Secretary or his delegate. Your committee has modified this, however, to provide that, if for 1958 a life insurance company selects the approximate revaluation method, it may change and select the exact revaluation for 1959 and subsequent years without the consent of the Secretary or his delegate. This flexibility in elections is provided because it has been suggested to your committee that the time now is too short to permit many insurance companies to make the computations necessary under the exact revaluation method for 1958. This makes the adoption of the approximate method necessary for 1958 and if the election were to be binding would make it impossible for a company to shift over to the exact method in a subsequent year unless the shift were approved by the Secretary or his delegate.

4. *Deficiency reserves.*—Both the House bill and your committee's bill revise the definition of life insurance reserves to exclude deficiency reserves. Such reserves are excluded even though they are required by State law. As a result, these reserves will not be taken into account in determining gains from operations, and thus deficiency reserves which have been built up prior to 1958 will not produce an increase in the life insurance company's tax base under phase 2 when they decrease in years after 1957. In addition these reserves will not be taken into account in determining whether life insurance reserves constitute more than 50 percent of a company's total reserves—a condition which must be met if a company is to be classified for tax purposes as a life insurance company.

Cases were called to the attention of your committee where companies had reinsured policies of assessment companies and the reserves of these companies were used by the reinsuring company to cover the difference between the gross premiums required under ordinary life insurance and the smaller premiums payable under the original assessment-type policies. Your committee thought that these reserves should qualify as deficiency reserves to the extent they did not represent loading expenses. Therefore, the definition of deficiency reserves has been modified by your committee so that it refers to

"that portion" of a reserve which meets the specified conditions, and so that portion which qualifies will be covered by this provision. In addition, your committee made certain technical changes in this provision to express it in terms of individual contracts instead of in terms of a group of contracts.

5. *Guaranteed renewable contracts.*—Both the House bill and your committee's bill provide that guaranteed renewable life, health, and accident insurance will be treated in the same manner as noncancelable life, health, and accident insurance. Reserves with respect to such insurance will, therefore, be treated in the same manner as life insurance reserves for purposes of computing taxable investment income and gains from operations. The type of insurance contracts referred to are life, health, and accident policies which are not cancelable by the company but under which the insurance company reserves the right to adjust premium rates by classes, in accordance with experience under the type of policy involved. By including such contracts specifically within life insurance reserves for the future, your committee intends no inferences to be drawn as to their tax treatment under prior law.

6. *Requirement of accrual accounting and related adjustments.*—Both the House and your committee's version of the bill provide that computations in determining life insurance company taxable income are to be made on an accrual basis and, to the extent not inconsistent with other income tax provisions, in the manner required in making the annual statement to the insurance commissioners. Since under prior law accrual basis accounting was not required, this necessitates adjustments for those who previously have not been on an accrual basis. To provide for this, a transitional rule requires adjustments in the income to be made which are necessary to prevent duplications or omissions from income, where the company's method of computing income for 1957 was different from that required by the bill for subsequent years.

The House bill requires that adjustments to income, resulting from a change in method of accounting required for 1958, are to be taken into account by recomputing the 1957 tax. In the 1957 recomputation, one-tenth of the adjustment is taken into account. The difference between the tax computed on this basis and the tax as previously computed for 1957 is then multiplied by 10 and is the change in tax attributable to the adjustment. If this results in a decrease in the 1957 tax, the amount so computed is credited or refunded to the taxpayer (but with no interest payable with respect to the refund or credit prior to March 16, 1960). However, in the usual case where the adjustment results in an increase in the amount of the 1957 tax, this additional amount of tax is payable in 10 equal installments beginning March 16, 1960. However, if at any time a company no longer qualifies as an insurance company, any balance of this amount becomes due.

Your committee's amendments accept the House method of computing the tax with respect to the accounting adjustment with two minor modifications. The committee has provided that, in measuring the additional tax on this adjustment for 1957, there is not to be taken into account the special ceiling on the policy deduction in the 1957 law (designed to tax investment income of overcapitalized companies

at 52 percent) where the reserve and other policy liability deduction otherwise available was not allowed to exceed two times the required interest on life insurance reserves. Also, your committee has provided that the special interest deduction available where investment income is less, or only slightly exceeds, the required interest on the reserves is not to be reduced because of the increase in investment income for 1957 resulting from the adjustment. The one-tenth of the readjustment income taken into account in 1957 (which after the tax is obtained is subsequently multiplied by 10) is a rough approximation of the result which would be obtained if this income were spread back over a 10-year period. The fact that these special provisions apply in 1957 is no indication that they would apply in the other 9 years of this spread and, therefore, since the tax determination is based upon a multiple of the 1957 tax computation, your committee concluded that it generally would achieve the wrong result to spread in effect the application of these special provisions over the other 9 years.

In general, the treatment under the House bill and your committee's amendments, for adjustments where there have been changes by life insurance companies in methods of accounting, is somewhat similar to the treatment provided by section 481 for other taxpayers where pre-1954 adjustments were involved.

7. *Foreign insurance companies carrying on U.S. insurance business.*—Both versions of the bill provide that foreign insurance companies carrying on a life insurance business within the United States are in general to be treated in the same manner as domestic life insurance companies. However, a special rule is provided where the surplus of a foreign life insurance company which is held in the United States is less than a specified minimum figure. This figure is expressed as the same percent of the foreign insurance company's liabilities on U.S. business as the average surplus of domestic companies is of their total liabilities. The Secretary of the Treasury will determine this ratio each year based on the prior year's experience of domestic companies. However, for 1958 this ratio is to be 9 percent which is a rough approximation of the 1957 surplus of domestic companies as compared to their liabilities. If the foreign insurance company's surplus held in the United States is less than this proportion of the taxpayer's total insurance liabilities on U.S. business, then the policy and other contract liability requirements, and the required interest for computing gain from operations, are to be reduced by this excess multiplied by the rate of earnings on investments. Due to the new formula contained in this bill, foreign companies (if it were not for this provision) could obtain far more advantage from reducing their U.S. surplus than they could have obtained under prior law. This is designed to prevent foreign insurance companies doing business in the United States from avoiding tax they would otherwise have to pay to the United States, merely by holding surplus with respect to U.S. business in countries outside of the United States.

For purposes of the phase 3 tax base, the House bill determines the portion of a distribution which is allocable to U.S. business on the basis of the ratio of the amount assumed to be the U.S. surplus to the company's actual total surplus. As an alternative to this your committee's amendments provide that the portion of a distribution considered as being made with respect to U.S. business can be determined on the basis of the ratio of the insurance liabilities of the

company in the United States to the company's total insurance liabilities. Your committee's bill also provides apportionment rules where a foreign insurance company mutualizes.

8. *Reserves strengthening or weakening.*—A special spread rule is applied under the House bill and your committee's bill where a company determines that its reserves require strengthening and additions are therefore made to its reserves. If no limitations were imposed in these cases, the company could take a substantial additional deduction in computing gain or loss from operations for the year when the reserves were strengthened. To spread the effect of such adjustments, it is provided that, in the case of reserve strengthening, deductions relating to the additions in reserves are to be taken into account ratably over a 10-year period instead of entirely in the year of change. Conversely, in the case of reserve weakening, the increases in income relating to the reductions in reserves are to be taken into account over a 10-year period.

9. *Mutualizations.*—Certain problems are presented in connection with phase 3 where a stock life insurance company is "mutualized," or converted into a mutual life insurance company, with a liquidating distribution being made to the stockholders and the remainder of the surplus and reserves being held for the benefit of policyholders in what now becomes a mutual company. In such cases a rule must be provided as to the type of capital or surplus being paid the shareholders for purposes of determining whether any amounts are paid out of the policyholders surplus account, and therefore properly includible in the tax base of the life insurance company at the time of distribution. Both the House and your committee's bill provide that these payments to stockholders are first to be considered as being paid out of capital or surplus paid in. Any amount remaining is divided into two parts: payments deemed from surplus accumulated before 1959 and payments deemed from surplus accumulated from 1959 forward, in proportion to the pre-1959 and the post-1958 surplus (the sum of the stockholders' surplus account and the policyholders surplus account) as at the beginning of the year of distribution. Any payments considered as coming from post-1958 surplus are treated as coming first from the already taxpaid shareholders surplus account, to the extent of the balance of this account, and then from the policyholders surplus account, withdrawals from which are subject to tax. Any further payments are treated as coming from prior accumulated surplus.

10. *Summary of changes made by your committee in House special provisions.*—The principal changes made by your committee in the special provisions contained in the House bill have been described above. They can be summarized, however, as follows:

(*a*) Your committee modified the House capital gains provision to eliminate from tax, gains included in post-1958 receipts from pre-1959 sales.

(*b*) Where a company in 1958 sold all of a particular type of its insurance contracts, such as its entire industrial insurance department, your committee agreed that such a transaction should be considered a capital transaction with respect to which no tax is imposed in 1958. No implications are to be drawn from this, however, as to the tax treatment of such transactions in the future.

(*c*) Your committee agreed that companies which elect to use the approximate revaluation method in converting preliminary term

reserves to a net level premium basis in 1958 may have a new option to use the exact revaluation method with respect to 1959 and subsequent years.

(*d*) Where a life insurance company is required to shift to an accrual method of accounting and one-tenth of the adjustment in income is included for purposes of measuring the additional tax on the 1957 income (the final tax on the adjustment subsequently is multiplied by 10) your committee agreed to provide that two special provisions in the 1957 law are to be made inapplicable with respect to measuring the additional tax arising from this adjustment. These are the so-called "2 for 1 limit" designed to tax investment income of overcapitalized companies at 52 percent and the special interest deduction where investment income was less or only slightly exceeded required interest.

(*e*) In the case of foreign insurers of United States business, your committee agreed that for purposes of the phase 3 tax, such a company may determine the portion of any distribution to stockholders which is allocable to U.S. business either on the basis of the specially determined U.S. surplus to total surplus (as is already provided by the House bill) or on the basis of U.S. insurance liabilities to total insurance liabilities. It also provides apportionment rules for foreign insurers which mutualize.

E. Special provisions added by your committee's amendments

1. *Assessment companies.*—In the case of mutual assessment companies, the House bill and also prior law provided that amounts deposited by these companies with State officials as guarantee or reserve funds, and also funds maintained exclusively for the payment of claims, were to be treated as life insurance reserves. Thus, these assessment companies have consistently been treated as life insurance companies and it was thought that they were so treated under the House bill. However, in determining the division of investment income between policyholders and the life insurance company, both for purposes of the phase 1 and phase 2 tax bases, it is necessary to have an assumed rate of interest. However, these assessment companies have no interest rate which qualifies for this purpose. To overcome this deficiency, your committee has amended the bill to provide that the assumed rate of interest for these mutual assessment companies is to be 3 percent.

2. *Variable annuities.*—Your committee has added a provision to the House bill to make it clear that variable annuities are in general to be taxed in the same manner as other annuities. This was considered especially desirable in view of the recent Supreme Court case in this area (*Securities and Exchange Commission* v. *Variable Life Insurance Company of America et al.*, March 23, 1959). Thus, companies issuing such contracts will, if they otherwise qualify, be treated as life insurance companies. Variable annuities differ from the ordinary or fixed dollar annuities in that the annuity benefits payable under the variable annuity vary with the insurance company's overall investment experience. The fixed dollar annuity, on the other hand, guarantees the payment of a specified amount irrespective of the actual investment earnings. Both the fixed dollar annuities and the variable annuities, however, are based upon the principle of paying out either specified amounts, or specified units with values which vary with investment experience, over the life of each member of an annuitant

group. Thus, in both cases the insuring company bears the mortality risk. In view of this your committee believes variable annuities should in general be treated like other annuities for tax purposes.

Your committee's amendments provide that variable annuity contracts using recognized mortality tables but with annuity payments based on the investment experience of the company issuing the contract are to be treated as regular annuity contracts for purposes of the life insurance company tax. Therefore, such reserves will qualify as life insurance reserves and companies primarily issuing such policies will qualify as life insurance companies for Federal income tax purposes. The current earnings rate of such a company to be used in determining the portion of investment income belonging to the policyholder and the portion representing the life insurance company's share is to be computed in the usual manner, except that there is to be deducted from the company's current earnings rate any actuarial margin charge prescribed by the contract. This same rate is also to be used as the company's assumed rate of interest.

This actuarial margin charge represents a charge made by the company to cover general expenses which are over and above the expenses provided for in the charges made against premiums. In addition, this actuarial margin provides contingency mortality reserves, as well as the profit margin for the shareholders of the company.

In the case of these variable annuity contracts, additions in reserves for tax purposes are to include only increases made by reason of premium receipts and investment income, and decreases in these reserves for tax purposes are to take into account only benefits paid under these contracts. The effect of this is to exclude from reserve additions or decreases capital gains and losses, both realized and unrealized. These are ordinarily reflected in these reserves by such companies. In the case of unrealized gains and losses, the tax laws generally do not take such amounts into account; and in the case of realized gains and losses, an entirely separate 25 percent tax is imposed with respect to any net long-term capital gains, both in the case of these companies and in the case of other insurance companies generally.

Your committee's bill provides that this treatment for variable annuity contracts is to apply only for the years through 1962. This special cutoff date for variable annuity contracts has been provided by your committee in order to give assurance that there will be an opportunity to review the tax treatment of variable annuities after these contracts have been in existence for a period of time. It is thought that, in view of the relative newness of such contracts, special problems may develop which will warrant review.

3. *Organizations meeting most, but not all, of the requirements for tax exemption under section 501(c)(9).*—Under present law (sec. 501(c)(9)) voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to members of the association or their dependents are exempt from income tax if no part of their net earnings inures to the benefit of any private shareholder or individual (other than through these payments) and if 85 percent or more of their income consists of amounts collected from the members and amounts contributed by the employer. The attention of your committee has been called to the fact that some employee beneficiary associations meet all of the requirements for this exemption except

for the fact that more than 15 percent of their income consists of earnings on accumulated funds. As a result they fail to qualify for exemption since less than 85 percent of their income is derived from the employees or the employer. In the past when such associations, because of this excess investment income, failed to qualify for exemption, they were taxed as life insurance companies where they paid life, sickness, or accident benefits. However, under the bill as passed by the House, no portion of their income would be set aside as belonging to the policyholder, as distinct from the insurance company, because the reserves of these companies do not meet the definition of "life insurance reserves" in one respect: these reserves are not required by law. To meet this problem, your committee has amended the bill to provide that in the case of policies issued by organizations which would qualify under section 501(c)(9) except for the 85 percent requirement, reserves are to qualify as life insurance reserves even though not required by State law.

In addition, the attention of your committee was called to one of these employee beneficiary associations where there apparently would have been a large phase 2 tax base because there was a large volume of voluntary lapses in policies. This results in decreases in reserves, which in turn increase the income subject to the phase 2 tax. These were lapses in policies issued before January 1, 1958, and thus the reserves were built up in a period before any phase 2 tax was applicable. To the extent there are no offsetting increases in reserves occurring currently, these lapses, in large part at least, represent pre-1958 income. Because of this your committee concluded that it would be appropriate to take these voluntary lapses into account only to the extent of 11½ percent of any decrease in life insurance reserves attributable to them with respect to policies issued before January 1, 1958. This will have the effect, in the case called to the attention of your committee, of imposing approximately the same tax in 1958 as was imposed in 1957. This is an elective provision and those who elect it are not to have available to them the carry-forward of losses from years prior to 1958 or the special 1958 10 percent reduction in the phase 2 tax base to the extent that this base exceeds the phase 1 tax base.

4. *Life insurance departments of mutual savings banks.*—The attention of your committee was called to the fact that in the case of life insurance departments of mutual savings banks in certain cases there is a centralized auditing of the life insurance departments for all of such departments within one State. It is further understood that the auditors in such cases make recommendations to the mutual savings banks as to the policyholder dividends which they believe should be made in the case of the bank's life insurance policies. Experience has indicated that it is not possible in all cases to supply this information to the boards of directors of mutual savings banks in time for them to set aside the amount determined for policyholder dividends before the 16th day of March of the year following the year of liability. Your committee decided, therefore, to give mutual savings banks with these life insurance departments up to April 16 for the determination of policyholder dividends.

Your committee would also like to make it clear that, wherever in the bill there is a reference to a life insurance company, in the case of mutual savings banks with life insurance departments this is intended

to include such a life insurance department. It is your committee's understanding that this is the effect of section 594 of the code, which imposes a substitute tax in the case of mutual savings banks having separate life insurance departments. The substitute tax provided in this case consists of two partial taxes: one a partial tax on the regular mutual savings bank operations and the second a tax on the life insurance department activities of the bank, the latter being computed in the same manner as for a separate life insurance company.

5. *Reserve for dividends to policyholders payable during 1958.*—The attention of your committee was called to a situation where the amount held at the end of 1957 as a reserve for dividends to policyholders payable in 1958 was erroneously larger than the amount intended to be paid on such dividends during 1958, and larger than the amount actually so paid. Your committee's bill corrects this by providing that the reserve held at the end of 1957 for dividends payable during 1958 is to be the amount of the dividends actually paid duirng 1958.

6. *Distributions in redemption of stock limited as to dividends, etc.*—Under phase 3 the bill in general provides that distributions to shareholders after 1958 are to be treated as being made first out of the shareholders surplus account to the extent of any balance in this account, then out of the policyholders surplus account, to the extent of any balance in this account, and finally out of all other accounts. Only after tax has been paid on the amount of policyholders surplus may redemptions be made out of surplus without tax effect. The attention of your committee has been called to situations where this may result in hardship because the companies involved had issued special callable stock before 1958 with the agreement that it would be callable at a small premium when the company no longer required the use of the funds. Under the general priority of distributions established under phase 3, the redemption of this stock would under the House bill result in a phase 3 tax whenever distributions exceed any balance in the shareholders surplus account. To prevent this effect where the clear and obvious intent of the parties involved was to make the funds available to the insurance company only for the period of time the funds were needed by the company, your committee has added a proviso to the bill providing that a distribution in redemption of stock issued before 1958 under certain conditions is not to be considered a distribution for purposes of applying the distribution priorities referred to above. The conditions which must be met are that the stock must at all times be limited as to dividends, and be callable at the option of the company at a price not in excess of 105 percent of the amount initially paid in with respect to the stock.

7. *Modified coinsurance.*—Modified coinsurance is a form of indemnity reinsurance (as contrasted to assumption reinsurance) to indemnify an insurer against a risk it has assumed. Hence, as distinct from assumption reinsurance, the initial risk in this case remains with the insurer but he covers this risk by reinsuring part or all of a contract with another insurance company (referred to here as the reinsurer). Three forms of this indemnity reinsurance have been developed. The first of these, called coinsurance, calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the

insurance policy (or part thereof) directly. Any expenses incurred by the initial insurer with respect to the policy are reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems. This is also true of the so-called yearly renewable term reinsurance. Under this plan the initial insurer covers his risk by purchasing one year renewable term insurance from the reinsurer. The insurance purchased in this case is usually the face amount of the policy less reserves with the premium per thousand dollars increasing as the age of the policyholder increases. No special tax problem is involved here because the entire investment income at all times remains with the initial insurer.

A problem of possible double taxation is presented, however, where the reinsurance takes the form of indemnity reinsurance which has come to be known as "modified coinsurance." Under modified coinsurance the reinsurer accepts all of the obligations it would assume under a conventional coinsurance policy, but the initial insurer retains the reserves and administers the investment of the reserve funds. However, the initial insurer pays over the gross investment income, less additions to reserves, to the reinsurer. In such cases it is possible for the same income to be taxed twice—once to the initial insurer as investment income and a second time to the reinsurer as underwriting gain. To prevent an imposition of a double tax in such cases, your committee has added a section to the bill which treats modified coinsurance in the same manner as conventional coinsurance; that is, a policy to the extent reinsured in this manner generally is treated as if it were a policy issued by the reinsurer instead of the initial insurer.

Thus, premiums, gross investment income, capital gains and losses, reserves, and assets and expenses which are related to the insurance reinsured are generally treated as received, held, or incurred (as the case may be) by the reinsurer instead of the initial insurer. Also, dividends to policyholders, paid with respect to the policy reinsured, are to be treated as dividends paid by the reinsurer rather than the initial insurer to the extent of reimbursement by the reinsurer to the initial insurer. This rule it is necessary to apply both in the case of modified coinsurance and also in the case of conventional coinsurance. (However, the experience refunds paid by the reinsurer to the initial insurer are treated as reductions in premium income of the reinsurer and as "other income" received by the initial insurer.)

The treatment described above for modified coinsurance applies only if agreed to by the initial insurer and the reinsurer. Once such an election is made, however, it may not be rescinded except with the approval of the Secretary or his delegate.

F. Relationship of bill to subchapter C

Except to the extent that specific provision is made by this bill, as amended, your committee does not intend to affect the general rules of the Internal Revenue Code, such as the rules relating to (i) the characterization of income, (ii) the recognition or nonrecognition of gain upon sales or exchanges, reorganizations, etc., and (iii) the taxation of shareholders. For example, although a tax is imposed upon a life insurance company with respect to amounts subtracted from the policyholders surplus account, the tax treatment of the shareholders of the life insurance company will be determined under the general rules of the Internal Revenue Code, including the rules contained in

subchapter C. Accordingly, if the distribution is in complete liquidation of a corporation as described in section 331(a)(1), the amounts received by the shareholders are to be treated as in full payment in exchange for their stock.

Under both versions of the bill, a new paragraph (22) is added to section 381(c) of the 1954 Code. This new paragraph is applicable where the assets of a life insurance company are acquired by another life insurance company in (1) a liquidation of an 80 percent controlled subsidiary under section 332 (other than a liquidation in which the basis of the assets distributed is determined under sec. 334(b)(2)), or (2) a reorganization described in section 381(a)(2) (statutory mergers or consolidations, mere changes in identity, form, or place of organization, etc.). In such cases the acquiring corporation, under the new section 381(c)(22), must take into account, to the extent proper to carry out the purposes of section 381 and the purposes of this bill, the items which the distributor or transferor corporation was required to take into account under this bill. Among the items of the distributor or transferor corporation that are required to be taken into account by the acquiring corporation under the new paragraph (22) are: (1) any remaining net increases or net decreases described in section 810(d)(1) (relating to the adjustment for change in computing reserves), (2) any remaining installments of tax described in section 818(e)(3)(A), (3) the shareholders surplus account described in section 815(b), and (4) the policyholders surplus account described in section 815(c). Thus, in the case of these acquisitions, the items described above will be taken into account (to the extent proper to carry out the purposes of sec. 381 and the purposes of pt. I of subch. L) by the successor corporation and will not, to the extent so taken into account by the successor corporation, result in the imposition of tax upon the distributor or transferor corporation.

Where distributions of boot are made to shareholders in connection with the reorganizations described above the provisions of this bill, under both the House and your committee's versions with respect to the imposition of tax upon life insurance companies on distributions to shareholders will, of course, be applicable and the policyholders and shareholders surplus accounts will be correspondingly adjusted. Similarly, in the case of acquisitions not described in section 381(a), or other transactions which, under other provisions of the Internal Revenue Code, might result in nonrecognition of gain to a corporation or its shareholders (e.g., secs. 311(a), 336, 337, 354, 355, 356, and 361) the provisions of the bill imposing a tax with respect to distributions to shareholders will be applicable.

Specific provision is also made with respect to the operations loss deduction provided by section 812. The provisions of subtitle A and subtitle F (except as specifically provided in the bill) will apply to operations loss carrybacks, carryovers, and the operations loss deduction in the same manner and to the same extent as the provisions of those subtitles apply in respect of net operating loss carrybacks, carryovers, and the net operating loss deduction. Accordingly, the rules and limitations contained in sections 381, 382, and 269 will be applicable to operations loss carrybacks and carryovers to the same extent as applicable to net operating loss carrybacks and carryovers.

IV. TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE

The first section of the bill, which is identical with section 1 of the House bill, contains a short title for the bill, namely the "Life Insurance Company Income Tax Act of 1959."

SECTION 2. REVISION OF PART I OF SUBCHAPTER L

Section 2, which corresponds to section 2 of the House bill, amends part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to the taxation of the income of life insurance companies) by substituting for the existing subparts and sections a new text which is divided into five subparts:

(1) Subpart A (secs. 801 and 802) which deals with the definition of life insurance company and the imposition of the tax.

(2) Subpart B (secs. 804 through 806) which deals with investment income.

(3) Subpart C (secs. 809 through 812) which deals with gain and loss from operations.

(4) Subpart D (sec. 815) which deals with distributions to shareholders.

(5) Subpart E (secs. 817 through 820) which contains miscellaneous provisions relating to certain gains and losses, accounting provisions, foreign life insurance companies, and the optional treatment of policies reinsured under modified coinsurance contracts.

SUBPART A—DEFINITION; TAX IMPOSED

SECTION 801. DEFINITION OF LIFE INSURANCE COMPANY

(*a*) *Life insurance company defined.*—This subsection, like the House bill, defines the term "life insurance company" for purposes of subtitle A of the 1954 Code. Except for the addition of the phrase "(whether or not ascertained)" after the phrase "unpaid losses" in paragraph (2) of this subsection, the language of the new section 801(a) is identical with the language of section 801(a) in existing law.

However, it should be noted that there will be 6 differences in the application of the term under your committee's bill:

(1) A special provision has been included with respect to the reserves under policies issued by certain voluntary employees' beneficiary associations. (See the discussion under new sec. 801(b)(2).)

(2) A special provision has been included with respect to the rate of interest assumed in calculating assessment company reserves. (See the discussion under sec. 801(b)(3).)

(3) Special provisions have been included with respect to deficiency reserves. (See the discussion of the new sec. 801(b)(4).)

