LIFE INSURANCE TAXATION

1571-10

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-EIGHTH CONGRESS

SECOND SESSION

ON

H.R. 5739, 8363

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CORRECT CERTAIN INEQUITIES WITH RESPECT TO THE TAXATION OF LIFE INSURANCE COMPANIES

S1327, 2955, 2973

JULY 29, 1964

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

36-072 WASHINGTON : 1964

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LIFE INSURANCE TAXATION

WEDNESDAY, JULY 29, 1964

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:20 a.m. in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Smathers, Gore, Talmadge, Hartke, McCarthy, Williams, Carlson and Morton.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The hearing today is on the bill H.R. 5739, an act to amend the Internal Revenue Code of 1954 to correct certain inequities with respect to the taxation of life insurance companies. The Chair places in the record a copy of the pending bill and departmental reports thereon from the Treasury Department and the Bureau of the Budget.

(The bill and departmental reports follow:)

[H.R. 5739, 88th Cong., 2d sess.]

AN ACT To amend the Internal Revenue Code of 1954 to correct certain inequities with respect to the taxation of life insurance companies

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (e) of section 812 of the Internal Revenue Code of 1954 (rules relating to new companies) is amended to read as follows:

"(e) 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 any predecessor, if section 381(c)(22) applies or would have applied if in effect) was authorized to do business as an insurance company."

(b) The amendment made by subsection (a) shall apply to a loss from operations for taxable years beginning after December 31, 1955; except that, in the case of a nonqualified corporation as defined in section 812(e)(2)(B) of the Internal Revenue Code of 1954 as in effect before such amendment—

(1) a loss from operations for a taxable year beginning in 1956 shall not be an operating loss carryover to the years 1962 and 1963, and there shall be no reduction in the portion of such loss from operations which may be carried to 1964 by reason of an offset with respect to the year 1962 or 1963, and

(2) a loss from operations for a taxable year beginning in 1957 shall not be an operating loss carryover to the year 1963, and there shall be no reduction in the portion of such loss from operations which may be carried to 1964 and 1965 by reason of an offset with respect to the year 1963.

SEC. 2. Section 815(b)(2)(A)(ii) of the Internal Revenue Code of 1954 (relating to additions to shareholders surplus account) is amended by adding at the end thereof the following: "reduced (in the case of a taxable year beginning after December 31, 1961) by the amount referred to in clause (i),".

SEC. 3. (a) Section 815(d) of the Internal Revenue Code of 1954 (relating to special rules with respect to distributions to shareholders) is amended by adding at the end thereof the following new paragraph:

"(5) REDUCTION OF POLICYHOLDERS SURPLUS ACCOUNT FOR CERTAIN UNUSED DEDUCTIONS.—If—

"(A) an amount added to the policyholders surplus account for any taxable year increased (or created) a loss from operations for such year, and

"(B) any portion of the increase (or amount created) in the loss from operations referred to in subparagraph (A) did not reduce the life insurance company taxable income for any taxable year to which such loss was carried,

the policyholders surplus account for the last taxable year to which such loss is carried under section 812(b)(2) shall be reduced by the amount described in subparagraph (B) or, if lesser, the amount in such account as of the close of such taxable year (computed before any subtractions for such taxable year)."

(b) The amendment made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1963.

Passed the House of Representatives June 29, 1964.

Attest:

RALPH R. ROBERTS, *Clerk.*

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
Washington, D.C., July 22, 1964.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Bureau of the Budget on H.R. 5739, a bill to amend the Internal Revenue Code of 1954 to correct certain inequities with respect to the taxation of life insurance companies.

The Treasury Department, in a report being made to your committee on this bill, is not opposed to its enactment, provided section 2 is amended to eliminate completely the unjustified tax benefit discussed in the report.

The Bureau of the Budget concurs with the views contained in that report and has no objection to the enactment of H.R. 5739, provided it is amended as discussed in the Treasury report.

Sincerely yours,

PHILLIP S. HUGHES,
Assistant Director for Legislative Reference.

TREASURY DEPARTMENT,
Washington, July 21, 1964.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to your request for the views of this Department on H.R. 5739, now pending before your committee, to amend the Internal Revenue Code of 1954 to correct certain inequities with respect to the taxation of life insurance companies.

H.R. 5739 contains three amendments to the life insurance company provisions of the Internal Revenue Code. Section 1 of H.R. 5739 would grant an 8-year loss carryover to any new life insurance company. Under present law, insurance companies in general are permitted only a 5-year loss carryover, as in the case of other businesses, but section 812 allows new life insurance companies an 8-year carryforward, under certain conditions. A "new" company is one that

is not more than 5 years old at the beginning of the taxable year in which the loss occurs. However, the 8-year loss carryover is not allowed to a life insurance company which is a 50-percent subsidiary unless the related corporation is an insurance company taxable under parts II or III of subchapter L (fire and casualty companies). The effect of the change proposed in section 1 of H.R. 5739 would be to grant the 8-year carryforward to any life insurance company regardless of its affiliation with any other corporation, including the presently excluded companies.

Section 2 of H.R. 5739 would amend section 815 to provide that the addition to the shareholders surplus account for capital gains shall be reduced in the case of taxable years beginning after December 31, 1961, by the amount of the life insurance taxable income, thus preventing a double addition of capital gains to the shareholders surplus account.

Under present law, an insurance company which has capital gains and also has operating income is permitted a double addition to its shareholders surplus account (i.e., the taxpaid profit account the size of which indicates the amount of dividends that can be paid without incurring phase III tax). This occurs since capital gains are included in taxable income, which is added to shareholders surplus account, and capital gains are listed separately among the items which are to be added to shareholders surplus account under section 815(b).

The double inclusion situation arose inadvertently as a result of amendments in 1962 which extended to life insurance companies the same alternative capital gains treatment allowed other corporations. Prior to 1962 life insurance companies computed their taxable income without regard to capital gains and then paid a separate 25-percent tax on capital gains. The 1962 amendments (Public Law 87-858) changed the definition of taxable income to include capital gains and then provided an alternative tax computation excluding capital gains and applying a separate 25-percent tax to those gains. No amendment was made, however, in the phase III tax computation. As a result capital gains are added twice to the shareholders surplus account—once as part of taxable income and again in its own basket.

The proposed amendment in section 2 of the bill will eliminate the double benefit arising under present law where an insurance company has capital gains and also has operating income—by reducing the addition to shareholders surplus account for capital gains by the amount of life insurance taxable income. The amendment is inadequate, however, in that it fails to eliminate an unjustified benefit under present law in the case where a company has capital gains and an operating loss (rather than taxable income). The unjustified benefit is that, although the capital gains are offset by the operating loss so that no tax is paid on the capital gains, the amount of such capital gains is added to the shareholders surplus account and thus increases the cushion