(4) Special provisions have been included with respect to guaranteed renewable life, health, and accident insurance. (See the discussion of the new sec. 801(e).)

(5) Special provisions have been included with respect to the treatment to be accorded variable annuities. (See the discussion under new sec. 801(g).)

(6) The addition of the phrase "(whether or not ascertained)" mentioned above. For a discussion related to this additional phrase, see the explanation of the new section 809(d)(1).

(*b*) *Lifes inurance reserves defined.*—This subsection, as in the House bill, defines life insurance reserves for purposes of part I of subchapter L of chapter 1 of the 1954 Code. In general, the definition is the same as that contained in section 801(b) of the House bill and existing law.

However, unlike the House bill, your committee's bill adds a new subparagraph (B) to paragraph (2) of this subsection to except reserves held under policies issued by certain voluntary employees' beneficiary associations from the requirement that "life insurance reserves" must be required by law. Such an exception is made only if these associations do not qualify for exemption from tax under section 501(c)(9) by reason of their failure to meet the income requirement of subparagraph (B) thereof.

In addition, your committee's bill adds a new sentence at the end of paragraph (3) of this subsection to provide that in calculating the "life insurance reserves" of an assessment life insurance company or association, the rate of interest assumed shall be 3 percent.

Your committee's bill retains the language contained in the first sentence of paragraph (4) of this subsection as it appeared in the House bill. This sentence provides that the term "life insurance reserves" does not include deficiency reserves. Such a sentence is not contained in existing law. However, in defining the term "deficiency reserves," your committee has made a change in the language contained in the second sentence of paragraph (4) as it appeared in the House bill to clarify the meaning of such term. As amended by your committee, this sentence provides, in effect, that the deficiency reserve for each individual contract is that portion of the reserve for such contract which is equal to the amount, if any, by which—

(1) the present value of the future net premiums required for such contract (by reason of the standard adopted by the insurer, the minimum standard required by State law, or otherwise), exceeds

(2) the present value of the future actual premiums and consideration charged for such contract.

The effect of this language, as in the House bill, is to exclude deficiency ceserves from both life insurance reserves and total reserves, even though such deficiency reserves are required by State law. However, any portion of the excess of (1) over (2) that is attributable to the inclusion of any factor such as an expense loading factor in the computation of such excess, shall not constitute a "deficiency reserve" but shall be treated as an item to which section 810 applies.

(*c*) *Total reserves defined.*—This subsection, like the House bill, defines the term "total reserves" for purposes of the new section 801(a) (definition of a life insurance company). Under the definition, total reserves comprise—

(1) life insurance reserves (within the meaning of the new section 801(b)),

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The last sentence of this subsection makes it clear that the term "total reserves" does not include deficiency reserves (within the meaning of the new sec. 801(b)(4)).

(*d*) *Adjustments in reserves for policy loans.*—This subsection, as in the House bill, is the same as section 801(d) of existing law.

(*e*) *Guaranteed renewable contracts.*—This subsection, as in the House bill, provides that guaranteed renewable life, health, and accident insurance shall be treated in the same manner as noncancelable life, health, and accident insurance. (For discussion of this provision, see item 5 of the special provisions included in the House bill discussed under the general explanation of the bill.)

(*f*) *Burial and funeral benefit insurance companies.*—This subsection, like the House bill, is the same as section 801(e) of the 1954 Code.

(*g*) *Variable annuities.*—This subsection, for which there is no corresponding provision in the House bill, states in paragraph (1) that an annuity contract includes a contract which provides for the payment of a variable annuity that is computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract. Accordingly, the reserves held under such contracts constitute "life insurance reserves" for the purposes of section 801(b) and, a company issuing such contracts, will qualify as a life insurance company if it fulfills the requirements of section 801(a).

Paragraph (2) of this new subsection provides that with respect to variable annuity contracts, the issuing life insurance company shall have (for the purposes of sec. 805(b)(1)) a current earnings rate computed as provided therein reduced by either—

> (*a*) the annual rate of the actuarial margin charge prescribed in the contract, or
>
> (*b*) if no such rate is prescribed in the contract, the percentage obtained by dividing the actuarial margin charges on all variable annuity contracts issued by the taxpayer by the mean of the assets of the taxpayer which are obligated under such contracts to satisfy the liabilities specified therein.

The actuarial margin charges referred to consist of general operating charges and other amounts retained by the issuing company pursuant to the terms of the contract to cover actuarial contingencies and to increase surplus.

Paragraph (3) of this new subsection provides that the rate of interest assumed in computing the reserves held with respect to variable annuity contracts for any taxable year shall be the same as the current earnings rate of the company issuing such contracts reduced in the manner described in paragraph (2). The determination of the assumed rate in this manner reflects the fact that the reserve assumptions used in computing the reserves under such contracts are based upon the investment experience of the company.

Paragraph (4) of this new subsection provides that for the purposes of section 810 (relating to rules for certain reserves), any increase in reserves held under variable annuity contracts shall be computed only with respect to increases therein due to premium and gross investment income additions thereto. Conversely, decreases in such reserves shall be computed only with respect to decreases due to benefits paid under such contracts. Accordingly increases or decreases in such reserves due to unrealized appreciation or depreciation in the value of the assets comprising such reserves is not taken into account. Similarly, except as provided in section 804(b)(2), increases or decreases in such reserve items due to realized capital gains or losses

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are not taken into account whether or not such gains or losses are required to be added to or subtracted from such reserves under the terms of the contracts.

Paragraph (5) of this new subsection provides that this subsection shall not apply to taxable years commencing after December 31, 1962.

SECTION 802. TAX IMPOSED

(*a*) *Tax imposed.*—Paragraph (1) of the new section 802(a), like the corresponding provision of the House bill, imposes a tax on the life insurance company taxable income of every life insurance company for each taxable year beginning after December 31, 1957. The tax is to consist of—

(1) a normal tax on such income, computed at the regular corporate normal tax rate provided by section 11(b) of the 1954 Code, and

(2) a surtax, on so much of such income as exceeds $25,000, computed at the regular corporate surtax rate provided by section 11(c) of the code.

Paragraph (2) of the new section 802(a) relates to the taxation of capital gains. Under this paragraph, if the net long-term capital gain (as defined in sec. 1222(7) of the code) of a life insurance company exceeds its net short-term capital loss (as defined in sec. 1222(6) of the code), a separate tax equal to 25 percent of such excess is imposed. This tax is imposed only in the case of taxable years beginning after December 31, 1958, and applies whether or not there is life insurance company taxable income or a loss from operations for the taxable year. Under the bill no tax is imposed on capital gains for the year 1958, and no such gains or losses enter into the computation of taxable investment income, gain or loss from operations, or life insurance company taxable income for 1958. For years after 1958 any excess of net short-term capital gain (as defined in sec. 1222(5) of the code) over net long-term capital loss (as defined in sec. 1222(8) of the code) is taken into account in computing taxable investment income and gain or loss from operations. Except as modified by the new section 817 (rules relating to certain gains and losses) and other applicable provisions of the new part I, the general rules of the 1954 Code relating to gains and losses (such as the rules for determining the amount, characterization, and treatment thereof) will apply with respect to life insurance companies.

Paragraph (3) of new section 802(a), for which there is no corresponding provision in the House bill, provides a transition rule for the phasing in of the impact of any increased tax liability imposed for the years 1959 and 1960 by reason of the operation of section 802(b)(3). Under this paragraph, any increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) is taken into account only to the extent of one-third and two-thirds for the years 1959 and 1960, respectively. Thus, if a company's total tax liability for 1959 and 1960 (computed without regard to this paragraph) were $130 and $140 respectively, of which $30 represented the increase in tax for each year that was attributable to the operation of section 802(b)(3), this paragraph would operate to reduce the tax liability to $110 ($130 minus two-thirds of $30) and $130 ($140 minus one-third of $30), for 1959 and 1960, respectively. For taxable years commencing after December 31, 1960, the full amount of any increase in

tax due to the operation of section 802(b)(3) would be imposed without any further transitional reduction.

It should be noted that the transitional relief provided by this paragraph is limited solely to an increase in tax under section 802(b)(3) that is occasioned by the operation of section 815(c)(3) (relating to subtractions from the policyholders surplus account by reason of distributions to shareholders). This relief is also limited to such distributions that are made by life insurance companies in 1959 or 1960 and does not extend to other distributions that are treated under section 815(d)(2)(B) as made by life insurance companies in 1959 or 1960. Furthermore, this paragraph is inapplicable to any increase in tax under section 802(b)(3) that is attributable to the operation of the special rules contained in section 815(d). However, the relief provided by this paragraph does apply in the case of a distribution to which section 815(e)(1)(B)(ii) applies.

(*b*) *Life insurance company taxable income defined.*—Subsection (b) of the new section 802, which is substantially the same as it appeared in the House bill, defines the term "life insurance company taxable income" for purposes of part I of subchapter L. However, your committee's bill makes a clarifying amendment to paragraph (1) of this subsection and, as amended, the term is defined to consist of the sum of—

(1) the taxable investment income or, if smaller, the gain from operations;

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess; and

(3) the amount subtracted from the policyholders surplus account for the taxable year (as determined under new sec. 815).

If for any taxable year there is a loss from operations (as defined in sec. 809(b)(2)), the amount taken into account under paragraphs (1) and (2) of the new section 802(b) shall be zero.

Your committee's bill also adds a final sentence to this subsection which did not appear in the House bill and which, in certain circumstances, will reduce a company's so-called step 2 tax base only for a taxable year beginning in 1958. Under this sentence if (1) gain from operations for 1958 exceeds taxable investment income, and (2) the step 2 tax base (i.e., 50 percent of such excess) also exceeds the taxable investment income for that year, then the step 2 tax base is reduced by 10 percent of the amount of the latter excess. If, however, the step 2 tax base (before the application of this sentence) does not exceed the taxable investment income, this sentence shall not apply.

The operation of the reduction in the step 2 tax provided by this sentence may be shown by the following example:

	Company A	Company B
(1) Gain from operations	300	400
(2) Taxable investment income	100	100
(3) Excess of (1) over (2)	200	300
(4) Step 2 base (50 percent of (3))	100	150
(5) Excess of (4) over (2)	0	50
(6) Sec. 802(b) reduction (10 percent of (5))	0	5
(7) Adjusted step 2 tax base (for 1958 only)	100	145

Subpart B—Investment Income

SECTION 804. TAXABLE INVESTMENT INCOME

Your committee's bill eliminates section 804 of the House bill and provides, in lieu thereof, a new section 804 which is consistent with the concept adopted by your committee for determining the taxable investment income of a life insurance company.

(*a*) *In general.*—Paragraph (1) of this new subsection provides that the policyholders' share of each and every item of the investment yield of a life insurance company (as defined in subsec. (c), including tax-exempt interest, partially tax-exempt interest, and dividends received) shall not be included in taxable investment income. For the purpose of determining the percentage which represents the policyholders' (as opposed to the life insurance company's) share of any item, this paragraph specifies that it is to be computed by dividing the policy and other contract liability requirements (as defined in section 805(a)) by the investment yield.

Paragraph (2) of this new subsection provides, therefore, that taxable investment income shall be an amount (not less than zero) equal to only the sum of the life insurance company's share of each and every item of investment yield, reduced by the sum of such company's share of (1) tax-exempt interest, (2) the deduction for partially tax-exempt interest, and (3) the deduction for dividends received, plus the small business deduction provided by paragraph (4). This paragraph also defines the life insurance company's share of any item as the percentage equal to the difference between 100 percent and the percentage determined under paragraph (1) to be the policyholders' share of such item.

Paragraph (3) of this new subsection provides that for purposes of this part, the deduction allowed by section 242 (relating to partially tax-exempt interest) shall be determined by applying to the amount of such interest, the ratio of the normal tax rate (presently 30 percent) to the total tax rate (presently 52 percent).

Paragraph (4) of this new subsection provides a small-business deduction equal to 10 percent of the investment yield of the company for the taxable year up to a maximum of $25,000. This deduction is computed on investment yield rather than upon net investment income (as under the House bill) and at double the 5-percent rate that was contained in the House bill.

Paragraph (5) of this new subsection provides that if it is established in any case that the application of the definition of taxable investment income under this subsection results in the imposition of tax on any wholly tax-exempt interest, any amount of partially tax-exempt interest which is allowed as a deduction, or any amount of dividends received which is allowed as a deduction, adjustment shall be made to the extent necessary to prevent such imposition.

(*b*) *Gross investment income.*—Subsection (b) of the new section 804, which is the same as subsection (b) as it appeared in the House bill, defines gross investment income. The definition is in substance the same as under existing section 803(b) of the 1954 Code except for the addition (for taxable years beginning after December 31, 1958) of the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss. For the effect of the technical changes in the language of this subsection and of other provisions which relate to the manner of accounting for items of income and deduction, see the discussion of section 818(a) (relating to method of accounting).

(c) *Investment yield defined.*—This subsection is substantially similar to subsection (c) as it appeared in the House bill. The new section 804(c) defines investment yield as gross investment income less the deductions enumerated in paragraphs (1) through (5) which generally constituted allowable investment expense deductions under the House bill and existing law.

Paragraph (1), which corresponds to section 803(c)(2) of the 1954 Code, relates to investment expenses. All investment expenses for the taxable year are allowed as deductions unless general expenses are in part assigned to or included in investment expenses. In such case the total deduction under paragraph (1) cannot exceed the sum of the following:

(A) One-fourth of 1 percent of the mean of the assets (as defined in the new sec. 805(b)(3)) held at the beginning and end of the taxable year.

(B) The amount of the mortgage service fees, including origination fees, for the taxable year.

(C) Whichever of the following amounts is the greater:

(i) One-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by par. (1)) exceeds 3¾ percent of the mean of the assets (as defined in new sec. 805(b)(3)) held at the beginning and end of the taxable year, reduced by the amount of the mortgage service fees referred to in subparagraph (B).

(ii) One-fourth of 1 percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year. The term "mortgages held" refers to mortgages, and other similar liens, on real property which are held by the company as security for "mortgage loans."

Paragraphs (2), (3), and (4), of the new section 804(c) (relating to real estate expenses, depreciation, and depletion) are in substance the same as paragraphs (3), (4), and (5), respectively, of section 803(c) of the 1954 Code. In addition, the new paragraph (3), relating to depreciation, contains a rule relating to rental value of real estate (see existing sec. 803(d) of the code). Paragraph (5) of the new section 804(c), relating to trade or business deductions, is substantially the same as section 803(c)(6) of the 1954 Code.

SECTION 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS

Your committee's bill eliminates section 805 of the House bill and provides, in lieu thereof, a new section 805 which is consistent with the concept adopted by your committee for determining the policy and other contract liability requirements of a life insurance company.

(a) *In general.*—Subsection (a) of the new section 805 provides, for purposes of part I of subchapter L, a definition of the term "policy and other contract liability requirements." Under your committee's bill, this term is defined to mean the sum of—

(1) the adjusted life insurance reserves (as defined in subsec. (c)), multiplied by the average earnings rate (as defined in subsec. (b)),

(2) the mean of the pension plan reserves (as defined in subsec. (d)) at the beginning and end of the taxable year, multiplied by the current earnings rate (as defined in subsec. (b)), and

(3) the interest paid (as defined in subsec. (e)).

(*b*) *Earnings rates*.—Subsection (b) of the new section 805 contained in your committee's bill defines the earnings rates to be used in computing the policy and other contract liability requirements under subsection (a).

Paragraph (1) of this new subsection provides that for the purposes of part I of subchapter L, the term "current earnings rate" for the taxable year means the percentage determined by dividing—

(A) the taxpayer's investment yield (as defined in sec. 804(c)) for the taxable year, by

(B) the mean of the taxpayer's assets (as defined in par. (3) of this subsection) at the beginning and end of such taxable year.

Subparagraph (A) of paragraph (2) of this new subsection provides that the term "average earnings rate" for the taxable year means the average of the "current earnings rate" for such taxable year and the "current earnings rate" for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

Subparagraph (B) of this paragraph provides that for the purpose of computing the 5-year average earnings rate under subparagraph (A) the following special rules are to be applied—

(i) the "current earnings rate" for any taxable year prior to 1958 shall be determined as if part 1 of subchapter L (as in effect for 1958) applied to such taxable year, and

(ii) the "current earnings rate" for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company as defined in sec. 801(a)), shall be determined as if this part applied to such company for such year.

Under this subparagraph, therefore, the determination of a taxpayer's current earnings rate for pre-1958 years must be computed on the basis of its investment yield (as determined under the new sec. 804(c)) for those years, and on the basis of the mean of its assets (as determined under par. (3) of this subsection) for those years even though these new provisions are not otherwise in effect for years prior to 1958. Furthermore, if, in computing the 5-year average earnings rate of a life insurance company for any taxable year, the taxpayer was an insurance company (but not a life insurance company) in any of the 4 years preceding the taxable year in question, the provision of this part shall be applied in determining the current earnings rate for any such year as if the taxpayer were a life insurance company for such year.

Paragraph (3) of the new section 805(b) defines the term "assets" for purposes of part I of subchapter L as meaning all assets of the company (including nonadmitted assets); except that such term does not include real and personal property (other than money) used by the company in carrying on an insurance trade or business. In applying this definition—

(A) the amount attributable to real property and to stock is the fair market value thereof, and

(B) the amount attributable to any other asset is the adjusted basis of such asset for purposes of determining gain on sale or other disposition.

It is contemplated that in the case of real property, under appropriate circumstances the fair market value may be determined on the basis of a reasonable approximation of fair market value rather than on the basis of an annual reappraisal. The adjusted basis referred to in subparagraph (B) above is to be determined under section 1016 and the other related provisions of subtitle A of the 1954 Code, without regard to the rule of section 817(b) relating to fair market value on December 31, 1958.

(*c*) *Adjusted life insurance reserves.*—Subsection (c) of the new section 805 of your committee's bill (except for the substitution of the average earnings rate for the deduction rate in par. (1)(B)(i)) contains the same provisions that appeared in paragraphs (3) and (4) of section 805(b) of the House bill.

Paragraph (1) of this new subsection defines the term "adjusted life insurance reserves." Under your committee's bill the adjusted life insurance reserves is the amount determined by multiplying—

(A) the mean of the life insurance reserves (other than pension plan reserves, determined for the taxable year under subsection (d)) at the beginning and end of the taxable year, by

(B) that percentage which equals 100 percent—

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

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

Paragraph (2) of the new section 805(c) relates to the average interest rate assumed in calculating reserves. Under your committee's bill, such rate is to be computed—

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

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

After 1958 the assumed rate will not be calculated with reference to the portion of the reserves treated for the taxable year as pension plan reserves.

(*d*) *Pension plan reserves.*—Subsection (d) of the new section 805 of your committee's bill, except for the addition of a new subparagraph (D) to paragraph (1), is the same as paragraph (2) of section 805(c) of the House bill.

Paragraph (1) of the new section 805(d) defines the term "pension plan reserves" as that portion of the life insurance reserves which is allocable to the contracts (including supplementary contracts) described in the bill. First, there are included contracts purchased by trusts under master contracts entered into with such trusts, but only if such trusts were deemed (at the time such master contracts were entered into) to be trusts described in section 401(a) and exempt from tax under section 501(a) of the 1954 Code, or trusts exempt from tax under section 165 of the 1939 Code (as it appeared subsequent to the 1942 amendments or as it appeared before such amendments) or the corresponding provisions of prior revenue laws. Also included are contracts entered into under qualified insured plans which (as of the time the contracts were entered into) were

deemed to be plans meeting the requirements of section 401(a) (3), (4), (5), and (6) of the 1954 Code or the requirements of section 165(a) (3), (4), (5), and (6) of the 1939 Code. Pension plan reserves also includes that portion of the life insurance reserves which is allocable to contracts provided for employees of the taxpayer under a plan which (for the taxable year) meets the requirements of section 401(a) (3), (4), (5), and (6) of the 1954 Code. For this purpose, the term "employees" includes full-time life insurance salesmen treated as employees under section 7701(a)(20).

Your committee has added a new provision (subpar. (D) of par. (1)) which expands the definition of "pension plan reserves," as it appeared in the House bill, to include reserves under contracts purchased to provide retirement annuities for the employees of an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) of the 1954 Code or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939, or the corresponding provisions of prior revenue laws. This expansion of the definition of pension plan reserves does not apply to life insurance reserves held under contracts purchased by other exempt organizations. Accordingly, the reserves held under contracts purchased by other exempt organizations, or by entities not subject to Federal income tax, will not be treated as pension plan reserves unless they qualify as such under subparagraph (A), (B), or (C) of this paragraph.

Paragraph (2) of the new section 805(d) provides a special transitional rule for the treatment of pension plan reserves. The effect of this paragraph is to provide that for 1958 the pension plan reserves shall be included with the other life insurance reserves in determining the policy and other contract liability requirements under new section 805(a). For 1959, two-thirds of the pension plan reserves will be taken into account under section 805(a)(1) and one-third will be taken into account under section 805(a)(2). For 1960, one-third of the pension plan reserves will be taken into account under section 805(a)(1) and two-thirds under section 805(a)(2). For 1961 and thereafter the entire amount of the pension plan reserves will be taken into account under section 805(a)(2).

(*e*) *Interest paid.*—Subsection (e) of the new section 805 of your committee's bill, except for the addition of a new paragraph (4), is the same as section 805(d) of the House bill.

This subsection defines the term "interest paid" for the purposes of part I of subchapter L. Paragraphs (1) (relating to interest on indebtedness) and (2) (relating to amounts in the nature of interest) are, in substance, the same as paragraphs (1) and (2) of section 805(d) of the 1954 Code. Paragraph (3), for which there is no corresponding provision in existing law, includes within the definition of "interest paid" all amounts accrued for the taxable year for discounts in the nature of interest (whether or not guaranteed) on premiums or other consideration paid in advance on insurance and annuity contracts.

Paragraph (4), which is added by your committee, also defines the term "interest paid" to include interest on certain special contingency reserves established pursuant to section 8(d) of the Federal Employees' Group Life Insurance Act of 1954.

SECTION 806. CHANGE OF BASIS IN COMPUTING RESERVES

Section 806 of your committee's bill differs from the comparable provision of the House bill only by incorporating therein, as subsection (a), a provision substantially the same as section 805(b)(7) in the House bill. Subsection (b) of this bill is the same as section 806 of the House bill.

(*a*) *Adjustments to means for certain transfers of liabilities.*—Subsection (a) of your committee's new section 806 relates to situations where there is a change in life insurance reserves (either increases or decreases) attributable to the transfer of liabilities under contracts taken into account in computing such reserves. This occurs, for example, when life insurance company I purchases all or a part of the business of life insurance company X under an arrangement (sometimes referred to as "assumption reinsurance") whereby company I becomes solely liable to the policyholders. Both I and X will have to make the adjustments provided by subsection (a).

In situations to which subsection (a) applies, the means of the reserves, and the mean of the assets (both of which would, but for the new subsection (a) be computed with respect to amounts at the beginning and end of the taxable year) are to be appropriately adjusted to reflect the amounts involved in such transfer. The adjustments shall be made on a daily basis. The adjustments required by the new subsection (a) are to be made under regulations prescribed by the Secretary or his delegate.

To illustrate the application of this provision with respect to the means of the reserves, assume that the taxpayer T had reserves of $1 million at the beginning of the year and $1,040,000 at the end of the year. On January 30, the R company assumed all of T's risks on a block of policies with reserves. The reserves for this block were $60,000 at the beginning of the year and $62,000 on January 30. The computation with respect to T may be made as follows:

Reserves at beginning of year	$1,000,000		
Less reserves (at beginning of year) on contracts transferred to R	60,000		
Recomputed amount at beginning of year			$940,000
Reserves at end of year			1,040,000
Sum			1,980,000
Mean			990,000
Reserves (at beginning of year) on contracts transferred to R		$60,000	
Reserves (on Jan. 30) on such contracts		62,000	
Mean		61,000	
Taken into account, 30/365			5,014
Mean of reserves			995,014

It should be noted that the new subsection (a) is to be applied without regard to whether or not the transferor of the liabilities was the original insurer.

The new subsection (a) does not apply to reinsurance ceded by another person to the taxpayer, or by the taxpayer to another person. For example, it does not apply when, in the ordinary course of business, a reinsurance contract is entered into with another company (on a

yearly renewable term basis, on a coinsurance basis, or otherwise) whereby there is a sharing of risks under one or more individual contracts.

(*b*) *Change of basis in computing reserves.*—Subsection (b) of your committee's new section 806 provides that if the basis for determining the amount of any item referred to in section 810(c) (life insurance reserves, etc.) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of determining taxable investment income the amount of the item as of the close of the taxable year shall be the amount computed on the old basis, and the amount of the item as of the beginning of the next taxable year shall be the amount computed on the new basis.

For example, assume that the life insurance reserves at the beginning of the year are 100, that during the year a portion of the reserves is strengthened (by reason of a change in mortality or interest assumptions, or otherwise), so that at the end of the year the reserves (computed on the new basis) are 130 but computed on the old basis would be 120. Assume further that at the close of the next taxable year the reserves (computed on the new basis) are 142. Under the new section 806, the mean of such reserves for the taxable year of the reserve strengthening is 110 (the mean of 100 and 120). The mean of such reserves for the next taxable year is 136 (the mean of 130 and 142).

Subpart C—Gain and Loss from Operations

SECTION 809. IN GENERAL

Your committee bill eliminates section 809 of the House bill and provides instead a new section 809 which is consistent with the concept adopted by your committee for determining life insurance company taxable income.

(a) *Exclusion of share of investment yield set aside for policyholders.*—Subparagraph (1) of subsection (a) provides that the share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. (See subsec. (b) below.) This subparagraph provides that the "share of any item set aside for policyholders" is equal to the product of (i) the amount of such item, multiplied by (ii) the policyholders percentage of such item. This percentage will be computed by the use of the following ratio:

$$\frac{\text{required interest (as defined in section 809(a)(2))}}{\text{investment yield (as defined in section 804(c))}}$$

Subparagraph (2) of subsection (a) defines the term "required interest." The "required interest" for any taxable year is the sum obtained by multiplying (i) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by (ii) the means of the amount of such reserves computed at such rate at the beginning and end of the taxable year.

(b) *Gain and loss from operations.*—Paragraph (1) of subsection (b) defines the term "gain from operations" (for purposes of pt. I of subch. L of ch. 1 of the 1954 code) as meaning the excess of the

receipt items over the sum of the deductions provided under subsection (d). The receipt items are as follows: (A) The life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) less certain reduction items (these reduction items are composed of—(i) the sum of the items described in sec. 809(b)(3) (relating to tax-exempt interest, etc.), and (ii) the small business deduction provided by sec. 804(a)(4)); and (B) the sum of (i) premiums (see sec. 809(c)(1)), (ii) decreases in certain reserves (see sec. 809(c)(2)), plus (iii) other amounts (see sec. 809 (c)(3)).

Paragraph (2) of subsection (b) defines the term "loss from operations" as meaning the excess of the sum of the deductions provided under subsection (d) over the sum of the receipt items. The receipt items under paragraph (2) are identical with the receipt items under paragraph (1). (See above discussion.)

Paragraph (3) of subsection (b) further defines certain of the reduction items referred to in section 809(b)(1)(A)(i). These reduction items are taken into account in arriving at one of the receipt items (the life insurance company's share of investment yield) taken into account in determining gain or loss from operations under either section 809(b) (1) or (2). The reduction items provided under this paragraph are—

(1) The life insurance company's share of interest which under section 103 is excluded from gross income;

(2) The deduction for partially tax-exempt interest provided by section 242 (as modified by sec. 804(a)(3)) computed with respect to the life insurance company's share of such interest; and

(3) The deductions for dividends received provided by sections 243, 244, and 245 (as modified by sec. 809(b)(5)) computed with respect to the life insurance company's share of the dividends received.

Paragraph (4) provides that the "life insurance company's share of any item" is equal to the product of (i) the amount of such item, multiplied by (ii) the life insurance company's percentage of such item. The life insurance company's percentage of any item is determined by subtracting the policyholders percentage (determined under sec. 809(a)) from 100 percent. For example, if the policyholders percentage, as determined under section 809(a), is 72.38 percent, then the life insurance company's percentage is 27.62 percent (100 minus 72.38 percent). In the above case, if the amount of a particular item was $200, then the "life insurance company's share of such item" would be $45.24 ($200 multiplied by 27.62 percent) and the "share of any item set aside for policyholders" would be $144.76 ($200 multiplied by 72.38 percent).

Paragraph (5) provides the method for applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of section 809(b). Under this method, the limit on the aggregate amount of the deductions allowed by sections 243(a), 244, and 245 shall be 85 percent of the gain from operations computed without taking into account the following: (i) the deductions provided by section 809(d) (3), (5), and (6); (ii) the operations loss deduction provided by section 812; and (iii) the deductions allowed by sections 243(a), 244, and 245. It is further provided that in the event of a loss from operations that such limitation will not apply for such taxable year.

Paragraph (6) provides that if it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on the following items, adjustment shall be made to the extent necessary to prevent such imposition. The items are (1) any interest which under section 103 of the code is excluded from gross income, (2) any amount of interest which under section 242 (as modified by sec. 804(a)(3)) is allowable as a deduction, and (3) any amount of dividends received which under sections 243, 244, and 245 (as modified by sec. 809(b)(5)) is allowable as a deduction.

(c) *Gross amount.*—Subsection (c) specifies three categories of receipt items which are taken into account in determining whether there is a gain or loss from operations under section 809. Under paragraph (1) the gross amount of all premiums and other consideration on insurance and annuity contracts (including supplementary contracts) is taken into account; less return premiums, and premiums and other consideration arising out of reinsurance ceded. The premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer. In excluding return premiums, amounts returned (by whatever name called) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management are not to be treated as return premiums, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Furthermore, amounts rebated or rendered due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

Under paragraph (2), each net decrease that is required by section 810 or 811(b)(2) to be taken into account must be taken into account as a receipt item.

Paragraph (3) provides that all items, not included in computing investment yield and not otherwise taken into account under paragraphs (1) and (2), must be taken into account as receipt items to the extent that such items are includible in gross income under subtitle A of the 1954 code.

Subsection (c) further provides that, except for any excess of net short-term capital gain over net long-term capital loss included in investment yield, gains from (or considered as from) sales or exchanges of capital assets are not taken into account under subpart C. See discussion of section 802 for the treatment, in general, of capital gains under your committee bill.

(d) *Deductions.*—Subsection (d) provides the following nine categories of deductions which are to be taken into account in determining gain or loss from operations under section 809:

(1) All claims and benefits accrued, and losses incurred (whether or not ascertained), during the year on insurance, annuity, and supplementary contracts.

(2) Net increases in the reserves which are required by section 810 to be taken into account.

(3) Policyholder dividends as described in section 811.

(4) The operations loss deduction described in section 812.

(5) Ten percent of the increase for the taxable year in certain life insurance reserves for nonparticipating contracts (excluding group contracts) or 3 percent of the premiums for the taxable year

attributable to nonparticipating contracts (excluding group contracts) issued or renewed for periods of 5 years or more, whichever is greater.

(6) Two percent of the net premiums for the taxable year attributable to group life insurance and group accident and health contracts. This deduction for the taxable year and all preceding taxable years may not exceed 50 percent of the net premiums attributable to such contracts for the taxable year.

(7) Consideration (other than consideration arising out of reinsurance ceded) attributable to the assumption by another insurer of the policy contract liabilities of the taxpayer.

(8) Investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield.

(9) Except as modified by subsection (e), all other deductions allowed under subtitle A of the code in computing taxable income to the extent not allowed as deductions in computing investment yield.

Under paragraph (1) the phrase "all claims and benefits accrued" includes, for example, matured endowments and amounts allowed on surrender. The term "losses incurred (whether or not ascertained)" refers to a reasonable estimate of the amount of the losses incurred but not reported as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year. The reserves referred to in paragraph (5) above include only life insurance reserves, but do not include those reserves which, consistent with the method used in reporting on the Annual Statements prescribed by the various State regulatory authorities, are shown as annuity reserves. The premiums referred to in paragraph (5) above include only premiums attributable to nonparticipating contracts (other than group contracts) which are issued for periods of 5 years or more or are renewed for periods of 5 years or more, but do not include that portion of the premiums which is allocable to annuity features. The determination of whether a contract meets the 5-year requirement will be made as of the date it was issued, or as of the date it was renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy will qualify under section 809(d)(5), even though the individual insured subsequently dies at the end of the second year, since the policy was issued for a period of 5 years or more. However, a 1-year renewable term contract will not qualify, in that, as of the date it was issued (or of any renewal date) it was not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period will not qualify. However, if this policy were renewed for a period of 5 years or more, the policy would qualify under section 809(d)(5) from the date it was renewed. The consideration referred to in paragraph (7) arises, for example, where taxpayer T (in the example given in the discussion of sec. 806(a)) makes a payment or transfers property to company R in connection with company R's assumption of taxpayer T's policy contract liabilities.

(e) *Modifications.*—Under subsection (e), deductions allowable under subsection (d)(9) are subject to the following modifications:

(1) No deduction is allowed under section 163 for interest in respect of the items described in section 810(c).

(2) No deduction is allowed for an addition to reserves for bad debts under section 166(c) but a deduction for specific bad debts is permitted to the extent that the other provisions of that section are applicable.

(3) The charitable contribution deduction limitation of 5 percent of the gain from operations is modified to conform the limitations of section 170(b) to the provisions of the new subpart C.

(4) No deduction is allowed under section 171 for the amortization of bond premiums since a deduction for such premiums is specifically taken into account under section 818(b).

(5) The net operating loss deduction provided by section 172 is not allowed since in lieu thereof a new "operations loss deduction" is allowed under section 812.

(6) No deduction is allowed under section 242 for partially tax-exempt interest in view of the reduction allowed under section 809(b) for such interest.

(7) No deduction is allowed under sections 243, 244, and 245 for dividends received in view of the reduction allowed under section 809(b).

(f) *Limitation on certain deductions.*—Paragraph (1) of subsection (f) limits the deductions allowed under section 809(d) for dividends to policyholders (par. (3)), for an increase in reserves for certain nonparticipating contracts (par. (5)), and for net premiums on group life, accident, and health insurance (par. (6)), to the amount (if any) by which the gain from operations (computed without regard to such deductions) exceeds the taxpayer's taxable investment income for such year plus $250,000.

Paragraph (2) establishes a priority system for applying paragraph (1). For example, assume that the gain from operation for the taxable year (computed without regard to these deductions) is $100 million, that the taxable investment income is $95 million, that the deduction under section 809(d)(6) for net premiums on group life, accident, and health insurance (without the limitation) is $4 million, that the deduction (without the limitation) for the increase in reserves for certain nonparticipating contracts under section 809(d)(5) is $6 million, and the dividends to policyholders under section 809(d)(3) is $10 million. Under the priority system established by paragraph (2), the entire amount of the deduction provided by section 809(d)(6), namely $4 million, is allowable. Only $1,250,000 of the deduction allowable under section 809(d)(5) may be taken into account, and none of the dividends to policyholders may be taken into account.

SECTION 810. RULES FOR CERTAIN RESERVES

(a) *Adjustment for decrease.*—Your committee bill eliminates subsection (a) of section 810 of the House bill and provides instead a new subsection (a) which conforms to the new approach adopted by your committee in this bill. Under new subsection (a), if the sum of the items described in section 810(c) as of the beginning of the taxable year is greater than the sum of such items at the end of the taxable year (less the amount of required interest for such taxable year as determined under sec. 809(a)(2)), the amount of such excess shall be taken into account as a receipt item in determining gain or loss from operations.

(b) *Adjustment for increase.*—Your committee bill eliminates subsection (b) of section 810 of the House bill and provides instead a new subsection (b) which conforms to the new approach adopted by your committee in this bill. Under new subsection (b), if the sum of the items described in section 810(c) at the end of the taxable year (less the amount of required interest for such taxable year as determined under sec. 809(a)(2)) is greater than the sum of such items at the beginning of the taxable year, the amount of such excess shall be deducted in determining gain or loss from operations.

(c) *Items taken into account.*—Subsection (c) of section 810, which is identical with the House bill, sets forth the items to be taken into account. In addition to life insurance reserves, these items are unearned premiums and unpaid losses not included in life insurance reserves; amounts necessary to satisfy obligations under insurance or annuity contracts (including supplementary contracts) where these obligations do not involve life, health, or accident contingencies; certain dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including supplementary contracts); and premiums received in advance, and liabilities for premium deposit funds. In applying section 810(c), the same item is to be counted only once. For purposes of this provision, deficiency reserves are not to be taken into account.

(d) *Adjustment for change in computing reserves.*—Subsection (d) of section 810, which is identical with the House bill, deals with the effect on deductions for increases in reserves (or amounts included in income for decreases in reserves) where there have been changes in the method of computing the reserves. Paragraph (1) refers to what is generally described as reserve strengthening. This paragraph provides in the case of reserve strengthening that the additional deduction which would otherwise be allowable because of additions to reserves occurring in this strengthening process is to be taken into account ratably over a 10-year period rather than in a single year. The paragraph also provides the reverse treatment in the case of reserve weakening. This subsection in effect deems the reserve strengthening or weakening to occur at the end of the taxable year so that the 10-year period commences with the succeeding taxable year.

Under paragraph (2) of section 810(d), if for any year a company which previously was a life insurance company no longer qualifies as a life insurance company, any adjustments remaining to be made for reserve strengthening or weakening will be taken into account for the preceding taxable year. This provision is subject to the provisions of section 381(c)(22), which relates to carryovers in certain corporate readjustments (for discussion of this provision, see item 10 of the special provisions discussed under the general explanation of the bill).

Paragraph (3) of section 810(d) provides that if a taxpayer elects to increase his reserves by changing from a preliminary term method of computation to a net level premium method in accordance with section 818(c), such an election shall not be considered a change in the basis of determining an item described in section 810(c). This paragraph also provides that if such an election applies to any taxable year, the effect thereof on the taxpayer's reserves shall be disregarded for the purpose of this subsection.

The last sentence of section 810(d)(3) refers to a change in basis of computing reserves which involves, with or without other changes,

a shift from a preliminary term method to the net level premium method, where the taxpayer had previously made an election under section 818(c) to obtain the effects of the net level premium method for tax purposes. The sentence states that the amount that may be deductible over 10 years is only so much of the reserve strengthening as is not attributable to the shift from a preliminary term method to the net level premium method. To illustrate this rule, assume that company A restates the reserves on a block of policies from a 3-percent assumed rate and the Commissioner's reserve valuation method (one of the preliminary term reserve methods) to a 2-percent assumed rate and the net level premium method. The significant figures are shown below:

	Jan. 1, 1960	Dec. 31, 1960
Book reserves at 3 percent assumed rate, Commissioner's reserve valuation method	$200	$210
Reserves at 3 percent assumed rate, after restatement under sec. 818(c)	220	231
Strengthened reserves 2 percent assumed rate and net level premium method		255

The company's deduction for the year 1960 with respect to these reserves would be the difference between $220 and $231 or $11 because of the election previously made. The amount to be spread as a deduction over the following 10 years would be the difference between $255 and $231 or $24.

(e) *Certain decreases in reserves of voluntary employees beneficiary associations.*—Subsection (e) of section 810, for which there is no corresponding provision in the House bill, provides an exception to section 810(a) (relating to adjustment for decrease in reserves) in the case of a life insurance company which is an organization which meets all the requirements of section 501(c)(9) of the 1954 Code (relating to voluntary employees beneficiary associations) except the requirement of section 501(c)(9)(B) (which requires that 85 percent of the association's income consists of amounts collected from its members and their employer). Such a life insurance company shall take into account under section 810(a) only 11½ percent of any decrease in life insurance reserves attributable to the voluntary lapse on or after January 1, 1958, of any policy issued prior to that date. This treatment is available only where the life insurance company has made a proper election for the taxable year involved. This election shall be made not later than the time prescribed by law, including any extensions, for filing the return for the taxable year in which the taxpayer desires the treatment provided by this subsection. This election shall be made in such manner as the Secretary or his delegate prescribes by regulation. This election is effective not only for the taxable year for which made but also for all subsequent taxable years, unless consent to revoke the election is obtained from the Secretary or his delegate. If this election is made, the following provisions will not apply to such company making the election: (1) The special limitation on phase 2 tax for the year 1958, as provided for in the last sentence of section 802(b) and (2) the loss from operations for any taxable year beginning after December 31, 1954, and before January 1, 1958, shall not be allowed as an operations loss carryover, as provided for in section 812(b)(1).

SECTION 811. DIVIDENDS TO POLICYHOLDERS

(a) *Dividends to policyholders defined.*—With the exception of a conforming cross reference change, subsection (a) of section 811 is identical with the House bill. This subsection defines dividends to policyholders to mean dividends and similar distributions made to policyholders in their capacity as such. In general, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management are to be treated as dividends to policyholders. However, the term does not include interest paid as defined in section 805(e). Thus, the term does not include, for example, so-called excess interest payments made with respect to supplementary contracts not involving life, accident, or health contingencies merely because such interest payments exceed the amounts of interest guaranteed under such contracts.

(b) *Amount of deduction.*—Paragraph (1) of subsection (b) is the same as in the House bill except for one change discussed herein. This paragraph provides that except as limited by section 809(f) (relating to the limitation on certain deductions) the deduction for dividends to policyholders shall be an amount equal to the dividends paid to policyholders during the taxable year plus (or minus) any increase (or decrease) in the reserves for policyholder dividends payable during the immediately succeeding taxable year. For this purpose, reserves for policyholder dividends at the end of any taxable year shall include all amounts set aside before the 16th day of the 3d month of the year following such taxable year for payment of policyholder dividends during the year following such taxable year. The amendment made by your committee provides that in the case of a mutual savings bank subject to the tax imposed by section 594 reserves for policyholder dividends at the end of any taxable year shall include all amounts set aside before the 16th day of the 4th month (rather than the 3d month) following such taxable year for payment of policy dividends during the year following such taxable year.

Paragraph (2) of section 811(b), except for technical changes, corresponds to the House bill. This paragraph provides that if the amount of the decrease for the taxable year in the reserves for policyholder dividends exceeds the amount of dividends paid to policyholders during such year, the amount of the excess shall be taken into account as a receipt item under section 809(c)(2).

Paragraph 3 of subsection 811(b), for which there is no corresponding provision in the House bill, provides that for purposes of section 811(b)(1) the amounts held at the end of 1957 as reserves for dividends to policyholders payable during 1958 shall be the amounts actually paid as dividends to policyholders during 1958. For example, assume that the X company and the Y company each held as of December 31, 1957, and as shown on their books, a total amount of $10,000 as reserves for dividends to policyholders which were to be paid during 1958. Assume further that the actual amounts paid as dividends to policyholders during the year 1958 were $8,000 by the X company and $13,000 by the Y company. For purposes of section 811(b)(1), the reserves for dividends to policyholders as of December 31, 1957, shall be $8,000 for the X company and $13,000 for the Y company (the amounts actually paid as dividends in 1958).

SECTION 812. OPERATIONS LOSS DEDUCTION

The operations loss deduction provided by this section is, in substance, the same as the net operating loss deduction provided by section 172 but with modifications to conform the new section 812 to the provisions of the new part I of subchapter L.

(a) *Deduction allowed.*—Subsection (a) of section 812, which is identical with the House bill, provides for an "operations loss deduction." The deduction for any taxable year consists of the sum of the carryovers of operations losses from prior years and carrybacks of operations losses from subsequent years.

(b) *Operations loss carrybacks and carryovers.*—Your committee bill eliminates the House provision corresponding to paragraph (1) of subsection (b) and provides instead that a loss from operations for any taxable year ending after December 31, 1954 (rather than 1957 as provided in the House bill), like the net operating loss of a corporation which is not an insurance company, may be carried back to each of the 3 taxable years preceding the loss year and may be carried forward to each of the 5 taxable years succeeding the loss year. However, a loss from operations for any taxable year beginning before January 1, 1958, shall not be carried back to any taxable year beginning before January 1, 1955. Furthermore, a loss from operations for any taxable year beginning after December 31, 1957, cannot be carried back to any year commencing prior to January 1, 1958. Your committee bill further provides that, subject to section 812(e) (rules relating to new companies), if the life insurance company is a new company for the loss year the loss from operations may be carried forward to each of the 10 taxable years succeeding the loss year.

The loss from operations for all taxable years beginning after December 31, 1954, and before January 1, 1958, shall be determined as if this part, as in effect for 1958, applied to those taxable years.

The provisions of this new paragraph may be illustrated by the following examples: Company A, organized in 1940, has a loss from operations of $1,000 in 1958; this loss may not be carried back, but may be carried forward to each of the 5 taxable years following 1958. Company B, organized in 1940, has a loss from operations of $1,200 in 1959; this loss must be carried back to the taxable year 1958 and then carried forward to each of the 5 taxable years following 1959. Company C, organized in 1940, had a loss from operations of $1,300 for the taxable year 1956 (computed as if this part as in effect for 1958 applied to such year); this loss must first be carried back to the taxable year 1955 (computed as if this part as in effect for 1958 applied to such year) and then carried forward to each of the 5 taxable years following 1956. Company D, organized in 1958 and meeting the provisions of section 812(e), had a loss from operations of $1,400 for the taxable year 1958; this loss may be carried forward to each of the 10 taxable years following 1958. Company E, organized in 1954 and meeting the provisions of section 812(e), had a loss from operations of $1,500 for the taxable year 1956; this loss must first be carried back to the taxable year 1955 and then carried forward to each of the 10 taxable years following 1956.

Paragraph (2) of subsection (b), which is identical with the House bill, provides that the full amount of the loss from operations must first be carried back to the earliest year permissible under paragraph (1). The portion of the loss carried to any of the other taxable years

is the excess of the amount of the loss over the sum of the offsets (as defined in sec. 812(d)) for all prior taxable years to which the loss may be carried.

(c) *Computation of loss from operations.*—Subsection (c) of section 812, except for a clerical change, is identical with the House bill. It provides that in computing the loss from operations for any taxable year, the sum of the operations loss carryovers and carrybacks to such year shall be disregarded and the dividends received deductions permitted under sections 243, 244, and 245 shall be computed without regard to the limitation on such deductions provided in section 246(b) as modified by section 809(b)(5).

(d) *Offset defined.*—Section 812(b)(2) provides that the portion of the loss from operations which may be carried to each of the taxable years referred to in section 812(b)(1) (other than the first taxable year) is the excess thereof over the sum of the offsets for each of the prior taxable years to which the loss may be carried.

Subsection (d), which corresponds to the House bill, defines the term "offset" for purposes of section 812(b)(2). For any of the prior taxable years referred to in the preceding paragraph, the offset is only that portion of the increase in the operations loss deduction which was necessary to reduce the life insurance company taxable income to zero. For purposes of the preceding sentence, life insurance company taxable income is to be computed without regard to amounts subtracted from the policyholders surplus account for the taxable year, but there will be taken into account the adjustments in certain deductions (such as the deduction for dividends to policyholders) which flow from an increase in the operations loss deduction.

(e) *Rules relating to new companies.*—Subsection (e), for which there is no corresponding provision in the House bill, provides certain rules and definitions relating to new life insurance companies.

Paragraph (1) provides the general rule that a life insurance company is a "new company" for any taxable year only if such taxable year begins not more than 5 years after the first day in which it (or, if section 381(c)(22) applies, any predecessor) was authorized to do business as an insurance company.

Subparagraph (A) of paragraph (2) provides that for purposes of section 812(b)(1)(A)(iii) (relating to a 10-year carryover of losses for new companies) a life insurance company shall not be considered a new company for any loss year if at any time during such loss year it was a nonqualified corporation. This paragraph further provides that if, at any time during any taxable year after the loss year, the life insurance company is a nonqualified corporation, section 812(b)(1)(A)(iii) (the 10-year carryover, as distinguished from the ordinary 5-year carryover) shall cease to apply to (1) such loss for the taxable year of the nonqualification, and (2) all subsequent taxable years.

Subparagraph (B) of paragraph (2) defines the term "nonqualified corporation" to mean any corporation connected through stock ownership with any other corporation where either of such corporations possesses at least 50 percent of the voting power of all classes of stock of the other corporation. A corporation, for purposes of subparagraph (A), shall be treated as becoming a nonqualified corporation at any time at which it becomes a party to a reorganization other than a reorganization described only in section 368(a)(1) (E) or (F).

(f) *Application of subtitle A and subtitle F.*—This subsection, which corresponds to subsection (e) of section 812 of the House bill, provides that except as modified by section 809(e) (relating to modifications of deduction items otherwise allowable under subtitle A of the 1954 Code) subtitle A and subtitle F shall apply to operations loss carrybacks and carryovers, and to the operations loss deduction, in the same manner and to the same extent that they apply to the net operating loss carrybacks and carryovers, and to the net operating loss deduction, of corporations generally.

The operation of the new section 812 may be illustrated by the following example. Assume that company I is organized on January 1, 1959, and for 1959 and 1960 has the following results:

	1959	1960
Taxable investment income	$9,000,000	$9,000,000
Gain from operations	10,000,000	8,500,000
Tax base (sec. 802(b) (1) and (2))	9,500,000	8,500,000

Assume further that for the years 1961 and 1962 company I has a loss from operations of $9,800,000 and $10,200,000, respectively. Under section 812 the results are as follows:

	1959	1960	1961	1962
Taxable investment income	$9,000,000	$9,000,000		
1961 carryback	(9,800,000)	0		
1962 carryback	(10,200,000)	(9,600,000)		
Gain from operations (before operations loss deduction)	10,000,000	8,500,000		
Operations loss deduction (for other than offset purposes)	(20,000,000)	(10,000,000)		
Loss from operations			($9,800,000)	($10,200,000)

The entire amount of the loss from operations for 1961 and 1962 is an operations loss carryback to 1959. The operations loss deduction for 1959 before the carrybacks is zero. $10,000,000 of the deduction reduces the gain from operations and the tax base for 1959 to zero. Under section 812(d)(2), in computing the amount of the 1962 loss which is a carryback to 1960, the operations loss deduction for 1959 is $9,800,000. Thus, the offset is $200,000 (namely, the amount required to increase $9,800,000 to $10,000,000), leaving $10,000,000 as the carryback to 1960. Under this example, $8,500,000 of the $10,000,000 operations loss deduction for 1960 is an offset against the 1962 carryback, leaving $1,500,000 as an operations loss carryover from 1962 to 1963.

If, in addition to the deductions reflected in the above example, company I would have (without regard to sec. 809(f)) a deduction for 1959 of $2,500,000 for dividends to policyholders, the gain from operations and tax base would be $8,750,000 before the application of section 812 ($1,250,000 being the allowable deduction for dividends to policyholders under sec. 809(f)). However, upon application of section 812, the results for 1959 and 1960 are the same as in the example above since (after the application of the operations loss deduction) the gain from operations is less than the taxable investment income.

Subpart D—Distributions to Shareholders

SECTION 815. DISTRIBUTIONS TO SHAREHOLDERS

Subpart D is concerned with the tax which is imposed on an insurance company by reason of section 802(b)(3) (which includes in life insurance company taxable income amounts subtracted from the policyholders surplus accounts).

(a) *General rule.*—Subsection (a) of section 815 is basically the same as the corresponding provision of the House bill and provides an order of priority for distributions made by a stock life insurance corporation to a shareholder with respect to its stock. In view of certain effective date changes made by your committee in sections 815(b) and 815(c), your committee bill has made a conforming amendment to subsection (a) which provides that the priority system is only applicable to distributions to shareholders after December 31, 1958.

The priority system for distributions to shareholders shall be as follows: Distributions shall be treated as first being made out of the shareholders surplus account. (See (b) below.) Once this account has been exhausted (that is, reduced to zero), distributions are then to be considered as being made out of the policyholders surplus account (see (c) below), until this account is exhausted. Finally, distributions in excess of the amounts in the shareholders surplus account and the policyholders surplus account are to be treated as being made out of other accounts (for example, earnings and profits accumulated prior to January 1, 1958, paid-in-surplus, capital, etc.).

The term "distribution," as used in this subsection and subsection (d), means any distribution to any or all of a corporation's shareholders with respect to its stock, including any distribution in redemption of the corporation's stock, whether or not in partial or complete liquidation of the corporation. For example, there is a distribution within the meaning of section 815(a) in any case in which a corporation acquires the stock of a shareholder in exchange for property in a redemption treated as a distribution in exchange for stock under section 302(a) or treated as a distribution of property under section 302(d). Under section 815(a), the term "distribution" does not include any distribution made by a corporation of the distributing corporation's stock, or of rights to acquire its stock, whether or not such distribution would be treated as a distribution of property under section 305(b). (For a discussion of the application of this provision with respect to certain liquidations of subsidiaries and reorganizations, see part F of the general explanation of the bill.)

A further amendment to subsection (a) made by your committee bill provides an exception to the definition of the term "distribution." This amendment provides that the term "distribution" does not include any distribution in redemption of stock issued prior to January 1, 1958, where such stock was at all times on and after the date of its issuance and on or before the date of its redemption limited as to the amount of dividends payable and was callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of its issue price plus the amount of contribution to surplus (if any) made by the original purchaser at the time of his purchase.

(b) *Shareholders surplus account.*—Paragraph (1) of subsection (b), which corresponds to section 815(b)(1) of the House bill, provides that

every stock life insurance company (both domestic and foreign) shall establish and maintain a shareholders surplus account. Your committee has amended this subsection to provide that this account shall be established as of January 1, 1958 (rather than January 1, 1959, as provided in the House bill). The beginning or opening balance of this account on January 1, 1958, shall be zero.

Paragraph (2) of this subsection, except for a change in the effective date (see above) and certain cross-reference changes of a technical nature, is identical with section 815(b)(2) of the House bill. This paragraph provides for an addition to be made to the shareholders surplus account for any taxable year beginning after December 31, 1957. To determine the amount of this addition there must be ascertained the sum of the following:

(1) The amount of the life insurance taxable income (computed without regard to sec. 802(b)(3));

(2) For taxable years beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (in other words, the amount subject to the 25-percent tax imposed by sec. 802(a)(2));

(3) The amount of the deductions for—

(a) Partially tax-exempt interest provided by section 242 (as modified by sec. 804(a)(3)), and

(b) Dividends received (as modified by sec. 809(b)(5));

(4) The amount of interest excluded from gross income under section 103; and

(5) The amount of the small business deduction provided by section 804(a)(4).

This paragraph further provides that the addition to the shareholders surplus account shall be the amount by which the sum of the items referred to above exceeds the taxes imposed for the taxable year by section 802(a), determined without regard to section 802(b)(3).

Furthermore, there will be added to the shareholders surplus account at the beginning of the taxable year those amounts required to be so treated by reason of paragraphs (1) and (4) of section 815(d) (relating to election to transfer amounts from policyholders surplus account to shareholders surplus account, and to the limitation on the amount in the policyholders surplus account).

Paragraph (3) of this subsection provides, as did section 815(b)(3) of the House bill, the general rule that there shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under section 815 as distributed out of such account. In addition, your committee has amended this paragraph to provide a special rule for subtractions from the shareholders surplus account for distributions during 1958, in view of the change made in the effective date of section 815(b). This special rule provides that there shall be subtracted from the shareholders surplus account for any taxable year beginning in 1958 the amount of the distributions to shareholders made by the company during the year 1958. This special rule may be illustrated by the following example: Assume company P had additions to its shareholders surplus account (as determined under sec. 815(b)(2)) for the taxable year 1958 of $10,000, and actually distributed as dividends to its shareholders $8,000 during the year 1958. The balance in company P's shareholders surplus account as of January 1, 1959, will be $2,000. If company P had

distributed $12,000 as dividends in 1958, the balance in its shareholders surplus account as of January 1, 1959, will be zero, and the other accounts referred to in section 815(a)(2) will be reduced by $2,000.

(c) *Policyholders surplus account.*—Paragraph (1) of subsection (c), which is identical with the House bill, provides that every stock life insurance company (both domestic and foreign) shall establish and maintain a policyholders surplus account. This account shall be established as of January 1, 1959, and its beginning or opening balance on that date shall be zero.

Paragraph (2) of subsection (c), which corresponds to the House bill, provides for an addition to be made to the policyholders surplus account for any taxable year beginning after December 31, 1958. The House bill provided only for the addition of an amount equal to 50 percent of the amount by which the gain from operations exceeds the taxable investment income. Your committee has retained this provision of the House bill and, moreover, has amended this paragraph to provide for the addition of two other amounts to the policyholders surplus account. These amounts are as follows:

(1) The deduction for certain nonparticipating contracts provided by section 809(d)(5), as limited by section 809(f); and

(2) The deduction for group life and group accident and health insurance contracts provided by section 809(d)(6), as limited by section 809(f).

Paragraph (3) of this subsection, except for a technical change necessitated by the special rule provided in section 802(a)(3), is identical with the corresponding provision of the House bill. This paragraph provides that there shall be subtracted from the policyholders surplus account for any taxable year an amount equal to the sum of—

(1) The amount which (without regard to (2) below) is treated under section 815 as distributed out of the policyholders surplus account, plus

(2) The amount (determined without regard to sec. 802(a)(3)) by which the tax imposed for the taxable year by section 802(a)(1) is increased by reason of section 802(b)(3).

Furthermore, there will be subtracted from the policyholders surplus account for the taxable year those amounts subtracted, or treated as subtracted, under paragraphs (1) and (4) of section 815(d). The subtractions referred to in the preceding sentence shall be treated as made after all other subtractions from the policyholders surplus account for the taxable year.

The amount subtracted from a policyholder surplus account (which is significant for purposes of sec. 802(b)(3) and sec. 819(c)) will exceed the actual distribution to shareholders by the amount of corporate tax which this distribution will entail. If the corporation is subject to a 52 percent tax on additions to life insurance company taxable income, the amount subtracted from the policyholders surplus account can be determined by multiplying the amount treated as distributed out of the policyholders surplus account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate (presently 100 percent minus 52 percent). If the life insurance company taxable income computed without regard to section 802(b)(3) is less than $25,000, the foregoing formula will overstate the necessary

adjustment. The amount obtained under the formula should be reduced by an amount equal to the corporate surtax rate for the year multiplied by the excess of the lesser of—

(i) $25,000, or

(ii) an amount equal to the amount treated as distributed out of the policyholders surplus account multiplied by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the normal tax rate for the year

over the life insurance company taxable income computed without regard to this section. This paragraph may be illustrated by the following example: Assume company S for the taxable year 1961 is treated as having distributed to shareholders $9,600 out of the policyholders surplus account (as determined under sec. 815(a) and without regard to sec. 815(c)(3)(B)), and that the S company is subject to a 52 percent tax on additions to life insurance company taxable income. The total amount to be subtracted from the policyholders surplus account is $20,000, determined as follows:

$$\$9{,}600\times\frac{100}{(100-52)}=\$9{,}600\times\frac{100}{48}=\$20{,}000$$

Of this total amount, $9,600 is due to the application of section 815(c)(3)(A) and $10,400 to the application of section 815(c)(3)(B).

(d) *Special rules.*—Subsection (d) of section 815 provides certain special rules for the shareholders surplus and the policyholders surplus account.

Paragraph (1) of this subsection, with the exception of a clarifying change, is identical with section 815(d)(1) of the House bill. Subparagraph (A) of paragraph (1) of this subsection permits a life insurance company to make an election, for any taxable year for which it is a life insurance company, to subtract from its policyholders surplus account any amount (either the total amount in such account, or any portion thereof) in such account as of the close of such taxable year. The amount so subtracted, less the amount of tax imposed with respect to such amount (by reason of sec. 802(b)(3)), shall be added to the shareholders surplus account. This addition to the shareholders surplus account shall be deemed made as of the beginning of the taxable year following the taxable year for which the taxpayer has made the election provided for herein.

If, in the above example, life insurance company S had elected, under section 815(d)(1), for the taxable year 1961 to subtract from its policyholders surplus account (as of the close of the year 1961) the amount of $20,000, the tax on such amount would be $10,400 ($20,000×52 percent) and the amount added to the shareholders surplus account as of January 1, 1962, would be $9,600 ($20,000, the amount elected to be subtracted from the policyholders surplus account, minus $10,400, the amount of tax imposed with respect to such amount by reason of sec. 802(b)(3)).

Under subparagraph (B) of paragraph (1), this election must be made after the close of the taxable year for which it is to apply and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year, and in such manner and form as the Secretary or his delegate may by regulations prescribe. An election applies only with respect to the year for which made.

Once an election for a taxable year has been made, it may not be subsequently revoked. It is to be noted, however, that the amount subtracted pursuant to such an election may be affected by a subsequent operations loss which is carried back to such year. For example, assume that for the years 1959 through 1961, company X has the following results (assuming a 30 percent tax rate for all years involved):

	1959	1960	9161
Taxable investment income	$40.00	$40.00	$40.00
Gain from operations	60.00	60.00	60.00
Tax base (sec. 802(b) (1) and (2))	50.00	50.00	50.00
Tax (sec. 802(b) (1) and (2) base)	15.00	15.00	15.00
Shareholders surplus account—			
At beginning of year	0	35.00	37.00
Added at beginning of year by reason of election	0	7.00	0
Added for year (without regard to election)	35.00	35.00	35.00
Subtracted (distributions)	0	40.00	40.00
Policyholders surplus account—			
At beginning of year	0	0	10.00
Added for year	10.00	10.00	10.00
Subtracted (distribution)	0	0	0
Subtracted (election)	10.00	0	0
Tax base (sec. 802(b)(3))	10.00	0	0
Tax (sec. 802(b)(3) base)	3.00	0	0

Assume further that company X has a loss from operations for the year 1962 of $25. This amount is carried back to 1959 and reduces the tax base under section 802(b) (1) and (2) to $35. The results for the years 1959 through the beginning of 1962 are as follows:

	1959	1960	1961	1962
Taxable investment income	$40.00	$40,00	$40,00	
Gain from operations	35.00	60.00	60.00	
Tax base (sec. 802(b) (1) and (2))	35.00	50.00	50.00	
Tax (sec. 802(b) (1) and (2) base)	10.50	15.00	15.00	
Shareholders surplus account—				
At beginning of year	0	24.50	19.50	$14.50
Added for year (without regard to election)	24.50	35.00	35.00	
Added by reason of election	0	0	0	
Subtracted (distributions)	0	40.00	40.00	
Policyholders surplus account—				
At beginning of year	0	0	10.00	20.00
Added for year	0	10.00	10.00	
Subtracted (distribution)	0	0	0	
Subtracted (election)	0	0	0	
Tax base (sec. 802(b)(3))	0	0	0	
Tax (sec. 802(b)(3) base)	0	0	0	

Under these circumstances company X is entitled to a refund for 1959 of $7.50 ($4.50 under the sec. 802(b) (1) and (2) base, plus the $3 paid by reason of the election).

Paragraph (2) of subsection (d), which corresponds to section 815(d)(2) of the House bill, provides special rules pertaining to the termination of a company as a life insurance or insurance company. The House bill provided that in the case a company ceased to be a life insurance company for 1 taxable year, the amount taken into account under section 802(b)(3) for the preceding year was to be increased by the entire balance remaining in the policyholders surplus account as of the close of the preceding taxable year. Your committee bill eliminated the House provision and provides instead that if (i) for any taxable year the taxpayer is not an insurance company,

or (ii) for any 2 successive taxable years the taxpayer is not a life insurance company (within the meaning of sec. 801), the amount taken into account under section 802(b)(3) for the last preceding year for which it was a life insurance company shall be increased (after the application of sec. 815(d)(2)(B)) by the entire balance in the policyholders surplus account at the close of such last preceding taxable year. These rules are subject to the exception provided in section 381(c)(22).

Your committee has provided a further rule in the case of certain distributions during a taxable year when the taxpayer is an insurance company but does not qualify as a life insurance company under section 801. Subparagraph (B) provides that in such event the distributions to shareholders during that taxable year shall be treated as having been made on the last day of the last preceding taxable year for which the taxpayer was a life insurance company.

Paragraph (3) of subsection (d), which is identical with the corresponding provision of the House bill, provides a special rule where a taxpayer makes any payment in discharge of its indebtedness, and such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959. This paragraph provides that the amount of such payments shall be treated as a distribution in cash to the shareholders, both for purposes of section 815 (particularly, in determining whether such payment is to be treated as made from the shareholders surplus account, the policyholders surplus account, or other accounts) and section 802(b)(3). The paragraph applies, however, only to the extent that the actual distribution to shareholders was treated as being out of accounts other than the shareholders and policyholders surplus accounts at the time of distribution.

Paragraph (4), which corresponds to section 815(d)(4) of the House bill, provides a limitation on the amount that any life insurance company may accumulate in its policyholders surplus account. Your committee, in addition to certain technical changes, has amended this provision to provide that if the policyholders surplus account (computed at the end of the taxable year without regard to this paragraph) exceeds the greatest of—

(1) 15 percent of life insurance reserves at the end of the taxable year (the House bill provided 25 percent),

(2) 50 percent of the sum of the premiums and other consideration taken into account for the taxable year under section 809(c)(1) (the House bill provided 60 percent), or

(3) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958 (the House bill contained no comparable provision),

then such excess shall be treated as subtraction from the policyholders surplus account as of the end of such taxable year. The amount so treated as subtracted (less the amount of tax imposed with respect to such amount by reason of sec. 802(b)(3)) shall be added to the shareholders surplus account at the beginning of the succeeding taxable year.

(e) *Special rule for certain mutualizations*.—Subsection (e) of section 815, except for technical changes, is identical with the House bill and refers to amounts distributed to shareholders in acquisition of

stock pursuant to a plan of mutualization of a life insurance company. A distribution is pursuant to a plan of mutualization only if the requirements of applicable law for the adoption of such plan (as, for example, approval by the requisite majority of the board of directors, shareholders, and policyholders) have been fulfilled. Paragraph (1) establishes a rule for allocating these distributions to various accounts that will operate in place of subsection (a).

Under paragraph (1) any amount distributed to stockholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization is first to be treated as a return of paid-in capital and paid-in surplus to the extent thereof. This much of any distribution will not involve any tax to the insurance company. After this amount is distributed, further amounts distributed under the plan of mutualization will be allocated, as made, into two parts. One part (which may be called a distribution out of pre-1959 earnings) is to be treated as made out of accounts referred to in subsection (a)(3) and consequently this part of the distribution will not involve additional tax to the insurance company. The other part of the distribution (which may be called a distribution out of post-1958 earnings) is to be treated under the rule provided in subsection (a), namely, first as being made out of the shareholders surplus account to the extent thereof, and then out of the policyholders surplus account to the extent thereof.

Subparagraph (A) of paragraph (2) defines the allocation ratio for allocating distributions to the category of pre-1959 and post-1958 earnings. The numerator of this ratio is the excess of the assets of the company (as defined in sec. 805(b)(3)) over the total liabilities (including reserves), both determined as of December 31, 1958, but adjusted as provided in subparagraph (B). The denominator of this ratio is the amount described in the numerator plus the amounts in the shareholders surplus account and in the policyholders surplus account, all determined as of the beginning of the year of the distribution.

Subparagraph (B) of paragraph (2) deals with a situation where the taxpayer has been treated between 1958 and the year of the distribution as having made a distribution out of accounts other than the shareholders surplus account and the policyholders surplus account. In all cases to which the allocation ratio applies, this will require subtracting from the numerator and the denominator the amount of the prior distributions (under the plan of mutualization or otherwise) which are treated as a return of paid-in capital and paid-in surplus or as out of the other accounts referred to in subsection (a)(3).

Subpart E—Miscellaneous Provisions

SECTION 817. RULES RELATING TO CERTAIN CAPITAL GAINS AND LOSSES

(a) *Treatment of capital gains and losses, etc.*—Subsection (a) of section 817, which is identical with the House bill, provides special rules for life insurance companies in the case of capital gains and losses and gains and losses on property used in the trade or business.

With respect to property used in the trade or business and held for more than 6 months, section 1231 of the code provides, in general, that where the gains from the sale or exchange of such property exceed such losses, each gain and loss is treated as though it was from the sale or exchange of a long-term capital asset. Where the losses exceed the

gains, then each gain or loss is considered as not being from the sale or exchange of a capital asset, with the result that ordinary gain or loss is realized.

Subsection (a) modifies the above section 1231 by limiting the term "property used in the trade or business" to include only property used in carrying on an insurance business. Specifically, this subsection provides that, for purposes of section 1231(a) (relating to property used in the trade or business and involuntary conversions), the term "property used in the trade or business" shall be treated as including only (1) "property used in carrying on an insurance business," of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in carrying on an insurance business, held for more than 6 months, which is not described in section 1231(b)(1)(A) (relating to property includible in inventory), section 1231(b)(1)(B) (relating to property held for sale to customers), or section 1231(b)(1)(C) (relating to a copyright, a literary, musical, or artistic composition, etc.); and (2) property described in section 1231(b)(2) (relating to timber and coal).

This subsection further provides that, for purposes of section 1221(2) (excluding certain property from the term "capital assets"), the reference to property used in trade or business shall be treated as including only "property used in carrying on an insurance business."

The term "property used in carrying on an insurance business" means (for purposes of applying both secs. 1231(a) and 1221(2)) only those assets used in the operation of the insurance trade or business. These assets include such items as the home office building, branch offices, office equipment, and furniture and fixtures. These assets do not include the so-called investment assets from which interest, rents, dividends, and royalties are derived. Thus, the gains or losses from the sale or exchange of depreciable assets attributable to any trade or business (other than an insurance business) carried on by the life insurance company, such as renting various pieces of real estate, or operating a radio station, a housing development, or a farm, will be treated as gains or losses from the sales or exchanges of capital assets rather than (if losses exceed gains) ordinary gains and losses.

(b) *Gain on property held on December 31, 1958, and certain substituted property acquired after 1958.*—Subsection (b) of section 817 is basically the same as the corresponding provision of the House bill. Although numerous clerical and technical changes have been made by your committee, such changes are designed to clarify the application of the principles of subsection (b) of the House bill rather than to change its fundamental theory.

Paragraph (1) of subsection (b), in effect, limits the amount of gain that is to be recognized on the sale or other disposition of certain property held by the taxpayer on December 31, 1958. This is accomplished specifically by treating the gain on the sale or disposition of such property as an amount (but not less than zero) equal to the amount by which the gain (determined without regard to this subsection) exceeds the difference between the fair market value on December 31, 1958, and the adjusted basis for determining gain as of such date. (See discussion under sec. 3(d) of your committee bill, relating to adjustments to basis under sec. 1016(a) of the code.) This limitation on the amount of gain recognized applies only if (1) the property was held by a life insurance company on December 31,

1958, (2) the fair market value of the property on December 31, 1958, is greater than the adjusted basis for determining gain as of that date, and (3) the taxpayer has been a life insurance company at all times on and after December 31, 1958, until the date of the sale or other disposition of the property.

Paragraph (2) of subsection (b) provides certain rules for property acquired after December 31, 1958, and having a substituted basis within the meaning of section 1016(b) of the code. Subparagraph (A) provides, for purposes of section 817(b)(1), that such property shall be deemed as having been held continuously by the taxpayer since the beginning of the holding period of the property, determined in accord with section 1223 of the code. Subparagraph (B) provides, for purposes of section 817(b)(1), that the fair market value and the adjusted basis shall be that of that property for which the holding period taken into account includes December 31, 1958. Subparagraph (C) provides that section 817(b)(1) shall apply only if the property or properties the holding period of which are taken into account were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account. Subparagraph (D) provides that the difference between the fair market value and the adjusted basis referred to in section 817(b)(1) shall be reduced (but not below zero) by the excess of (i) the gain that would have been recognized but for section 817(b) on all prior sales or dispositions after December 31, 1958, of properties referred to in section 817(b)(2)(C), over (ii) the gain that was recognized on such sales or other dispositions. Subparagraph (E) provides that the basis of such property shall be determined as if the gain which would have been recognized but for section 817(b), were recognized gain.

The new section 817(b)(2) clarifies the application of the basic rule provided in section 817(b)(1) to gain on the sale or other disposition of property which has a substituted basis—that is, its basis is determined (1) by reference to the basis in the hands of a transferor, donor, or grantor, or (2) by reference to other property held at any time by the person for whom the basis is determined.

For example, assume that life insurance company I owned property X on December 31, 1958, at which time its adjusted basis was $1,000 and its fair market value was $1,800. On January 31, 1960, in a transaction to which section 1031 of the 1954 Code applies, I receives property Y having a fair market value of $1,700 plus $300 in cash in exchange for property X. The gain on the transaction without regard to section 817(b) is $1,000 (assuming no adjustment to basis for the period since December 31, 1958). Under section 817(b) the gain is treated as $200. All of this $200 is recognized gain since under section 1031, $300 of the $1,000 gain would be recognized.

Under section 817(b)(2)(E), the basis of Y is determined as if the entire $300 cash received had been recognized gain. Thus, the basis of Y under section 1031 is $1,000 (the basis of X) minus $300 (the amount of money received) plus $300 (the gain of $200 recognized on the exchange plus $100 which would have been recognized but for sec. 817(b)) or $1,000.

If I later sells Y for $2,200 cash and its adjusted basis is $1,000, the gain is $1,200, which under section 817(b) is treated as a gain of $700 (under sec. 817(b)(2)(D), the $800 difference is reduced by the excess of $300, the amount which would have been recognized on

all prior dispositions but for sec. 817(b), over $200, the gain that was recognized on all prior dispositions).

Paragraph (3) of subsection (b) provides that the term "property" (for purposes of this subsection) does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in paragraph (1) of section 1221 (relating to stock in trade or inventory-type property).

(c) *Limitation on capital loss carryovers.*—Subsection (c) of section 817, which is identical with the House bill, provides that a net capital loss for any taxable year beginning before January 1, 1959, shall not be taken into account. For any taxable year beginning after December 31, 1958, the provisions of part II of subchapter P (relating to the treatment of capital losses) of the 1954 Code will be applicable to life insurance companies for purposes of determining the tax imposed by section 802(a)(2) (relating to the tax in case of capital gains).

(d) *Gain on transactions occurring prior to January 1, 1959.*—Subsection (d) of section 817, for which there is no corresponding provision in the House bill, makes it clear that any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset which results from sales or other dispositions of property prior to January 1, 1959, shall not be included under this part. Thus, this subsection excludes from section 802(a)(2) (relating to the tax in case of capital gains) any gain from the sale of a capital asset consummated before 1959 where the sale was on the installment method.

(e) *Certain reinsurance transactions in 1958.*—Subsection (e) of section 817, for which there is no corresponding provision in the House bill, provides a special rule applicable only to the year 1958 which characterizes the reinsurance (or sale) by a life insurance company of all of its life insurance contracts of a particular type as a sale of a capital asset. This subsection further provides that the reinsurance must have taken place in a single transaction, or in a series of related transactions, all of which occurred during 1958, and the reinsuring company or companies must have assumed all liabilities under such contracts. For example, this provision would apply where a life insurance company reinsured or sold its entire industrial business to one or more life insurance companies during 1958. For any taxable year beginning after December 31, 1958, the determination as to whether the reinsurance or sale of a group of contracts where the reinsurer assumes all liabilities under such contracts shall be treated as a sale of a capital asset shall be made as if this subsection had not been enacted.

SECTION 818. ACCOUNTING PROVISIONS

(a) *Method of accounting.*—Subsection (a) of section 818, which is identical with the House bill, provides the general rule that all computations entering into the determination of taxes imposed by the new part I of subchapter L shall be made under an accrual method of accounting. This subsection further provides that, to the extent permitted under regulations prescribed by the Secretary or his delegate, a life insurance company may determine its taxes under a combination of an accrual method of accounting with any other method permitted by chapter 1 (other than the cash receipts and disbursements method). For example, the Secretary or his delegate may determine that the use of the installment method for reporting sales

of realty and casual sales of personalty (see sec. 453(b)) may, in combination with an accrual method of accounting, properly reflect life insurance company taxable income. To the extent not inconsistent with the provision of the 1954 Code and an accrual method of accounting, all computations entering into the determination of taxes imposed by the new part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(b) *Amortization of premium and accrual of discount.*—Subsection (b) of section 818 is identical with the corresponding provision of the House bill. Paragraph (1) of subsection (b), relating to the amortization of premium and accrual of discount on evidences of indebtedness, provides, in substance, the same rule as in existing section 803(e) of the code, insofar as life insurance companies are concerned. However, special rules are provided in subparagraphs (A) and (B) of paragraph (2) with respect to the amortizable bond premium in the case of bonds acquired after December 31, 1957, and with respect to convertible evidences of indebtedness whenever acquired. Under subparagraph (A), the provisions of section 171(b) are to be applied in determining the total amount of bond premium and in determining the amount of amortizable bond premium for any particular taxable year. The effect of this provision is to make the same rules (chiefly sec. 171(b)(1)(B)(ii)) applicable to life insurance companies as were made applicable to other corporations by the amendments to section 171(b) of the 1954 code made by section 13 of the Technical Amendments Act of 1958.

With respect to convertible evidences of indebtedness, subparagraph (B) provides that the amount of premium shall in no case include any amount attributable to the conversion features of an evidence of indebtedness. This rule which applies to any convertible evidence of indebtedness is the same rule as is applied under section 171(b) in the case of a convertible bond. This rule is to be applied without regard to the date that the evidence of indebtedness was acquired.

(c) *Life insurance reserves computed on preliminary term basis.*—Subsection (c) of section 818 is the same as the corresponding section of the House bill except for one amendment pertaining to a 1958 election which is discussed herein. This subsection provides that where a company actually computes its life insurance reserves on one of the recognized preliminary term bases, it may elect to convert them to a net level premium basis in the computation of life insurance reserves for tax purposes.

The reserves may be converted from a preliminary term basis to a net level premium basis for tax purposes by one of two methods. Paragraph (1) provides the so-called exact revaluation method. Under this method, the life insurance company must compute the reserves for all such contracts on a net level premium basis, using the same mortality assumptions and interest rates for both the preliminary term basis and the net level premium basis. Paragraph (2) provides an approximate revaluation method. Under this method, with respect to contracts for which reserves are computed under the preliminary term basis, the reserves are increased by the sum of (A) $21 per $1,000 of insurance in force (other than term insurance), less 2.1 percent of reserves therefor, and (B) $5 per $1,000 of term insurance in force

under contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves therefor.

If the taxpayer elects one of the two methods provided in this subsection, all contracts for which life insurance reserves are computed on a preliminary term basis must be so converted. Whichever basis (i.e., the exact revaluation or the approximate revaluation) is adopted for tax purposes must be adhered to in making the computations under this part (other than for purposes of the definition of a life insurance company as determined under sec. 801) for the taxable year of election and all subsequent taxable years, unless a change in the basis of computing such reserves is approved by the Secretary or his delegate. The amendment made by your committee provides an exception to the above rule. This amendment provides that if, pursuant to an election made for a taxable year beginning in 1958, the basis adopted is the approximate revaluation basis, then the taxpayer may change to the exact revaluation basis for its next taxable year.

(d) *Short taxable years.*—Subsection (d) of section 818, which is identical with the House bill, provides that if any return of a corporation made under part I is for a period of less than the entire calendar year, then section 443 (relating to returns for a period of less than 12 months) shall not apply in respect of the short period.

Where a life insurance company has a short period, the bill provides the following rules for determining the life insurance company taxable income for such short period:

(1) First, the taxable investment income (as defined in sec. 804) and the gain or loss from operations (as defined in sec. 809) shall be determined, under regulations prescribed by the Secretary or his delegate, on an annual basis by a ratable daily projection of the appropriate figures for the short period, using techniques similar to those illustrated in the discussion of section 806(a).

(2) Then, the portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) (pertaining to taxable investment income and gain or loss from operations) shall be determined on an annual basis by treating the amounts so determined under (1), above, as being the taxable investment income and the gain or loss from operations for the taxable year.

(3) Finally, the portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) for the short period shall be an amount which bears the same ratio to the amount ascertained under (2), above, as the number of days in the short period bears to the number of days in the entire calendar year.

(e) *Transitional rule for changes in methods of accounting.*—Subsection (e) of section 818 is basically the same as the corresponding provision of the House bill except for paragraph (4) which your committee has added in order to provide certain modifications to the recomputation formula which are not found in the House bill. Subsection (e) of section 818 of the new part I provides transitional rules applicable with respect to changes in method of accounting.

Paragraph (1) of section 818(e) provides that if the method of accounting required to be used in computing the taxpayer's taxes for the taxable year 1958 under the new part I is different from the method used in computing its taxes for 1957 under the old part I then there shall be ascertained the net amount of those adjustments which are determined (as of the close of 1957) to be necessary solely by reason of the change to the method required by section 818(a)

in order to prevent amounts from being duplicated or omitted. The term "net amount of those adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in the various accounts, on December 31, 1957. This subsection further provides that the amount of the taxpayer's tax for 1957 shall be recomputed (under the law applicable to 1957, modified as provided in paragraph (4)) taking into account an amount equal to one-tenth of the "net amount of those adjustments." The amount of increase or decrease in tax (as the case may be) referred to in paragraph (2) or (3) (explained below) is the amount of the increase or decrease ascertained under the preceding sentence, multiplied by 10.

Paragraph (2) of section 818(e) of the new part I provides that if the recomputation under paragraph (1) results in a decrease, the amount thereof is to be a decrease in the tax imposed for 1957; except that for purposes of computing the period of limitation on the making of refunds or the allowance of credits with respect to such overpayment, the amount of such decrease is to be treated as an overpayment of tax for 1959. No interest is to be allowed, for any period before March 16, 1960, on any overpayment of the tax imposed for 1957 which is attributable to such decrease.

Paragraph (3) provides that for purposes of subtitle F (other than secs. 6016 and 6655 relating to declarations of estimated income tax by corporations and failure by corporations to pay estimated income tax), if the recomputation under paragraph (1) results in an increase, the amount thereof is to be treated as a tax imposed by this subsection for 1959. Such tax is to be payable in 10 equal annual installments, beginning with March 15, 1960.

Your committee has added paragraph (4) of subsection (e). This paragraph provides that for purposes of section 818(e)(1) in recomputing the tax for 1957 the following modifications must be taken into account—(1) section 804(b), as in effect for 1957, shall not apply with respect to any amount required to be taken into account by virtue of section 818(e)(1) of your committee's bill, and (2) the amount of the deduction allowed by section 805, as in effect for 1957, shall not be reduced by reason of any amount required to be taken into account by virtue of section 818(e)(1) of your committee's bill.

(f) *Denial of double deduction.*—Subsection (f) of section 818, which is identical with the House bill, provides that nothing in the new part I shall permit the same item to be deducted more than once in determining taxable investment income (under subpt. B) and more than once in determining gain or loss from operations (under subpt. C). This subsection is, in substance, the same as existing section 817 of the code.

SECTION 819. FOREIGN LIFE INSURANCE COMPANIES

(a) *Carrying on U.S. insurance business.*—Subsection (a) of section 819, which is identical with the House bill, provides that a foreign life insurance company carrying on life insurance business within the United States (if with respect to its U.S. business it would qualify as a life insurance company under sec. 801) is to be taxable on its U.S. business in the same manner as a domestic life insurance company. Except as provided in subsection (b) of this section and

section 818(a), the determinations necessary for purposes of subtitle A shall be made on the basis of the annual statement for the taxable year of the U.S. business of such company on the form approved by the National Association of Insurance Commissioners.

(b) *Adjustment where surplus held in United States is less than specified minimum.*—Paragraph (1) of subsection (b), which corresponds to section 819(b)(1) of the House bill, provides a special rule where the surplus of a foreign life insurance company which is held in the United States is less than the minimum figure (an amount which the average domestic life insurance company would have maintained with respect to its total insurance liabilities). The amendments made by your committee to this paragraph of the House bill are to conform it to the concept adopted by your committee for determining life insurance company taxable income, rather than to change its fundamental theory. Where the surplus held in the United States is less than the "minimum figure" (as defined below), this subsection provides that the amount of the policy and other contract liability requirements and the amount of the required interest shall each be reduced. The amount of the reduction is determined by multiplying the excess of the minimum figure over the surplus held in the United States by the company's current earnings rate, as determined under section 805(b)(1). The policy and other contract liability requirements under section 805 and the required interest under section 809(a)(2) shall first be determined without regard to this subsection.

Paragraph (2) of subsection (b), which is identical with the House bill, contains certain definitions of terms used in this subsection. The "minimum figure," in the case of a taxable year beginning after December 31, 1957, but before January 1, 1959, is the amount obtained by multiplying the company's total insurance liabilities on U.S. business by 9 percent. In the case of any taxable year beginning after December 31, 1958, the "minimum figure" will be obtained by multiplying the company's total insurance liabilities on U.S. business for such year by a percentage to be determined and proclaimed by the Secretary or his delegate as being applicable to such year. This percentage is to be based on such data with respect to domestic life insurance companies for the preceding taxable year as the Secretary of the Treasury or his delegate considers representative. This percentage will be computed by the use of the following ratio:

$$\frac{\text{assets minus total insurance liabilities}}{\text{total insurance liabilities.}}$$

For purposes of this subsection, certain terms are specifically defined as follows: (1) the "surplus held in the United States" is the excess of the assets held in the United States over the total insurance liabilities on U.S. business; and (2) "total insurance liabilities" means the sum of the total reserves, as defined in section 801(c) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), and (5) of section 810(c). The definition of the term "assets" contained in section 805(b)(3) applies to such term when used in this subsection. The current earnings rate of a foreign life insurance company is to be determined by reference to assets held in the United States.

The application of this subsection may be illustrated by the following example: Assume for the taxable year 1958 that C corporation,

a foreign life insurance company, has total life insurance liabilities on U.S. business of $940,000, assets held in the United States of $1,000,000, a policy and other contract liability requirements in the amount of $30,000, required interest in the amount of $20,000, and a current earnings rate of 4 percent. In order to determine whether section 819(b) is applicable for the taxable year 1958, the company must first compute its "minimum figure." If the minimum figure is less than the surplus held in the United States, section 819(b) does not apply. However, in this case, the minimum figure is $84,600 ($940,000, the total insurance liabilities on U.S. business, multiplied by 9 percent, the percentage applicable for the year 1958). Since the minimum figure, $84,600, exceeds the surplus held in the United States, namely, $60,000 (the difference between the assets held in the United States, $1,000,000, and the total insurance liabilities on U.S. business, $940,000), by $24,600, section 819(b) applies for the taxable year. Therefore, the amount of the policy and other contract liability requirements, as determined under section 805, and the amount of the required interest, as determined under section 809(a)(2), must each be reduced by $984 ($24,600, the amount of the excess, multiplied by 4 percent, the current earnings rate). Thus, the policy and other contract liability requirements are now reduced to $29,016 ($30,000 minus $984) and the required interest is reduced to $19,016 ($20,000 minus $984).

(c) *Distributions to shareholders.*—Paragraph (1) of subsection (c) of your committee bill retains the rule contained in subsection (c) of section 819 of the House bill which provided a rule for determining, in the case of a foreign life insurance company, the amount of distributions to shareholders for purposes of section 815 (relating to distributions to shareholders) and section 802(b)(3) (relating to life insurance company taxable income). This rule may be expressed as follows:

The amount of the distributions to shareholders is the amount determined by dividing—

(1) The product obtained by multiplying the minimum figure for the taxable year by the total amount of the distributions to shareholders, by

(2) The assets of the company minus the total insurance liabilities.

Furthermore, your committee has provided in paragraph (1) of subsection (c) an alternative rule or method for determining the amount of distributions to shareholders. This alternative method may be expressed as follows:

The amount of the distributions to shareholders is the amount determined by dividing—

(1) The product obtained by multiplying the total insurance liabilities on U.S. business for the taxable year by the total amount of the distributions to shareholders, by

(2) The total insurance liabilities.

Your committee bill further provides that the taxpayer may elect, for each taxable year, whichever of the two methods provided in subparagraph (1) it desires. Thus, the method elected for one taxable year is only binding upon the taxpayer for such taxable year and is not binding for future taxable years.

For purposes of this subsection, the "minimum figure for the taxable year" is determined in accordance with section 819(b)(2)(A); the "total amount of the distributions to shareholders" means all

distributions (within the meaning of this term in sec. 815) by the foreign life insurance company to all of its shareholders whether or not in the United States; the "assets of the company" means all of the assets (as defined in sec. 805(b)(3)) of the company whether or not in the United States; and the term "total insurance liabilities" means the total insurance liabilities (as defined in sec. 819(b)(2)) of the company on all of its business whether or not in the United States. Once the amount of "distributions to shareholders" is determined under the above formula, the rules of section 815 will apply to the shareholders surplus account and the policyholder's surplus account of the stock foreign life insurance company in the same manner as they would apply to a domestic stock life insurance company.

(d) *No U.S. insurance business.*—Subsection (d) of section 819, which corresponds to the House bill, is identical with section 816(b) of existing law.

SECTION 820. OPTIONAL TREATMENT OF POLICIES REINSURED UNDER MODIFIED COINSURANCE CONTRACTS

This section, for which there is no corresponding provision in the House bill, provides an optional treatment for policies reinsured under a modified coinsurance contract.

(a) *In general.*—Subsection (a) provides the rule that an insurance or annuity policy reinsured under a "modified coinsurance" contract (as defined below) shall be treated as if such policy were reinsured under a "conventional coinsurance" contract if both the reinsured company and the reinsuring company so consent. This consent shall be made in such manner as the Secretary or his delegate shall prescribe by regulations, and, once made, this consent may not be rescinded except with the approval of the Secretary or his delegate. This consent shall apply to all insurance or annuity policies reinsured under the modified coinsurance contract. Moreover, in order for the consent to be effective, both companies must agree to the application of the rules provided by section 820(c) and the rules under this subsection.

(b) *Definition of modified coinsurance contract.*—Subsection (b) defines the term "modified coinsurance contract" to mean an indemnity reinsurance contract in which—

(1) one life insurance company (the reinsurer) agrees to indemnify another life insurance company (the reinsured) against the risk, or part thereof, assumed by the reinsured company under the insurance or annuity policy reinsured under the contract of reinsurance,

(2) the reinsured company retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) all or part of the gross investment income derived from such assets is paid by the reinsured company to the reinsuring company as a part of the consideration for the reinsurance of such policy, and

(4) the reinsured company is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

(c) *Special rules.*—Subsection (c) provides that in applying section 820(a)(1) with respect to any insurance or annuity policy, under regulations prescribed by the Secretary or his delegate, certain rules shall

(to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) be applied in respect of the amount of such policy reinsured.

Subparagraph (1) provides that the premiums, to the extent allocable to the participation of the reinsurer therein, received for the policy reinsured shall be treated as received by the reinsurer and not by the reinsured company. The gross investment income, to the extent allocable to the participation of the reinsurer therein, derived from the assets in relation to the reserve on the policy reinsured shall be treated as gross investment income of the reinsurer and not of the reinsured. The gross investment income so treated shall be considered derived proportionately from each of the various sources of gross investment income of the reinsured.

Paragraph (2) provides that the gains and losses from sales and exchanges of capital assets, and gains and losses considered as gains and losses from sales and exchanges of capital assets, of the reinsured company shall, to the extent of the participation therein by the reinsurer under the terms of the modified coinsurance contract, be treated as gains and losses from sales and exchanges of capital assets of the reinsurer and not of the reinsured.

Paragraph (3) provides that the reserve on the policy reinsured shall be treated as a part of the reserves of the reinsurer and not as a part of the reserves of the reinsured. Furthermore, the assets in relation to such reserve shall be treated as owned by the reinsurer and not by the reinsured.

Paragraph (4) provides that the expenses, to the extent reimbursable by the reinsurer, incurred with respect to the policy reinsured and with respect to the assets referred to in section 820(c)(3) shall be treated as incurred by the reinsurer and not by the reinsured.

Paragraph (5) provides that dividends to policyholders paid in respect of the policy reinsured shall be treated as paid by the reinsurer and not by the reinsured. For purposes of this paragraph, the amount of dividends to policyholders treated as paid by the reinsurer shall be the amount paid, in respect of the policy reinsured, by the reinsurer to the reinsured as reimbursement for dividends to policyholders paid by the reinsured. The rule provided in this paragraph also applies in respect of insurance and annuity policies reinsured under conventional coinsurance contracts.

Paragraph (6) provides that any amount paid in 1958 or any subsequent year by the reinsurer to the reinsured as reimbursement for Federal income taxes imposed for a taxable year beginning in 1957 or any preceding taxable year shall not be taken into account by the reinsured as an item under section 809(c) or by the reinsurer as a deduction under section 809(d).

Paragraph (7) grants to the Secretary or his delegate the authority to prescribe such other special rules as may be necessary to carry out the intent of this section.

This subsection further provides that in applying the rules provided by section 820(c)(1), (2), (3), (4), (5), and (6) and the rules prescribed under section 820(c)(7), an item shall be taken into account as income only once under subpart B and only once under subpart C by both the reinsured and the reinsurer, and an item shall be allowed as a deduction only once under subpart B and only once under subpart C to both the reinsured and the reinsurer.

SECTION 3. TECHNICAL AMENDMENTS AND PROVISIONS

This section, which corresponds to section 3 of the House bill, makes certain technical changes to provisions of the Internal Revenue Code of 1954 outside of part I of subchapter L to conform those provisions to the changes in subchapter L made by sections 2 and 3 of the bill. Your committee has amended this section by adding a new subsection (g) which amends section 6501(c) of the code so as to extend the statute of limitations on assessment and collection of tax resulting from certain distributions or from termination as a life insurance company. Subsection (g) of the House bill has been renumbered as subsection (h) of your committee's bill.

(a) *Credit and exclusion for dividends received by individuals from life insurance companies.*—Subsection (a) of this section amends section 34(c) of the code (relating to denial of credit for dividends received by individuals) and section 116(b) of the 1954 Code (relating to denial of exclusion for certain dividends) so as to allow the credit and exclusion with respect to dividends paid by life insurance companies. These amendments are to apply only to dividends received from life insurance companies after December 31, 1958, in taxable years ending after such date.

(b) *Credit for foreign taxes.*—Subsection (b) of this section amends section 841 of the 1954 Code (providing for the allowance to an insurance company of the foreign tax credit provided in sec. 901) so as to define the term "taxable income," as used in section 904, to mean the life insurance company taxable income as defined in section 802(b).

(c) *Carryovers.*—Subsection (c) of this section amends section 381(c) of the 1954 Code (relating to items of distributor or transferor corporations taken into account) by adding a new paragraph thereto. For a discussion of the application of this provision, see part F of the general explanation of the bill.

(d) *Adjustments to basis.*—Paragraph (1) of subsection (d) of this section amends section 1016 of the code (relating to adjustments to basis) to provide, in effect, that any exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained (and to the extent sec. 1016(a)(2) does not apply) on property held by a life insurance company since February 28, 1913, and before January 1, 1958, must be taken into account in determining the adjusted basis of such property.

Paragraph (2) of subsection (d) of this section amends section 1016 of the code (relating to adjustments to basis) to provide that the basis of any evidence of indebtedness referred to in section 818(b) (relating to amortization of premium and accrual of discount in the case of life insurance companies) shall be properly adjusted, for the taxable year and all prior taxable years, to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws).

(e) *Bonds and other evidences of indebtedness.*—Subsection (e) of section 3 of the bill amends section 1232(a)(2)(C) of the 1954 Code (relating to the taxation of bonds and other evidences of indebtedness) to make it clear that amounts includable in income under section 818(b) of the new part 1 of subchapter L are not required to be again included in income under section 1232.

(f) *Conforming changes in cross-references.*—Subsection (f) of this section eliminates the cross-references to section 811 presently con-

tained in sections 842, 891, and 1504(b)(2), of the 1954 Code. Section 811 (the imposition of tax under the 1942 formula) has no counterpart in the new part I. Section 1201 of the 1954 Code is amended by adding a new subsection (c), which contains a cross-reference to section 802(a)(2), relating to the tax on capital gains in case of life insurance companies.

(g) *Limitations on assessment and collection.*—Subsection (g) of this section amends section 6501(c) of the 1954 Code by adding a new paragraph thereto. This paragraph provides that in the case of any tax imposed under section 802(a)(1) by reason of section 802(b)(3) on account of (1) a termination of the taxpayer as an insurance company or as a life insurance company to which section 815(d)(2)(A) applies, or (2) a distribution by the taxpayer to which section 815(d)(2)(B) applies, such tax may be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) for the taxable year for which the taxpayer ceases to be an insurance company, the second taxable year for which the taxpayer is not a life insurance company, or the taxable year in which the distribution is actually made, as the case may be.

(h) *Estimated tax for 1958.*—Subsection (h) of this section provides that any life insurance company subject to tax under section 811 of the 1954 Code (as such section was in effect before the enactment of this bill) shall not be subject to the provision of section 6655 (relating to failure by corporations to pay estimated tax) for a taxable year beginning in 1958.

SECTION 4. EFFECTIVE DATE

This section of the bill, which is identical with section 4 of the House bill, provides that the amendments made by the bill, except as otherwise provided, shall apply only to taxable years beginning after December 31, 1957.

V. 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 bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

SEC. 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

(a) GENERAL RULE.—Effective with respect to taxable years ending after July 31, 1954, there shall be allowed to an individual, as a credit against the tax imposed by this subtitle for the taxable year, an amount equal to 4 percent of the dividends which are received after July 31, 1954, from domestic corporations and are included in gross income.

(b) LIMITATION ON AMOUNT OF CREDIT.—The credit allowed by subsection (a) shall not exceed whichever of the following is the lesser:

(1) the amount of the tax imposed by this chapter for the taxable year, reduced by the credit allowable under section 33 (relating to foreign tax credit); or

(2) the following percent of the taxable income for the taxable year:

(A) 2 percent, in the case of a taxable year ending before January 1, 1955.

(B) 4 percent, in the case of a taxable year ending after December 31, 1954.

(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—Subsection (a) shall not apply to any dividend from—

[(1) an insurance company subject to a tax imposed by part I or II of subchapter L (sec. 801 and following);]

[(2)] *(1)* a corporation organized under the China Trade Act, 1922 (see sec. 941); or

[(3)] *(2)* a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

* * * * * * *

SEC. 116. PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS.

(a) EXCLUSION FROM GROSS INCOME.—Effective with respect to any taxable year ending after July 31, 1954, gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $50. If the dividends received in a taxable year exceed $50, the exclusion provided by the preceding sentence shall apply to the dividends first received in such year.

(b) CERTAIN DIVIDENDS EXCLUDED.—Subsection (a) shall not apply to any dividend from—

[(1) an insurance company subject to a tax imposed by part I or II of subchapter L (sec. 801 and following);]

[(2)]*(1)* a corporation organized under the China Trade Act, 1922 (see sec. 941); or

[(3)]*(2)* a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

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PART V—CARRYOVERS

Sec. 381. Carryovers in certain corporate acquisitions.
Sec. 382. Special limitations on net operating loss carryovers.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) GENERAL RULE.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a

case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) OPERATING RULES.—Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

(c) ITEMS OF THE DISTRIBUTOR OR TRANSFEROR CORPORATION.—The items referred to in subsection (a) are:

(1) NET OPERATING LOSS CARRYOVERS.—* * *

(2) EARNINGS AND PROFITS.—* * *

(3) CAPITAL LOSS CARRYOVER.—* * *

(4) METHOD OF ACCOUNTING.—* * *

* * * * * * *

(22) SUCCESSOR LIFE INSURANCE COMPANY.—If the acquiring corporation is a life insurance company (as defined in section 801(a)), there shall be taken into account (to the extent proper to carry out the purposes of this section and part I of subchapter L, and under such regulations as may be prescribed by the Secretary or his delegate) the items required to be taken into account for purposes of part I of subchapter L (relating to life insurance companies) in respect of the distributor or transferor corporation.

(d) OPERATIONS LOSS CARRYBACKS AND CARRYOVERS OF LIFE INSURANCE COMPANIES.—

For application of this part to operations loss carrybacks and carryovers of life insurance companies, see section 812(f).

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[PART I—LIFE INSURANCE COMPANIES

[Subpart A. 1955 formula.
[Subpart B. 1942 formula.
[Subpart C. Miscellaneous provisions.

[Subpart A—1955 Formula

[Sec. 801. Definition of life insurance company.
[Sec. 802. Tax imposed for 1955.
[Sec. 803. Income and deductions.
[Sec. 804. Reserve and other policy liability deduction.
[Sec. 805. Special interest deduction.

[SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

[(a) LIFE INSURANCE COMPANY DEFINED.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

[(1) its life insurance reserves (as defined in subsection (b)), plus

[(2) unearned premiums and unpaid losses on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

[(b) LIFE INSURANCE RESERVES DEFINED.—

[(1) IN GENERAL.—For purposes of this part, the term "life insurance reserves" means amounts—

[(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

[(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

[(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

[(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

[(B) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

[(3) ASSESSMENT COMPANIES.—In the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

[(A) sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and

[(B) any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a

State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

[(4) Amount of reserve.—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

[(c) Total Reserves Defined.—For purposes of subsection (a), the term "total reserves" means—

[(1) life insurance reserves,

[(2) unearned premiums and unpaid losses not included in life insurance reserves, and

[(3) all other insurance reserves required by law.

[(d) Adjustments in Reserves for Policy Loans.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, the life insurance reserves, and the total reserves, shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained.

[(e) Burial and Funeral Benefit Insurance Companies.—A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under this part but shall be taxable under section 821 or section 831.

[SEC. 802. TAX IMPOSED.

[(a) Tax Imposed.—A tax is hereby imposed for each taxable year beginning after December 31, 1954, and before January 1, 1958, on the income of every life insurance company. Except as provided in subsection (c), such tax shall consist of a normal tax (computed under section 11(b)) and a surtax (computed under section 11(c)) on the sum of—

[(1) the life insurance taxable income (as defined in subsection (b)), plus

[(2) the non-life insurance taxable income (as defined in subsection (f)).

[(b) Life Insurance Taxable Income Defined.—For purposes of this subpart, the term "life insurance taxable income" means the net investment income (as defined in section 803 (c)), minus the sum of—

[(1) the net investment income allocable to non-life insurance reserves (determined under section 804(d)),

[(2) the reserve and other policy liability deduction (determined under section 804), and

[(3) the special interest deduction, if any, allowed by section 805.

[(c) Alternative Tax in the Case of Companies Having Non-Life Insurance Reserves.—

[(1) In general.—In the case of a life insurance company which has non-life insurance reserves, the tax imposed by subsection (a) of this section for any taxable year beginning after December 31, 1954, and before January 1, 1958, shall be the tax com-

puted under such subsection (or under section 1201(a) if applicable) or the tax computed under paragraph (2) of this subsection, whichever is the greater.

[(2) ALTERNATIVE 1 PERCENT TAX ON NON-LIFE INSURANCE BUSINESS.—The tax referred to in paragraph (1) is a tax equal to the sum of the following:

[(A) A partial tax consisting of a normal tax (computed under section 11(b)) and a surtax (computed under section 11(c)) on the life insurance taxable income.

[(B) A partial tax consisting of—

[(i) 1 percent of the amount which bears the same ratio to the gross investment income (reduced by the deduction for wholly-exempt interest allowed by section 803(c)(1)) as the non-life insurance reserves bear to the qualified reserves (determined under section 804(c)), plus

[(ii) 1 percent of the excess of the amount by which the net premiums on contracts meeting the requirements of section 804(d)(2)(A) exceed the dividends to policyholders on such contracts. For purposes of this clause, net premiums, and dividends to policyholders, shall be computed in the manner provided in section 823.

[(d) DEDUCTIONS FOR PARTIALLY TAX-EXEMPT INTEREST.—

[(1) COMPUTATIONS UNDER SUBSECTION (a).—For purposes of computing the normal tax under subsection (a), there shall be allowed as a deduction an amount which bears the same ratio to the amount of the deduction provided by section 242 for partially tax-exempt interest as (A) the sum of the life insurance taxable income and the net investment income allocable to non-life insurance reserves bears to (B) the net investment income

[(2) COMPUTATIONS UNDER SUBSECTION (c)(2)(A).—In computing the normal tax for purposes of subsection (c)(2)(A), there shall be allowed as a deduction an amount which bears the same ratio to the amount of the deduction provided by section 242 for partially tax-exempt interest as (A) the life insurance taxable income bears to (B) the net investment income.

[(e) ALTERNATIVE TAX ON CAPITAL GAINS.—In the case of a life insurance company which has non-life insurance reserves, the term "excess" used in section 1201(a) (relating to alternative tax on capital gains of corporations) means, for purposes of section 1201(a), an amount which bears the same ratio to the excess described in such section as the non-life insurance reserves (determined under section 804(d)) bear to the qualified reserves (determined under section 804(c)). For purposes of any such computation, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into account.

[(f) NON-LIFE INSURANCE TAXABLE INCOME DEFINED.—For purposes of this subpart, the term "non-life insurance taxable income" means the net investment income allocable to non-life insurance reserves (determined under section 804(d))—

[(1) increased by an amount which bears the same ratio to the net capital gain as the non-life insurance reserves bear to the qualified reserves; and

[(2) decreased by an amount which bears the same ratio to the total of the deductions provided in sections 243, 244, and 245 as the non-life insurance reserves bear to the qualified reserves.

In computing a net capital gain for purposes of paragraph (1) of this subsection, a net capital loss for any taxable year beginning before January 1, 1955, shall not be taken into account.

[SEC. 803. INCOME AND DEDUCTIONS.

[(a) APPLICATION OF SECTION.—The definitions and rules contained in this section shall apply only in the case of life insurance companies.

[(b) GROSS INVESTMENT INCOME.—For purposes of this part, the term "gross investment income" means the sum of the following:

[(1) The gross amount of income received or accrued from—

[(A) interest, dividends, rents, and royalties,

[(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

[(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

[(2) The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

In computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

[(c) NET INVESTMENT INCOME DEFINED.—The term "net investment income" means the gross investment income less the following deductions:

[(1) TAX-FREE INTEREST.—The amount of interest received or accrued during the taxable year which under section 103 is excluded from gross income.

[(2) INVESTMENT EXPENSES.—

[(A) Investment expenses paid or accrued during the taxable year.

[(B) If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed—

[(i) one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus

[(ii) one-fourth of the amount by which the net investment income (computed without any deduction for investment expenses allowed by this paragraph, or for tax-free interest allowed by paragraph (1)) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

[(3) REAL ESTATE EXPENSES.—Taxes (as provided in section 164), and other expenses, paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

[(4) DEPRECIATION.—The depreciation deduction allowed by section 167.

[(5) DEPLETION.—The deduction allowed by section 611 (relating to depletion).

[(6) TRADE OR BUSINESS DEDUCTIONS.—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that for purposes of this paragraph—

[(A) There shall be excluded losses from—

[(i) sales or exchanges of capital assets,

[(ii) sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

[(iii) the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

[(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

[(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

[(d) RENTAL VALUE OF REAL ESTATE.—The deduction under subsection (c) (3) and (4) on account of any real estate owned and occupied in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this subsection) as the rental value of the space not so occupied bears to the rental value of the entire property.

[(e) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—The gross investment income, the deduction for wholly-exempt interest allowed by subsection (c)(1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

[(1) in accordance with the method regularly employed by such company, if such method is reasonable, and

[(2) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

[SEC. 804. RESERVE AND OTHER POLICY LIABILITY DEDUCTION.

[(a) GENERAL RULE.—Except as provided in subsection (b), for purposes of this subpart the term "reserve and other policy liability deduction" means the sum of the amounts determined by applying the following percentages to the excess of the net investment income over the net investment income allocable to non-life insurance reserves (determined under subsection (d)):

[(1) 87.5 percent of so much of such excess as does not exceed $1,000,000; and

[(2) 85 percent of so much of such excess as exceeds $1,000,000.

[(b) MAXIMUM DEDUCTION.—

[(1) IN GENERAL.—The reserve and other policy liability deduction shall in no case exceed that amount which is equal to the sum of the following:

[(A) the amount equal to 2 times the amount determined under paragraph (1) of section 805(c) (relating to required interest on life insurance reserves);

[(B) the amount determined under paragraph (2) of section 805(c) (relating to required interest on reserves for deferred dividends);

[(C) the amount of the interest paid (as defined in section 805(d));

[(D) the dividends to policyholders paid or declared (other than dividends on contracts meeting the requirements of subsection (d)(2)(A)); and

[(E) in the case of a mutual assessment life insurance company or association, the amount equal to 2 times whichever of the following is the lesser: (i) the amount of the net investment income on life insurance reserves described in subparagraph (A) or (B) of section 801(b)(3), or (ii) 3 percent of the life insurance reserves so described,

reduced by the amount of the adjustment for policy loans provided in paragraph (2) of this subsection. For purposes of subparagraph (D) of the preceding sentence, the term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company.

[(2) REDUCTION FOR CERTAIN POLICY LOANS.—The adjustment described in paragraph (1) of this subsection shall be an amount equal to—

[(A) the mean of the aggregates, at the beginning and end of the taxable year, of the outstanding policy loans with respect to contracts for which life insurance reserves are maintained, multiplied by

[(B) the average rate of interest applicable to life insurance reserves.

For purposes of subparagraph (B) of the preceding sentence, the term "average rate of interest applicable to life insurance reserves" means the ratio obtained by dividing the sum obtained under paragraph (1) of section 805(c) by the sum obtained under paragraph (1)(B) of section 805(c).

[(3) DIVIDENDS RECEIVED DEDUCTION WHERE MAXIMUM LIMIT APPLIES.—

[(A) If paragraph (1) of this subsection reduces the reserve and other policy liability deduction allowed by this section or section 812 for the taxable year, then in computing life insurance taxable income under section 802(b), and in computing life insurance company taxable income under section 811(b), there shall be allowed an additional deduction in an amount determined under subparagraph (B).

[(B) The amount of the additional deduction referred to in subparagraph (A) shall be the amount which bears the same ratio to the total of the deductions provided in sections 243, 244, and 245 as the net investment income reduced by the sum of—

[(i) the net investment income allocable to non-life insurance reserves (or, for purposes of section 811(b), the amount of the adjustment for certain reserves provided in section 813), and

[(ii) 100/85 of the maximum limitation determined under paragraphs (1) and (2) of this subsection,

bears to the net investment income.

[(c) QUALIFIED RESERVES DEFINED.—For purposes of this subpart, the term "qualified reserves" means the sum of the following:

[(1) The life insurance reserves (as defined in section 801(b)), plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

[(2) The non-life insurance reserves (as defined in subsection (d)(2)).

[(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance and annuity contracts (including contracts supplementary thereto), but only if (A) such obligations when satisfied will reflect an increment in the nature of interest, and (B) such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

[(4) The amounts held at the end of the taxable year as reserves for dividends to policyholders, the payment of which dividends is deferred for a period which expires not earlier than 5 years from the date of the policy contract. This paragraph does not apply to dividends payable during the year following the taxable year.

[(5) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

[(6) Premiums received in advance, and liabilities for premium deposit funds.

In applying this subsection the same item shall be counted only once. For purposes of this section (other than paragraph (4) of this subsection), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

[(d) NET INVESTMENT INCOME ALLOCABLE TO NON-LIFE INSURANCE RESERVES.—

[(1) ALLOCATION RATIO.—For purposes of this subpart, the net investment income allocable to non-life insurance reserves is that amount which bears the same ratio to the net investment income as such reserves bear to the qualified reserves.

[(2) NON-LIFE INSURANCE RESERVES DEFINED.—For purposes of this subpart, the term "non-life insurance reserves" means the sum of the unearned premiums and the unpaid losses (whether or not ascertained)—

[(A) on contracts other than life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance), and

[(B) which are not included in life insurance reserves (as defined in section 801(b)).

For purposes of this paragraph, such unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such other contracts.

[(3) ADJUSTMENTS WITH RESPECT TO CERTAIN NON-LIFE INSURANCE CONTRACTS.—For purposes of this subpart, if—

[(A) any computation under this subpart is made by reference to a contract meeting the requirements of paragraph (2)(A) of this subsection, and

[(B) part of the reserves for such contract are life insurance reserves,

then, under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made in the amount taken into account with respect to such contract for purposes of such computation.

[SEC. 805. SPECIAL INTEREST DEDUCTION.

[(a) SPECIAL INTEREST DEDUCTION.—For purposes of the tax imposed by section 802 (and the tax imposed by section 811), there shall be allowed a special interest deduction determined as follows:

[(1) Divide the amount of the adjusted net investment income (as defined in subsection (b)) by the amount of the required interest (as defined in subsection (c)).

[(2) If the quotient obtained in paragraph (1) is 1.05 or more, the special interest deduction shall be zero.

[(3) If the quotient obtained in paragraph (1) is 1.00 or less, the special interest deduction shall be an amount equal to 50 percent of the amount by which—

[(A) the net investment income (reduced by the net investment income allocable to non-life insurance reserves), exceeds

[(B) the reserve and other policy liability deduction for the taxable year.

[(4) If the quotient obtained in paragraph (1) is more than 1.00 but less than 1.05, the special interest deduction shall be the amount obtained by multiplying—

[(A) the amount by which (i) the net investment income (reduced by the net investment income allocable to non-life insurance reserves) exceeds (ii) the reserve and other policy liability deduction for the taxable year, by

[(B) 10 times the difference between the figure 1.05 and the quotient obtained in paragraph (1).

[(b) ADJUSTED NET INVESTMENT INCOME.—For purposes of subsection (a) (1), the term "adjusted net investment income" means—

[(1) the net investment income (computed without the deduction for wholly-exempt interest allowed by section 803(c)(1)), minus

[(2) 50 percent of the net investment income allocable to non-life insurance reserves.

[(c) REQUIRED INTEREST.—For purposes of subsection (a)(1), the term "required interest" means the total of—

[(1) the sum of the amounts obtained by multiplying—

[(A) each rate of interest assumed in computing the taxpayer's life insurance reserves, by

[(B) the means of the amounts of the taxpayer's life insurance reserves computed at such rate at the beginning and end of the taxable year, plus 7 percent of the portion of such reserves at such rate as are computed on a preliminary term basis;

[(2) the sum of the amounts obtained by multiplying—

[(A) each rate of interest assumed in computing the taxpayer's reserves for deferred dividends described in section 804(c)(4), by

[(B) the means of the amounts of such reserves computed at such rate at the end of the taxable year; and

[(3) interest paid.

[(d) INTEREST PAID.—For purposes of subsection (c)(3), the term "interest paid" means—

[(1) all interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from taxation under this chapter; and

[(2) all amounts in the nature of interest, whether or not guaranteed, paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time of payment or accrual, life, health, or accident contingencies.

[Subpart B—1942 Formula

[Sec. 811. Tax imposed.
[Sec. 812. Reserve and other policy liability deduction.
[Sec. 813. Adjustment for certain reserves.

[SEC. 811. TAX IMPOSED.

[(a) TAX IMPOSED.—A tax is hereby imposed, on the life insurance company taxable income of every life insurance company, for each taxable year beginning after December 31, 1957. Such tax shall consist of—

[(1) a normal tax on such income computed under section 11 (b), and

[(2) a surtax on such income computed under section 11(c).

[(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.—For purposes of this subpart, the term "life insurance company taxable income" means the net investment income (as defined in section 803(c))—

[(1) minus the reserve and other policy liability deduction allowed by section 812,

[(2) minus the special interest deduction, if any, allowed by section 805, and

[(3) plus the amount of the adjustment for certain reserves provided in section 813.

For purposes of the normal tax, the life insurance company taxable income shall be reduced by the deduction provided in section 242 for partially tax-exempt interest.

[(c) RULE FOR COMPUTATION OF SPECIAL INTEREST DEDUCTION.—In computing the special interest deduction under section 805 in the case of any taxable year with respect to which a tax is imposed under this section—

[(1) in lieu of the reduction of the net investment income provided in paragraphs (3)(A) and (4)(A) of section 805(a), the net investment income shall be reduced by the amount of the adjustment for certain reserves provided in section 813, and

[(2) in lieu of subtracting the amount provided in paragraph (2) of section 805(b), subtract 50 percent of the amount of the adjustment for certain reserves provided in section 813.

[SEC. 812. RESERVE AND OTHER POLICY LIABILITY DEDUCTION.

[(a) GENERAL RULE.—For purposes of this subpart, the term "reserve and other policy liability deduction" means an amount computed by multiplying the net investment income by a figure, to be determined and proclaimed by the Secretary or his delegate for each taxable year with respect to which a tax is imposed by section 811. This figure shall be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary or his delegate considers representative and shall be computed in accordance with the following formula: The ratio which a numerator comprised of the aggregate of the sums of—

[(1) 2 percent of the reserves for deferred dividends,

[(2) interest paid, and

[(3) the product of—

[(A) the mean of the adjusted reserves at the beginning and end of the taxable year, and

[(B) the reserve earnings rate,

bears to a denominator comprised of the aggregate of the excess of net investment incomes (computed without the deduction for wholly-exempt interest allowed by section 803(c)(1)) over the adjustment for certain reserves provided in section 813.

[(b) DEFINITIONS.—For purposes of subsection (a)—

[(1) RESERVES FOR DEFERRED DIVIDENDS.—The term "reserves for deferred dividends" has the same meaning as when used in section 804(c)(4).

[(2) INTEREST PAID.—The term "interest paid" has the meaning given to such term by section 805(d).

[(3) ADJUSTED RESERVES.—The term "adjusted reserves" means the life insurance reserves (as defined in section 801(b)), plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

[(4) RESERVE EARNINGS RATE.—The term "reserve earnings rate" means a rate computed by adding 2.1125 percent (65 percent of 3¼ percent) to 35 percent of the average rate of interest 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 mean of the total adjusted reserves at the beginning and end of the taxable year.

[(c) MAXIMUM DEDUCTION.—The reserve and other policy liability deduction allowed by subsection (a) of this section shall in no case exceed an amount equal to the amount which would be determined under subsection (b) of section 804 if such subsection applied with respect to the taxable year.

[SEC. 813. ADJUSTMENT FOR CERTAIN RESERVES.

[In the case of a life insurance company writing contracts other than life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means, for purposes of this sub-

part, an amount equal to 3¼ percent of the unearned premiums and unpaid losses on such other contracts which are not included in life insurance reserves (as defined in section 801(b)). For purposes of this section, such unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such other contracts.

[Subpart C—Miscellaneous Provisions

[Sec. 816. Foreign life insurance companies.
[Sec. 817. Denial of double deductions.
[Sec. 818. Certain new insurance companies.

[SEC. 816. FOREIGN LIFE INSURANCE COMPANIES.

[(a) CARRYING ON UNITED STATES INSURANCE BUSINESS.—A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable in the same manner as a domestic life insurance company; except that the determinations necessary for purposes of this subtitle shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Insurance Commissioners.

[(b) NO UNITED STATES INSURANCE BUSINESS.—Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under this part but shall be taxable as other foreign corporations.

[SEC. 817. DENIAL OF DOUBLE DEDUCTIONS.

[Nothing in this part shall permit the same item to be deducted more than once.

[SEC. 818. CERTAIN NEW INSURANCE COMPANIES.

[(a) GENERAL RULE.—If the taxable year begins not more than 9 years after the first day on which the taxpayer was authorized to do business as an insurance company, then—

[(1) for purposes of subpart A, the life insurance taxable income shall not exceed (A) the amount of the net gain from operations after dividends to policyholders, reduced by (B)(i) the net investment income allocable to non-life-insurance reserves and (ii) the special reduction for dividends received provided by subsection (c); or

[(2) for purposes of subpart B, the life insurance company taxable income shall not exceed (A) the amount of the net gain from operations after dividends to policyholders, reduced by (B) the special reduction for dividends received provided by subsection (c).

For purposes of this subsection, the net gain from operations after dividends to policyholders shall be computed in the manner required for purposes of the annual statement approved by the National Convention of Insurance Commissioners, except that no reduction shall be made for any Federal income tax.

[(b) LIMITATION.—This section shall not reduce the tax for any taxable year below the amount which (but for this section) would be imposed by section 802 or section 811, as the case may be, computed

without the applicable limitation on the reserve and other policy liability deduction contained in section 804(b) or section 812(c).

[(c) SPECIAL RULE FOR DIVIDENDS RECEIVED.—The reduction referred to in paragraph (1)(B)(ii) and in paragraph (2)(B) of subsection (a) shall be an amount computed under section 804(b)(3), except that, for purposes of such computation, the maximum limitation referred to in section 804(b)(3)(B)(ii) shall be—

[(1) in the case of a taxable year with respect to which tax is imposed by section 802, the amount by which (A) the net investment income (reduced by the net investment income allocable to non-life insurance reserves), exceeds (B) the life insurance taxable income (computed without regard to the reduction provided by this subsection); or

[(2) in the case of a taxable year with respect to which tax is imposed by section 811, the amount by which (A) the sum of the net investment income and the amount of the adjustment for certain reserves provided in section 813, exceeds (B) the life insurance company taxable income (computed without regard to the reduction provided by this subsection).]

PART I—LIFE INSURANCE COMPANIES

Subpart A. Definition; tax imposed.
Subpart B. Investment income.
Subpart C. Gain and loss from operations.
Subpart D. Distributions to shareholders.
Subpart E. Miscellaneous provisions.

Subpart A—Definition; Tax Imposed

Sec. 801. Definition of life insurance company.
Sec. 802. Tax imposed.

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

(a) LIFE INSURANCE COMPANY DEFINED.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) LIFE INSURANCE RESERVES DEFINED.—

(1) IN GENERAL.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) Reserves must be required by law.—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

(3) Assessment companies.—In the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

(A) sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and

(B) any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner), of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

For purposes of this part, the rate of interest assumed in calculating the reserves described in subparagraphs (A) and (B) shall be 3 percent.

(4) Deficiency reserves excluded.—The term "life insurance reserves" does not include deficiency reserves. For purposes of this subsection and subsection (c), the deficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

(A) the present value of the future net premiums required for such contract, exceeds

(B) the present value of the future actual premiums and consideration charged for such contract.

(5) Amount of reserves.—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

(c) Total Reserves Defined.—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

(d) Adjustments in Reserves for Policy Loans.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, the life insurance reserves, and the total reserves, shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained.

(e) Guaranteed Renewable Contracts.—For purposes of this part, guaranteed renewable life, health, and accident insurance shall be treated in the same manner as noncancellable life, health, and accident insurance.

(f) Burial and Funeral Benefit Insurance Companies.—A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under this part but shall be taxable under section 821 or section 831.

(g) Variable Annuities.—

(1) In general.—For purposes of this part, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract.

(2) Current earnings rate.—For purposes of section 805(b)(1), the current earnings rate of a life insurance company with respect to contracts described in paragraph (1) is the current earnings rate determined under such section reduced by—

(A) the annual rate of the actuarial margin charge as prescribed by the contract, or

(B) if no such rate is prescribed by the contract, the percentage obtained by dividing the amount of the actuarial margin charge on all contracts described in paragraph (1) issued by the taxpayer by the mean of the taxpayer's assets obligated under all such contracts to satisfy liabilities under all such contracts.

(3) Assumed rate.—For purposes of this part, the rate of interest assumed by the taxpayer for any taxable year in calculating the reserve on an annuity contract described in paragraph (1) shall be the percentage obtained under paragraph (2).

(4) Increases and decreases in reserves.—In the case of annuity contracts described in paragraph (1)—

(A) for purposes of section 810, any increase in reserves shall be computed only with respect to increases by reason of premiums and gross investment income, and

(B) for purposes of section 810, any decrease in reserves shall be computed only with respect to decreases by reason of benefits paid under such contracts.

(5) Termination.—Paragraphs (1), (2), (3), and (4) shall not apply with respect to any taxable year beginning after December 31, 1962.

SEC. 802. TAX IMPOSED.

(a) Tax Imposed.—

(1) In general.—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

(2) Tax in case of capital gains.—If for any taxable year beginning after December 31, 1958, the net long-term capital gain of any life insurance company exceeds the net short-term capital loss, there is hereby imposed a tax equal to 25 percent of such excess.

(3) Special rule for 1959 and 1960.—If any amount is subtracted from the policyholders surplus account under section 815(e)(3)

for a taxable year beginning in 1959 or 1960 on account of a distribution in 1959 or 1960 (not including any distribution treated under section 815(d)(2)(B) as made in 1959 or 1960), the tax imposed for such taxable year on the life insurance company taxable income shall be the amount determined under paragraph (1) reduced by the following percentage of the amount by which the tax imposed by paragraph (1) is (without regard to this paragraph) increased, on account of the amount so subtracted, by reason of section 802(b)(3)—

(A) in the case of a taxable year beginning in 1959, 66⅔ percent; and

(B) in the case of a taxable year beginning in 1960, 33⅓ percent.

The preceding sentence shall not apply with respect to any payment treated as a distribution under section 815(d)(3).

(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

In the case of a taxable year beginning in 1958, if the amount determined under paragraph (2) (without regard to this sentence) exceeds the amount determined under paragraph (1), the amount taken into account under paragraph (2) shall be reduced by an amount equal to 10 percent of such excess.

Subpart B—Investment Income

Sec. 804. Taxable investment income.
Sec. 805. Policy and other contract liability requirements.
Sec. 806. Certain changes in reserves and assets.

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) IN GENERAL.—

(1) EXCLUSION OF POLICYHOLDERS' SHARE OF INVESTMENT YIELD.—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield.

(2) TAXABLE INVESTMENT INCOME DEFINED.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4). For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

(3) PARTIALLY TAX-EXEMPT INTEREST.—For purposes of this part, the deduction allowed by section 242 shall be an amount which bears the same ratio to the amount determined under such section without regard to this paragraph as (A) the normal tax rate for the taxable year prescribed by section 11, bears to (B) the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(4) SMALL BUSINESS DEDUCTION.—For purposes of this part, the small business deduction is an amount equal to 10 percent of the investment yield for the taxable year. The deduction under this paragraph shall not exceed $25,000.

(5) EXCEPTION.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) GROSS INVESTMENT INCOME.—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) INTEREST, ETC.—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) SHORT-TERM CAPITAL GAIN.—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) TRADE OR BUSINESS INCOME.—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) *Investment Yield Defined.—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—*

(1) Investment expenses.—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(3)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(3)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) Real estate expenses.—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) Depreciation.—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) Depletion.—The deduction allowed by section 511 (relating to depletion).

(5) Trade or business deductions.—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

(A) There shall be excluded losses—

(i) from (or considered as from) sales or exchanges of capital assets,

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

SEC 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) In General.—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

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

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

(3) the interest paid.

(b) Earnings Rates.—

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

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(2) Average earnings rate.—

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

(B) Special rules.—For purposes of subparagraph (A)—

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

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

(3) Assets.—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

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

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

(c) Adjusted Life Insurance Reserves.—

(1) Adjusted life insurance reserves defined.—For purposes of this part, the term "adjusted life insurance reserves" means—

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

(B) that percentage which equals 100 percent—

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

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

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

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

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

(d) PENSION PLAN RESERVES.—

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

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

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

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

(D) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501 (c)(3) which was exempt from tax under section 501(a) or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws.

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

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

(B) in the case of a taxable year beginning after December 31, 1958, and before January 1, 1960, 33⅓ percent of the amount thereof (determined without regard to this paragraph);

(C) in the case of a taxable year beginning after December 31, 1959, and before January 1, 1961, 66⅔ percent of the amount thereof (determined without regard to this paragraph); and

(D) in the case of a taxable year beginning after December 31, 1960, 100 percent of the amount thereof.

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

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

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

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

(4) *INTEREST ON CERTAIN SPECIAL CONTINGENCY RESERVES.—Interest for the taxable year on special contingency reserves established pursuant to section 8(d) of the Federal Employees' Group Life Insurance Act of 1954 (5 U.S.C. § 2097(d)).*

SEC. 806. CERTAIN CHANGES IN RESERVES AND ASSETS

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

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

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

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

Subpart C—Gain and Loss From Operations

Sec. 809. In general.
Sec. 810. Rules for certain reserves.
Sec. 811. Dividends to policyholders.
Sec. 812. Operations loss deduction.

SEC. 809. IN GENERAL

(a) *EXCLUSION OF SHARE OF INVESTMENT YIELD SET ASIDE FOR POLICYHOLDERS.—*

(1) *AMOUNT.—The share of each and every item of investment yield (including tax-exempt interest, partially-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield.*

(2) *Required interest.*—*For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—*

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

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

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—*For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):*

(A) *the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—*

(i) *the sum of the items described in paragraph (3), and*

(ii) *the small business deduction provided by section 804(a)(4): and*

(B) *the sum of the items referred to in subsection (c)*

(2) *Loss from operations defined.*—*For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—*

(A) *the amount determined under paragraph (1)(A); and*

(B) *the sum of the items referred to in subsection (c).*

(3) *Tax-exempt interest, etc.*—*The items referred to in paragraph (1)(A)(i) are—*

(A) *the life insurance company's share of interest which under section 103 is excluded from gross income,*

(B) *the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)) computed with respect to the life insurance company's share of such interest, and*

(C) *the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received.*

(4) *Life insurance company's share.*—*For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.*

(5) *Application of section 246(b).*—*In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subsection—*

(A) *the limit on the aggregate amount of the deductions allowed by sections 243(a), 244, and 245 shall be 85 percent of the gain from operations computed without regard to—*

(i) *the deductions provided by paragraphs (3), (5), and (6) of subsection (d),*

(ii) *the operations loss deduction provided by section 812, and*

(iii) *the deductions allowed by sections 243(a), 244, and 245, but*

(B) *such limit shall not apply for any taxable year for which there is a loss from operations.*

(6) Exception.—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) Gross Amount.—For purposes of subsections (b) (1) and (2), the following items shall be taken into account:

(1) Premiums.—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) Decreases in certain reserves.—Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) Other amounts.—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) Deductions.—For purposes of subsections (b) (1) and (2), there shall be allowed the following deductions:

(1) Death benefits, etc.—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) Increases in certain reserves.—The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) Dividends to policyholders.—The deduction for dividends to policyholders (determined under section 811(b)).

(4) Operations loss deduction.—The operations loss deduction (determined under section 812).

(5) Certain nonparticipating contracts.—An amount equal to 10 percent of the increase in the reserves for the taxable year for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are

issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

(6) GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE.—An amount equal to 2 percent of the premiums for the taxable year attributable to group life insurance contracts and group accident and health insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) ASSUMPTION BY ANOTHER PERSON OF LIABILITIES UNDER INSURANCE, ETC., CONTRACTS.—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) INVESTMENT EXPENSES.—Investment expenses to the extent no tallowed as a deduction under section 804(c)(1) in computing investment yield.

(9) OTHER DEDUCTIONS.—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

(e) MODIFICATIONS.—The modifications referred to in subsection (d)(9) are as follows:

(1) INTEREST.—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c).

(2) BAD DEBTS.—Section 166(c) (relating to reserve for bad debts) shall not apply.

(3) CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.—In applying section 170—

(A) the limit on the total deductions under such section provided by the first sentence of section 170(b)(2) shall be 5 percent of the gain from operations computed without regard to—

(i) the deduction provided by section 170,

(ii) the reduction required by subsection (b)(1)(A)(i),

(iii) the deductions provided by paragraphs (3), (5), and (6) of subsection (d), and

(iv) any operations loss carryback to the taxable year under section 812; and

(B) under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(b)(3) shall be applied.

(4) AMORTIZABLE BOND PREMIUM.—Section 171 shall not apply.

(5) NET OPERATING LOSS DEDUCTION.—The deduction for net operating losses provided in section 172 shall not be allowed.

(6) Partially tax-exempt interest.—The deduction for partially tax-exempt interest provided by section 242 shall not be allowed.

(7) Dividends received.—The deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

(f) Limitation on Certain Deductions.—

(1) In general.—The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

(B) the taxable investment income for the taxable year.

(2) Application of limitation.—The limitation provided by paragraph (1) shall apply first to the amount of the deduction under subsection (d)(6), then to the amount of the deduction under subsection (d)(5), and finally to the amount of the deduction under subsection (d)(3).

"SEC. 810. RULES FOR CERTAIN RESERVES.

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

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

(c) Items Taken Into Account.—The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b)).

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(5) Premiums received in advance, and liabilities for premium deposit funds.

In applying this subsection, the same item shall be counted only once.

(d) Adjustment for Change in Computing Reserves.—

(1) In general.—If the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

(A) the amount of the item at the close of the taxable year, computed on the new basis, and

(B) the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account for purposes of this subpart as follows:

(i) if the amount determined under subparagraph (A) exceeds the amount determined under subparagraph (B), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) applies; or

(ii) if the amount determined under subparagraph (B) exceeds the amount determined under subparagraph (A), 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) applies.

(2) TERMINATION AS LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this paragraph shall be taken into account for the preceding taxable year.

(3) EFFECT OF PRELIMINARY TERM ELECTION.—An election under section 818(c) shall not be treated as a change in the basis for determining an item referred to in subsection (c) to which this subsection applies. If an election under section 818(c) applies for the taxable year, the amounts of the items referred to in subparagraphs (A) and (B) of paragraph (1) shall be determined without regard to such election. If such an election would apply in respect of such item for the taxable year but for the new basis, the amount of the item referred to in subparagraph (B) shall be determined on the basis which would have been applicable under section 818(c) if the election applied in respect of the item for the taxable year.

(e) CERTAIN DECREASES IN RESERVES OF VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS.—

(1) DECREASES DUE TO VOLUNTARY LAPSES OF POLICIES ISSUED BEFORE JANUARY 1, 1958.—For purposes of subsection (a), in the case of a life insurance company which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, there shall be taken into account only 11½ percent of any decrease in life insurance reserves attributable to the voluntary lapse on or after January 1, 1958, of any policy issued before such date. The preceding sentence shall apply for any taxable year only if the taxpayer has made an election under paragraph (3) which is effective for such taxable year.

(2) INAPPLICABILITY OF CERTAIN PROVISIONS.—In the case of a life insurance company to which paragraph (1) applies for the taxable year—

(A) the last sentence of section 802(b) shall not apply, and

(B) section 812(b)(1) shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(3) ELECTION.—Paragraph (1) shall apply to any taxpayer for any taxable year only if the taxpayer elects, not later than the time prescribed by law (including extensions thereof) for filing the return for such taxable year, to have such paragraph apply. Such election shall be made in such manner as the Secretary or his delegate shall

prescribe by regulations. Such election shall be effective for the taxable year for which made and for all succeeding taxable years, and shall not be revoked except with the consent of the Secretary or his delegate.

SEC. 811. DIVIDENDS TO POLICYHOLDERS.

(a) Dividends to Policyholders Defined.—For purposes of this part, the term "dividends to policyholders" means dividends and similar distributions to policyholders in their capacity as such. Such term does not include interest paid (as defined in section 805(e)).

(b) Amount of Deduction.—

(1) In general.—Except as limited by section 809(f), the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year—

(A) increased by the excess of (i) the amounts held at the end of the taxable year as reserves for dividends to policyholders (as defined in subsection (a)) payable during the year following the taxable year, over (ii) such amounts held at the end of the preceding taxable year, or

(B) decreased by the excess of (i) such amounts held at the end of the preceding taxable year, over (ii) such amounts held at the end of the taxable year.

For purposes of subparagraphs (A) and (B), there shall be included as amounts held at the end of any taxable year amounts set aside, before the 16th day of the third month of the year following such taxable year (or, in the case of a mutual savings bank subject to the tax imposed by section 594, before the 16th day of the fourth month of the year following such taxable year), for payment during the year following such taxable year.

(2) Certain amounts to be treated as net decreases.—If the amount determined under paragraph (1)(B) exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be a net decrease referred to in section 809(c)(2).

(3) 1958 reserve for dividends to policyholders.—For purposes of paragraph (1), the amounts held at the end of of 1957 as reserves for dividends to policyholders payable during 1958 shall be the amounts actually paid as such dividends during 1958.

SEC. 812. OPERATIONS LOSS DEDUCTION.

(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of—

(1) the operations loss carryovers to such year, plus

(2) the operations loss carrybacks to such year.

For purposes of this part, the term "operations loss deduction" means the deduction allowed by this subsection.

(b) Operations Loss Carrybacks and Carryovers.—

(1) Years to which loss may be carried.—

(A) In general.—The loss from operations for any taxable year (hereinafter in this section referred to as the "loss year") beginning after December 31, 1954, shall be—

(i) an operations loss carryback to each of the 3 taxable years preceding the loss year,

(ii) an operations loss carryover to each of the 5 taxable years following the loss year, and

(iii) subject to subsection (e), if the life insurance company is a new company for the loss year, an operations loss carryover to each of the 5 taxable years following the 5 taxable years described in clause (ii).

(B) SPECIAL TRANSITIONAL RULES FOR CARRYBACKS.—A loss from operations for any taxable year beginning before January 1, 1958, shall not be an operations loss carryback to any taxable year beginning before January 1, 1955. A loss from operations for any taxable year beginning after December 31, 1957, shall not be an operations loss carryback to any taxable year beginning before January 1, 1958.

(C) APPLICATION FOR YEARS PRIOR TO 1958.—For purposes of this section, this part (as in effect for 1958) shall be treated as applying to all taxable years beginning after December 31, 1954, and before January 1, 1958.

(2) AMOUNT OF CARRYBACKS AND CARRYOVERS.—The entire amount of the loss from operations for any loss year shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (d)) for each of the prior taxable years to which such loss may be carried.

(c) COMPUTATION OF LOSS FROM OPERATIONS.—In computing the loss from operations for purposes of this section—

(1) The operations loss deduction shall not be allowed.

(2) The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) as modified by section 809(b)(5).

(d) OFFSET DEFINED.—

(1) IN GENERAL.—For purposes of subsection (b)(2), the term "offset" means, with respect to any taxable year, an amount equal to that increase in the operations loss deduction for the taxable year which reduces the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero.

(2) OPERATIONS LOSS DEDUCTION.—For purposes of paragraph (1), the operations loss deduction for any taxable year shall be computed without regard to the loss from operations for the loss year or for any taxable year thereafter.

(e) RULES RELATING TO NEW COMPANIES.—

(1) NEW COMPANY DEFINED.—For purposes of this part, a life insurance company is a new company for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or, if section 381(c)(22) applies, any predecessor) was authorized to do business as an insurance company.

(2) LIMITATIONS ON 10-YEAR CARRYOVER.—

(A) IN GENERAL.—For purposes of subsection (b)(1)(A)(iii), a life insurance company shall not be treated as a new company for any loss year if at any time during such year it was a nonqualified corporation. If, at any time during any taxable year after the loss year, the life insurance company is

a nonqualified corporation, subsection (b)(1)(A) (iii) shall cease to apply with respect to such loss for such taxable year and all subsequent taxable years.

(B) NONQUALIFIED CORPORATION DEFINED.—For purposes of subparagraph (A), the term "nonqualified corporation" means any corporation connected through stock ownership with any other corporation, if either of such corporations possesses at least 50 percent of the voting power of all classes of stock of the other such corporation. For purposes of subparagraph (A), a corporation shall be treated as becoming a nonqualified corporation at any time at which it becomes a party to a reorganization (other than a reorganization which is not described in any subparagraph of section 368(a)(1) other than subparagraphs (E) and (F) thereof).

(f) APPLICATION OF SUBTITLE A AND SUBTITLE F.—Except as provided in section 809(e), subtitle A and subtitle F shall apply in respect of operations loss carrybacks, operations loss carryovers, and the operations loss deduction under this part in the same manner and to the same extent as such subtitles apply in respect of net operating loss carrybacks, net operating loss carryovers, and the net operating loss deduction.

Subpart D—Distributions to Shareholders

Sec. 815. Distributions to shareholders.

SEC. 815. DISTRIBUTIONS TO SHAREHOLDERS.

(a) GENERAL RULE.—For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, shall be treated as made—

(1) first out of the shareholders surplus account, to the extent thereof,

(2) then out of the policyholders surplus account, to the extent thereof, and

(3) finally out of other accounts.

For purposes of this subsection and subsection (d), the term "distribution" includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include any distribution made by the corporation in its stock or in rights to acquire its stock, and does not include any distribution in redemption of stock issued before 1958 which at all times on and after the date of issuance and on and before the date of redemption is limited as to dividends and is callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of the issue price and the amount of any contribution to surplus made by the original purchaser at the time of his purchase.

(b) SHAREHOLDERS SURPLUS ACCOUNT.—

(1) IN GENERAL.—Each stock life insurance company shall, for purposes of this part, establish and maintain a shareholders surplus account. The amount in such account on January 1, 1958, shall be zero.

(2) ADDITIONS TO ACCOUNT.—The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which—

(A) the sum of—

(i) the life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) in the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss,

(iii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245, (as modified by section (b)(5)), and the amount of interest excluded from gross income under section 103, and

(iv) the small business deduction provided by section 804(a)(4), exceeds

(B) the taxes imposed for the taxable year by section 802(a), determined without regard to section 802(b)(3).

(3) SUBTRACTIONS FROM ACCOUNT.—

(A) IN GENERAL.—There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.

(B) DISTRIBUTIONS IN 1958.—There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of distributions to shareholders made during 1958.

(c) POLICYHOLDERS SURPLUS ACCOUNT.—

(1) IN GENERAL.—Each stock life insurance company shall, for purposes of this part, establish and maintain a policyholders surplus account. The amount in such account on January 1, 1959, shall be zero.

(2) ADDITIONS TO ACCOUNT.—The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of—

(A) an amount equal to 50 percent of the amount by which the gain from operations exceeds the taxable investment income,

(B) the deduction for certain nonparticipating contracts provided by section 809(d)(5) (as limited by section 809 (f)), and

(C) the deduction for group life and group accident and health insurance contracts provided by section 809(d)(6) (as limited by section 809(f)).

(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the policyholders surplus account for any taxable year and amount equal to the sum of—

(A) the amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and

(B) the amount (determined without regard to section 802(a)(3)) by which the tax imposed for the taxable year by section 802(a)(1) is increased by reason of section 802(b)(3).

(d) SPECIAL RULES.—

(1) ELECTION TO TRANSFER AMOUNTS FROM POLICYHOLDERS SURPLUS ACCOUNT TO SHAREHOLDERS SURPLUS ACCOUNT.—

(A) IN GENERAL.—A taxpayer may elect for any taxable year for which it is a life insurance company to subtract from its policyholders surplus account any amount in such account as of the close of such taxable year. The amount so subtracted, less the amount of the tax imposed with respect to such amount

by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

(B) MANNER AND EFFECT OF ELECTION.—The election provided by subparagraph (A) shall be made (in such manner and in such form as the Secretary or his delegate may by regulations prescribe) after the close of the taxable year and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year. Such an election, once made, may not be revoked.

(2) TERMINATION AS LIFE INSURANCE COMPANY.—

(A) EFFECT OF TERMINATIOON—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if—

(i) for any taxable year the taxpayer is not an insurance company, or

(ii) for any two successive taxable years the taxpayer is not a life insurance company,

then the amount taken into account under section 802(b)(3) for the last preceding taxable year for which it was a life insurance company shall be increased (after the application of subparagraph (B)) by the amount remaining in its policyholders surplus account at the close of such last preceding taxable year.

(B) EFFECT OF CERTAIN DISTRIBUTIONS.—If for any taxable year the taxpayer is an insurance company but not a life insurance company, then any distribution to shareholders during such taxable year shall be treated as made on the last day of the last preceding taxable year for which the taxpayer was a life insurance company.

(3) TREATMENT OF CERTAIN INDEBTEDNESS.—If—

(A) the taxpayer makes any payment in discharge of its indebtedness, and

(B) such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959,

then the amount of such payment shall, for purposes of this section and section 802(b)(3), be treated as a distribution in cash to shareholders, but only to the extent that the distribution referred to in subparagraph (B) was treated as made out of accounts other than the shareholders and policyholders surplus accounts.

(4) LIMITATION ON AMOUNT IN POLICYHOLDERS SURPLUS ACCOUNT.—There shall be treated as a subtraction from the policyholders surplus account for a taxable year for which the taxpayer is a life insurance company the amount by which the policyholders surplus account (computed at the end of the taxable year without regard to this paragraph) exceeds whichever of the following is the greatest—

(A) 15 percent of life insurance reserves at the end of the taxable year,

(B) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(C) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1).

The amount so treated as subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

(e) SPECIAL RULE FOR CERTAIN MUTUALIZATIONS.—

(1) IN GENERAL.—For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization shall be treated—

(A) first, as made out of paid-in capital and paid-in surplus, to the extent thereof,

(B) thereafter, as made in two allocable parts—

(i) one part of which is made out of the other accounts referred to in subsection (a)(3), and

(ii) the remainder of which is a distribution to which subsection (a) applies.

(2) SPECIAL RULES.—

(A) ALLOCATION RATIO.—The part referred to in paragraph (1)(B)(i) is the amount which bears the same ratio to the amount to which paragraph (1)(B) applies as—

(i) the excess (determined as of December 31, 1958, and adjusted as provided in subparagraph (B)) of the assets over the total liabilities, bears to

(ii) the sum (determined as of the beginning of the year of the distribution) of the excess described in clause (i), the amount in the shareholders surplus account, plus the amount in the policyholders surplus account.

(B) ADJUSTMENT FOR CERTAIN DISTRIBUTIONS.—The excess described in subparagraph (A)(i) shall be reduced by the aggregate of the prior distributions which have been treated under subsection (a)(3) as made out of accounts other than the shareholders surplus account and the policyholders surplus account.

Subpart E—Miscellaneous Provisions

Sec. 817. Rules relating to certain gains and losses.
Sec. 818. Accounting provisions.
Sec. 819. Foreign life insurance companies.
Sec. 820. Optional treatment of policies reinsured under modified coinsurance contracts.

SEC. 817. RULES RELATING TO CERTAIN GAINS AND LOSSES.

(a) TREATMENT OF CAPITAL GAINS AND LOSSES, ETC.—In the case of a life insurance company—

(1) in applying section 1231(a), the term "property used in the trade or business" shall be treated as including only—

(A) property used in carrying on an insurance business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in carrying on an insurance business, held for more than 6 months, which is not described in section 1231(b)(1)(A), (B), or (C), and

(B) property described in section 1231(b)(2), and

(2) in applying section 1221(2), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

(b) Gain on Property Held on December 31, 1958, and Certain Substituted Property Acquired After 1958.—

(1) Property held on december 31, 1958.—In the case of property held by the taxpayer on December 31, 1958, if—

(A) the fair market value of such property on such date exceeds the adjusted basis for determining gain as of such date, and

(B) the taxpayer has been a life insurance company at all times on and after December 31, 1958,

the gain on the sale or other disposition of such property shall be treated as an amount (not less than zero) equal to the amount by which the gain (determined without regard to this subsection) exceeds the difference between the fair market value on December 31, 1958, and the adjusted basis for determining gain as of such date.

(2) Certain property acquired after december 31, 1958.—In the case of property acquired after December 31, 1958, and having a substituted basis (within the meaning of section 1016(b))—

(A) for purposes of paragraph (1), such property shall be deemed held continuously by the taxpayer since the beginning of the holding period thereof, determined with reference to section 1223,

(B) the fair market value and adjusted basis referred to in paragraph (1) shall be that of that property for which the holding period taken into account includes December 31, 1958,

(C) paragraph (1) shall apply only if the property or properties the holding periods of which are taken into account were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account,

(D) the difference between the fair market value and adjusted basis referred to in paragraph (1) shall be reduced (not less than zero) by the excess of (i) the gain that would have been recognized but for this subsection on all prior sales or dispositions after December 31, 1958, of properties referred to in subparagraph (C), over (ii) the gain that was recognized on such sales or other dispositions, and

(E) the basis of such property shall be determined as if the gain which would have been recognized but for this subsection were recognized gain.

(3) Property defined.—For purposes of paragraphs (1) and (2), the term "property" does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in paragraph (1) of section 1221.

(c) Limitation on Capital Loss Carryovers.—A net capital loss for any taxable year beginning before January 1, 1959, shall not be taken into account.

(d) Gain on Transactions Occurring Prior to January 1, 1959.—For purposes of this part, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset, resulting from sales or other dispositions of property prior to January 1, 1959.

(e) *CERTAIN REINSURANCE TRANSACTIONS IN 1958.—For purposes of this part, the reinsurance in a single transaction, or in a series of related transactions, occurring in 1958, by a life insurance company of all of its life insurance contracts of a particular type, through the assumption by another company or companies of all liabilities under such contracts, shall be treated as a sale of a capital asset.*

SEC. 818. ACCOUNTING PROVISIONS.

(a) METHOD OF ACCOUNTING.—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(b) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—

(1) IN GENERAL.—The appropriate items of income, deductions, and adjustments under this part shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

(B) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(2) SPECIAL RULES.—

(A) AMORTIZATION OF BOND PREMIUM.—In the case of any bond (as defined in section 171(d)) acquired after December 31, 1957, the amount of bond premium, and the amortizable bond premium for the taxable year, shall be determined under section 171(b) as if the election set forth in section 171(c) had been made.

(B) CONVERTIBLE EVIDENCES OF INDEBTEDNESS.—In no case shall the amount of premium on a convertible evidence of indebtedness include any amount attributable to the conversion features of the evidence of indebtedness.

(c) LIFE INSURANCE RESERVES COMPUTED ON PRELIMINARY TERM BASIS.—For purposes of this part (other than section 801), at the election of the taxpayer the amount taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

(1) EXACT REVALUATION.—As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) APPROXIMATE REVALUATION.—The amount computed without regard to this subsection—

(A) increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(B) increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

If the taxpayer makes an election under either paragraph (1) or (2) for any taxable year, the basis adopted shall be adhered to in making the computations under this part (other than section 801) for the taxable year and all subsequent taxable years unless a change in the basis of computing such reserves is approved by the Secretary or his delegate, except that if, pursuant to an election made for a taxable year beginning in 1958, the basis adopted is the basis provided in paragraph (2), the taxpayer may adopt the basis provided by paragraph (1) for its first taxable year beginning after 1958.

(d) SHORT TAXABLE YEARS.—If any return of a corporation made under this part is for a period of less than the entire calendar year (referred to in this subsection as "short period"), then section 443 shall not apply in respect of such period, but—

(1) the taxable investment income and the gain or loss from operations shall be determined, under regulations prescribed by the Secretary or his delegate, on an annual basis by a ratable daily projection of the appropriate figures for the short period,

(2) that portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) shall be determined on an annual basis by treating the amounts ascertained under paragraph (1) as the taxable investment income and the gain or loss from operations for the taxable year, and

(3) that portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) for the short period shall be the amount which bears the same ratio to the amount ascertained under paragraph (2) as the number of days in the short period bears to the number of days in the entire calendar year.

(e) TRANSITIONAL RULE FOR CHANGES IN METHOD OF ACCOUNTING.—

(1) IN GENERAL.—If the method of accounting required to be used in computing the taxpayer's taxes under this part for the taxable year 1958 is different from the method used in computing its taxes under this part for 1957, then there shall be ascertained the net amount of those adjustments which are determined (as of the close of 1957) to be necessary solely by reason of the change to the method required by subsection (a) in order to prevent amounts from being duplicated or omitted. The amount of the taxpayer's tax for 1957 shall be recomputed (under the law applicable to 1957, modified as provided in paragraph (4)) taking into account an amount equal to 1/10 of the net amount of the adjustments determined under the preceding sentence. The amount of increase or decrease (as the case may be) referred to in paragraph (2) or (3) shall be the amount of the increase or decrease ascertained under the preceding sentence, multiplied by 10.

(2) TREATMENT OF DECREASE.—For purposes of subtitle F, if the recomputation under paragraph (1) results in a decrease, the amount thereof shall be a decrease in the tax imposed for 1957;

except that for purposes of computing the period of limitation on the making of refunds or the allowance of credits with respect to such overpayment, the amount of such decrease shall be treated as an overpayment of tax for 1959. No interest shall be paid, for any period before March 16, 1960, on any overpayment of the tax imposed for 1957 which is attributable to such decrease.

(3) TREATMENT OF INCREASE.—

(A) IN GENERAL.—For purposes of subtitle F (other than sections 6016 and 6655), if the recomputation under paragraph (1) results in an increase, the amount thereof shall be treated as a tax imposed by this subsection for 1959. Such tax shall be payable in 10 equal annual installments, beginning with March 15, 1960.

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

(i) No interest shall be paid on any installment described in subparagraph (A) for any period before the time prescribed in such subparagraph for the payment of such installment.

(ii) Section 6152(c) (relating to proration of deficiencies to installments) shall apply.

(iii) In applying section 6502(a)(1) (relating to collection after assessment), the assessment of any installment described in subparagraph (A) shall be treated as made at the time prescribed by such subparagraph for the payment of such installment.

(iv) Except as provided in section 381(c)(22), if for any taxable year the taxpayer is not a life insurance company, the time for payment of any remaining installments described in subparagraph (A) shall be the date (determined without regard to any extension of time) for filing the return for such taxable year.

(4) MODIFICATIONS OF 1957 TAX COMPUTATION.—In recomputing the taxpayer's tax for 1957 for purposes of paragraph (1)—

(A) section 804(b) (as in effect for 1957) shall not apply with respect to any amount required to be taken into account by such paragraph, and

(B) the amount of the deduction allowed by section 805 (as in effect for 1957) shall not be reduced by reason of any amount required to be taken into account by such paragraph.

(f) DENIAL OF DOUBLE DEDUCTIONS.—Nothing in this part shall permit the same item to be deducted more than once under subpart B and once under subpart C.

SEC. 819. FOREIGN LIFE INSURANCE COMPANIES.

(a) CARRYING ON UNITED STATES INSURANCE BUSINESS.—A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable on the United States business of such company in the same manner as a domestic life insurance company.

(b) ADJUSTMENT WHERE SURPLUS HELD IN UNITED STATES IS LESS THAN SPECIFIED MINIMUM.—

(1) IN GENERAL.—In the case of any company described in subsection (a), if the minimum figure determined under paragraph (2) exceeds the surplus held in the United States, then—

(A) the amount of the policy and other contract liability requirements (determined under section 805 without regard to this subsection), and

(B) the amount of the required interest (determined under section 809(a)(2) without regard to this subsection),

shall each be reduced by an amount determined by multiplying such excess by the current earnings rate (as defined in section 805(b)(1)).

(2) DEFINITIONS.—For purposes of paragraph (1)—

(A) The minimum figure is the amount determined by multiplying the taxpayer's total insurance liabilities on United States business by—

(i) in the case of a taxable year beginning before January 1, 1959, 9 percent, and

(ii) in the case of a taxable year beinning after December 31, 1958, a percentage for such year to be determined and proclaimed by the Secretary or his delegate.

The percentage determined and proclaimed by the Secretary or his delegate under clause (ii) shall be based on such data with respect to domestic life insurance companies for the preceding taxable year as the Secretary or his delegate considers representative. Such percentage shall be computed on the basis of a ratio the numerator of which is the excess of the assets over the total insurance liabilities, and the denominator of which is the total insurance liabilities.

(B) The surplus held in the United States is the excess of the assets held in the United States over the total insurance liabilities on United States business.

For purposes of this paragraph and subsection (c), the term "total insurance liabilities" means the sum of the total reserves (as defined in section 801(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), and (5) of section 810(c).

(c) DISTRIBUTIONS TO SHAREHOLDERS.—

(1) IN GENERAL.—In applying sections 802(b)(3) and 815 for purposes of subsection (a), the amount of the distributions to shareholders shall be determined by multiplying the total amount of the distributions to shareholders (within the meaning of section 815) of the foreign life insurance company by whichever of the following percentages is selected by the taxpayer for the taxable year:

(A) the percentage which the minimum figure for the taxable year (determined under subsection (b)(2)(A)) is of the excess of the assets of the company over the total insurance liabilities; or

(B) the percentage which the total insurance liabilities on United States business for the taxable year is of the company's total insurance liabilities.

(2) DISTRIBUTIONS PURSUANT TO CERTAIN MUTUALIZATIONS.—In applying section 815(e) for purposes of subsection (a)—

(A) the paid-in capital and paid-in surplus referred to in section 815(e)(1)(A) of a foreign life insurance company is the portion of such capital and surplus determined by multiplying such capital and surplus by the percentage selected for the taxable year under paragraph (1); and

(B) the excess referred to in section 815(e)(2)(A)(i) (without the adjustment provided by section 815(e)(2)(B)) is whichever of the following is the greater:

(i) the minimum figure for 1958 determined under subsection (b)(2)(A), or

(ii) the surplus described in subsection (b)(2)(B) (determined as of December 31, 1958).

(d) NO UNITED STATES INSURANCE BUSINESS.—Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under this part but shall be taxable as other foreign corporations.

SEC. 820. OPTIONAL TREATMENT OF POLICIES REINSURED UNDER MODIFIED COINSURANCE CONTRACTS.

(a) IN GENERAL.—

(1) TREATMENT AS REINSURED UNDER CONVENTIONAL COINSURANCE CONTRACT.—Under regulations prescribed by the Secretary or his delegate, an insurance or annuity policy reinsured under a modified coinsurance contract (as defined in subsection (b)) shall be treated, for purposes of this part (other than for purposes of section 801), as if such policy were reinsured under a conventional coinsurance contract.

(2) CONSENT OF REINSURED AND REINSURER.—Paragraph (1) shall apply to an insurance or annuity policy reinsured under a modified coinsurance contract only if the reinsured and reinsurer consent, in such manner as the Secretary or his delegate shall prescribe by regulations—

(A) to the application of paragraph (1) to all insurance and annuity policies reinsured under such modified coinsurance contract, and

(B) to the application of the rules provided by subsection (c) and the rules prescribed under such subsection.

Such consent, once given, may not be rescinded except with the approval of the Secretary or his delegate.

(b) DEFINITION OF MODIFIED COINSURANCE CONTRACT.—For purposes of this section, the term "modified coinsurance contract" means an indemnity reinsurance contract under the terms of which—

(1) a life insurance company (hereinafter referred to as "the reinsurer") agrees to indemnify another life insurance company (hereinafter referred to as "the reinsured") against a risk assumed by the reinsured under the insurance or annuity policy reinsured,

(2) the reinsured retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) all or part of the gross investment income derived from such assets is paid by the reinsured to the reinsurer as a part of the consideration for the reinsurance of such policy, and

(4) the reinsurer is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

(c) SPECIAL RULES.—Under regulations prescribed by the Secretary or his delegate, in applying subsection (a)(1) with respect to any insurance or annuity policy the following rules shall (to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) be applied in respect of the amount of such policy reinsured:

(1) PREMIUMS AND GROSS INVESTMENT INCOME.—The premiums (to the extent allocable to the participation of the reinsurer therein) received for the policy reinured shall be treated as received by the reinsurer and not by the reinsured. The gross investment income (to

the extent allocable to the participation of the reinsurer therein) derived from the assets in relation to the reserve on the policy reinsured shall be treated as gross investment income of the reinsurer and not of the reinsured. The gross investment income so treated shall be considered as derived proportionately from each of the various sources of gross investment income of the reinsured.

(2) CAPITAL GAINS AND LOSSES.—The gains and losses from sales and exchanges of capital assets, and gains and losses considered as gains and losses from sales and exchanges of capital assets, of the reinsured shall (to the extent of the participation therein by the reinsurer under the terms of the modified coinsurance contract) be treated as gains and losses from sales and exchanges of capital assets of the reinsurer and not of the reinsured.

(3) RESERVES AND ASSETS.—The reserve on the policy reinsured shall be treated as a part of the reserves of the reinsurer and not of the reinsured, and the assets in relation to such reserve shall be treated as owned by the reinsurer and not by the reinsured.

(4) EXPENSES.—The expenses (to the extent reimbursable by the reinsurer) incurred with respect to the policy reinsured and with respect to the assets referred to in paragraph (3) shall be treated as incurred by the reinsurer and not by the reinsured.

(5) DIVIDENDS TO POLICYHOLDERS.—The dividends to policyholders paid in respect of the policy reinsured shall be treated as paid by the reinsurer and not by the reinsured. For purposes of the preceding sentence, the amount of dividends to policyholders treated as paid by the reinsurer shall be the amount paid, in respect of the policy reinsured, by the reinsurer to the reinsured as reimbursement for dividends to policyholders paid by the reinsured. This paragraph shall also apply in respect of an insurance or annuity policy reinsured under a conventional coinsurance contract.

(6) REIMBURSEMENT FOR 1957 FEDERAL INCOME TAX.—Any amount paid in 1958 or any subsequent year by the reinsurer to the reinsured as reimbursement for Federal income taxes imposed for a taxable year beginning in 1957 or any preceding taxable year shall not be taken into account by the reinsured as an item under section 809(c) or by the reinsurer as a deduction under section 809(d).

(7) RULES PRESCRIBED BY THE SECRETARY.—Such other rules as may be prescribed by the Secretary or his delegate.

In applying the rules provided by paragraphs (1), (2), (3), (4), (5), and (6) and the rules prescribed under paragraph (7), an item shall be taken into account as income only once under subpart B and only once under subpart C by both the reinsured and the reinsurer, and an item shall be allowed as a deduction only once under subpart B and only once under subpart C to both the reinsured and the reinsurer.

SEC. 841. CREDIT FOR FOREIGN TAXES.

The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, [811,] 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence, the term "taxable income" as used in section 904 means—

[(1) in the case of the tax imposed by section 802 or 811, the net investment income (as defined in section 803(c)).]

(1) in the case of the tax imposed by section 802, the life insurance company taxable income (as defined in section 802(b)), and

(2) in the case of the tax imposed by section 831, the taxable income (as defined in section 832 (a)).

SEC. 842. COMPUTATION OF GROSS INCOME.

The gross income of insurance companies subject to the tax imposed by section 802, [811,] or 831 shall not be determined in the manner provided in part I of subchapter N (relating to determination of sources of income).

* * * * * * *

SEC. 891. DOUBLING OF RATES OF TAX ON CITIZENS AND CORPORATIONS OF CERTAIN FOREIGN COUNTRIES.

Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, [811,] 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

* * * * * * *

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167(b)(1). Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020. Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) in respect of any period—

(A) before March 1, 1913, [and]

(B) since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws, *and*

(C) since February 28, 1913, and before January 1, 1958, during which such property was held by a person subject to tax under part I of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,

for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

* * * * * * *

(17) in the case of any evidence of indebtedness referred to in section 818(b) (relating to amortization of premium and accrual of discount in the case of life insurance companies), to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years;

* * * * * * *

SEC. 1201. ALTERNATIVE TAX.

(a) CORPORATIONS.—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, [802(a),] 821(a)(1) or (b), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

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(*c*) *LIFE INSURANCE COMPANIES.—*

For alternative tax in case of life insurance companies, see section 802(a)(2).

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SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) GENERAL RULE.—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) RETIREMENT.—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) SALE OR EXCHANGE.—

(A) GENERAL RULE.—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), or

(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity.

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

(B) EXCEPTIONS.—This paragraph shall not apply to—

(i) obligations the interest on which is not includible in gross income under section 103 (relating to certain governmental obligations), or

(ii) any holder who has purchased the bond or other evidence of indebtedness at a premium.

[(C) ELECTION AS TO INCLUSION.—In the case of obligations with respect to which the taxpayer has made an election provided by section 454 (a) and (c) (relating to accounting

rules for certain obligations issued at a discount), this section shall not require the inclusion of any amount previously includible in gross income.]

(C) Double inclusion in income not required.—This section shall not require the inclusion of any amount previously includible in gross income.

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SEC. 1504. DEFINITIONS.

(a) Definition of "Affiliated Group".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(b) Definition of "Includible Corporation".—As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802, [811,] or 821.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States.

(5) Corporations organized under the China Trade Act, 1922.

(6) Regulated investment companies subject to tax under subchapter M of chapter 1.

(7) Unincorporated business enterprises subject to tax as corporations under section 1361.

(8) An electing small business corporation (as defined in section 1371(b)).

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SEC. 4371. IMPOSITION OF TAX.

There is hereby imposed, on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer, a tax at the following rates:

(1) Casualty insurance and indemnity bonds.—Four cents on each dollar, or fractional part thereof, of the premium charged on the policy of casualty insurance or the indemnity bond, if issued to or for, or in the name of, an insured as defined in section 4372(d);

(2) Life insurance, sickness, and accident policies, and annuity contracts.—One cent on each dollar, or fractional part

thereof, of the premium charged on the policy of life, sickness, or accident insurance, or annuity contract, unless the insurer is subject to tax under section [816] *819*;

(3) REINSURANCE.—One cent on each dollar, or fractional part thereof, of the premium charged on the policy of reinsurance covering any of the contracts taxable under paragraph (1) or (2).

* * * * * * *

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) GENERAL RULE.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

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(c) EXCEPTIONS.—

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(6) TAX RESULTING FROM CERTAIN DISTRIBUTIONS OR FROM TERMINATION AS LIFE INSURANCE COMPANY.—In the case of any tax imposed under section 802(a)(1) by reason of section 802(b)(3) on account of a termination of the taxpayer as an insurance company or as a life insurance company to which section 815(d)(2)(A) applies, or on account of a distribution by the taxpayer to which section 815(d)(2)(B) applies, such tax may be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) for the taxable year for which the taxpayer ceases to be an insurance company, the second taxable year for which the taxpayer is not a life insurance company, or the taxable year in which the distribution is actually made, as the case may be.

VI. SUPPLEMENTAL VIEWS ON H.R. 4245

It has been, and is, a matter of wise public policy in the United States to encourage individual and group participation in various forms of life insurance and other forms of social security. It has long been felt that individuals should be encouraged to provide for future contingencies, both for themselves and for their dependents. The Federal Government has contributed toward the fulfillment of this public policy objective by granting special tax concessions to beneficiaries of life insurance policies.

While it may be desirable to give favorable tax treatment in certain instances to policy beneficiaries, it is neither necessary nor advisable to provide unduly favorable tax treatment for life insurance companies.

There is no testimony in the record of the hearing on this bill to indicate a need on the part of the life insurance industry for favorable tax treatment. On the contrary, all evidence indicates that the life insurance industry enjoys a high degree of prosperity, with many new companies entering the field every year. The industry appears to be on a sound, profitable footing and is undergoing rapid expansion. In the absence of a demonstrated need, then, for favorable tax treatment, the primary objective of a special law for the taxation of life insurance companies is to define what may properly be considered net income or net gain from the operation of a life insurance company. After a determination of the proper tax base, the life insurance company should be taxed on its corporate profits at current rates as is any other corporation. To do less would be unfair to other taxpayers who would be thus required to bear a disproportionately greater share of the tax burden.

It has often been said that the life insurance industry is unique and that life insurance companies could not be fitted into the regular corporate tax pattern.

The traditional life insurance policy is a contract between the insured and the company, which contract contemplates the accumulation of a fund which is to be invested, usually in long-term investments, and which will be increased each year by the addition of a portion of the return from these investments as well as by the addition of a part of each year's premium. Typically, this contract also specifies certain fixed or determinable benefits which will accrue to the insured or his beneficiaries. Because of the importance of long-term investments, variations in risks, and the long-term nature of the policy of insurance, it is said to be difficult to determine the true net gain for any given company for any given year.

For these reasons, every tax law applicable to life insurance companies since 1921 has taxed only a portion of the net investment income of the company. This was, perhaps, a reasonable approach as long as ordinary life and annuities were the types of policies written.

More and more, however, in recent years, the type of policy has been undergoing change. Today, approximately 40 percent of life in-

surance in force constitutes the term insurance element in policies. More and more, accident and health, industrial, credit, and other low reserve and specialty lines are being written. The underwriting profits from these lines are often far larger than the return from long-term investments. In view of all these facts, fairness and equity require that all true profits of life insurance companies, not just a small portion of net investment income, be subject to normal tax liability.

It is our opinion that, although a special bill is necessary to fit life insurance company operations, special concessions are not called for. The bill H.R. 4245, as it was passed by the House of Representatives, is a vast improvement over existing law. Indeed, it is a vast improvement over any of the life insurance company tax laws which have been enacted since 1921. Even so, the House bill is quite generous in its treatment of life insurance companies and, in certain important respects, it has been made more so by amendments adopted by the Senate Finance Committee.

There are three areas in particular in which the measure, as amended by the Finance Committee, should be strengthened. In two of these areas, Finance Committee action has weakened the bill. In the third, the bill has been strengthened but not realistically so. These areas are:

1. The computation of the "deduction rate" in phase 1.
2. The establishment of a ceiling for the policyholders surplus account in phase 3.
3. The delay in the application of phase 2 and phase 3.

THE DEDUCTION RATE

Although the bill H.R. 4245 appears to provide for a tax on the total net gain from operations, it is so constructed that the tax on investment income is of primary importance for most companies. This is particularly true for mutual life insurance companies; indeed, for the typical mutual life insurance company, the tax on net investment income, the so-called phase 1 tax, is the only tax which the company will likely pay under this bill. Of the $558 million estimated revenue for 1958 which this bill as passed by the House of Representatives would bring in, $518 million would come from the phase 1 portion of the tax. The correctness of the computation of this portion of the tax, then, is the first step in insuring an equitable tax law.

The key to the computation of this portion of the tax is the "policy and other contract liability requirements" in the case of investment income. The remainder of the taxable net investment income is the phase 1 tax base, to which the current corporate rate is applied.

When the premium for an insurance policy is computed, one of the factors taken into consideration is the earning rate which the company expects to enjoy during the time the policy reserves are invested. Insofar as it is possible to do so by tax forbearance, the Federal Government has sought to insure that reserves are built up by the company for the protection of the insured. For this reason, all tax formulas based on investment income have provided for the deduction from the tax base (or the setting aside) of this reserve buildup.

The amount which should be exempt from taxation in order that it may be added to the reserve fund for the protection of the policyholders is theoretically computed by multiplying the amount of the

current reserve by the "assumed" rate which was used in computing the premium. As a matter of practice, however, according to testimony before the committee, the rate of return actually expected by the company when the premium was computed may vary materially from the "assumed" rate, the "assumed" rate being used primarily to compute the rate of reserve buildup necessary to satisfy State requirements of safety and liquidity.

The methods which have been used in past laws to determine the proper deduction have varied, but usually have been based on some sort of "global" approach. The so-called 1955 formula, for example, assumed that each company needed approximately 85 percent of its net investment income for additions to reserves. The law which was in effect during 1958, the so-called 1942 formula, provided for a very complicated and variable deduction rate which was recomputed on a "global" basis from year to year. This formula yielded no tax for 1948, for example, but for 1958 would yield approximately $500 million. It bears little relation to the actual needs of any given company.

The bill H.R. 4245, as passed by the House of Representatives, provides for a modified "global" approach. In this case, the deduction rate (average earnings rate under the Finance Committee amendments) is computed by averaging the individual company's earning rate with the individual company's assumed rate or an industry assumed rate. This, too, bears little relation to the real needs of the company. As earning rates go up, the needs of the company do not increase accordingly, needs being fixed by the terms of existing policies.

The amendment adopted by the Finance Committee bears even less relationship to reality. This modified so-called Menge formula assumes that the company needs a deduction which is measured by its actual earnings. To compensate for a higher earning rate the reserves are recomputed, supposedly on the basis of this higher earning rate.

Several actuaries have attempted to explain and justify the increased deduction given by this formula. The fact remains that this method of computation bears no relationship to the company's needs as shown by the company's own books. The recomputation of reserves does not compensate for the increase in deduction rate. It can readily be seen that an increase of 50 percent in the deduction rate (in the case of a company with an assumed rate of 2 percent and an earning rate of 3 percent) is not compensated for by reducing the reserves by 10 percent. The product of the earning rate and recomputed reserves will be greater than the product of the assumed rate and the actual reserves.

As the actual earning rate advances the deduction increases further and further beyond the actual need for reserve buildup. This is true of the modified Menge formula adopted by the committee, the pure Menge formula, and the formula adopted by the House of Representatives. Of the three, the formula adopted by the House, though itself considerably short of reality, gives the smallest deduction, and the one closest to actual requirements under current conditions. This is true because, in the formula adopted by the House of Representatives, in arriving at the deduction rate, the current earning rate is averaged with a constant—either the company or the industry assumed rate. Averaging a variable with a constant decreases by one-half the effect of changes in the variable.

The following table shows the deduction which would be allowed for each hundred dollars of reserves under the various formulas which have been discussed. Let us consider a typical company having an assumed rate of 2½ percent and earning rates as follows:

	Percent		*Percent*
1954	3.0	1957	3.6
1955	3.4	1958	3.6
1956	3.5	1959	3.8

Let us further assume that the industry assumed rate is 3 percent.

	House of Representatives formula	Finance Committee formula	Menge formula
Deduction rate (1958)	3.3	3.402	3.6
Deduction rate (1959)	3.4	3.58	3.8
Recomputed reserves (1958)	92	90.98	89
Recomputed reserves (1959)	91	89.2	87
Deduction for each $100 of reserves (1958)	3.036	3.095	3.204
Deduction for each $100 of reserves (1959)	3.094	3.193	3.306
Additional deduction for 1959 over 1958	.058	.098	.102

This table illustrates two interesting points. First, both the formula adopted by the Finance Committee and the Menge formula provide larger deductions than the formula adopted by the House of Representatives. Second, the increase in the deduction, for a given interest rate increase, is greater in both the Finance Committee and the Menge formulas, the increase for the Menge formula being almost twice the increase under the House of Representatives formula. As interest rates continue to rise, or even if they level off at the present high average rate, the formula adopted by the Senate Finance Committee will approach the pure Menge formula in behavior. The additional deduction given to the life insurance industry by the formula adopted by the Finance Committee will amount to more than $43 million this year, perhaps much more in later years. A small portion of this extra deduction will, of course, be recovered from stock life insurance companies under the phase 2 tax. Practically none of it will be recovered from the large mutual companies. This is an unjustified tax favor.

We feel that the formula in the bill as passed by the House of Representatives should be retained, at the very least.

POLICYHOLDERS SURPLUS ACCOUNT

The justification for currently taxing only one-half the net gain from operations in phase 2 is said to rest on the premise that it is difficult to determine for any given year the actual income of a life insurance company. In order that the income on which tax is not currently paid will eventually be taxed, in part, the bill H.R. 4245 provides certain ceilings or "triggering" limits for this account.

These limits are divided into two classes. First is the provision for taxing amounts transferred from the account for the purpose of paying stockholders dividends. This "triggering" limit is, of course, wholly under the control of the company. If the company chooses to pay stockholder dividends only to the extent of available funds on which the tax has already been paid, it can retain this untaxed amount

indefinitely as a surplus fund on which further expansion can be based. The company thus has the ability, to some extent, to determine its own tax liability for any given year.

The second class of limits consists of those which are not under the control of the company. The bill, as passed by the House of Representatives, contained the following limits of this type, with the "greater" of the alternatives providing the ceiling:

1. 25 percent of life insurance reserves.
2. 60 percent of the year's premium payments.

The Finance Committee, in an effort to lower the ceiling, reduced these limits to 15 percent and 50 percent, respectively, and added a third, i.e., 25 percent of the increase in reserves subsequent to 1958.

Under current conditions the well-established company, writing a variety of lines, will not reach these limits in the foreseeable future. Each year life insurance companies, taking the industry as a whole, increase policy reserves by about 7 percent under current conditions. For the typical stock life insurance company this annual increase in reserves will amount to more than the annual additions to the policyholders surplus account. Thus the policyholders surplus account will not, in the foreseeable future for most companies, reach or exceed any reasonable percentage of reserves.

For some specialty companies having low reserves, the above may not be true. The reserve "trigger" ceiling may be reached within a very short time. In that case, however, there will still be the shelter of 50 percent of premiums under which to take refuge.

The only realistic approach to the question of proper "triggering" limits is to apply the "lesser" instead of the "greater" of the alternative ceilings. This would still provide ample protection to the typical stock life insurance companies and their policyholders. It would apply a more nearly equitable tax on the so-called specialty companies most of which are not in need of, or entitled to, the extra benefits which accrue to companies able to accumulate substantial tax-free surplus funds.

In our opinion these "triggering" limits should be lowered at least to the points established by the Finance Committee, but the lesser of these limits for any given company should establish the ceiling on the amount of tax-free surplus which that company can accumulate.

*Delay in the application of phase 2 and phase 3**

The bill H.R. 4245 as passed by the House of Representatives provides for the application of the phase 1 and phase 2 portions of the tax to 1958 income, the phase 3 tax to apply to 1959 and subsequent years. The Finance Committee has adopted amendments which would apply phase 3 gradually over a period of 3 years beginning in 1959 and which provide, under certain circumstances, for a forgiveness of part of the phase 2 tax for 1958.

We recognize that the bill, either in its House-passed form or with Finance Committee amendments, imposes a greatly increased tax on some companies, particularly those concerns that have had a relatively small tax liability. We also recognize the questionability, but not the illegality, of retroactive taxation. Existing law, the so-called 1942 formula, was the law under which life insurance companies operated during 1958. Spokesmen for the life insurance industry,

*Senator Douglas wishes to reserve final judgment on this point.

however, generally agreed that the subject bill was preferable to existing law. If it is felt that this proposed new law should be effective for 1958, we see no reason for not making it fully effective. There seems to be no justification whatsoever for a "graduated" period of effectiveness.

The amendments adopted by the Finance Committee involving the delay in applying phases 2 and 3 will benefit primarily a few credit-life companies, specialty companies, or companies dealing in extremely low reserve lines of insurance, many of which have enjoyed extremely low tax liability. These companies do not engage primarily in the traditional forms of life insurance and are not entitled, even to the extent to which the ordinary type of life insurance company may be so entitled, to the bounty of tax forbearance.

It is strange logic, indeed, to argue that a company which has been able to escape equitable taxation by reason of defective tax laws should be allowed to continue to avoid a part of its just tax merely because it has not been paying its fair share of the cost of government and national defense heretofore.

SUMMARY

In our opinion the bill H.R. 4245 as passed by the House of Representatives is an improvement over existing law. Even under its provisions, however, life insurance companies would still enjoy a favorable Federal income tax position. Certain amendments adopted by the Finance Committee, especially those discussed herein, have weakened the bill when, in fact, the bill should be strengthened.

We urge the Senate to pass the bill in a form at least as effective as the form in which it passed the House of Representatives.

Paul H. Douglas.
Albert Gore.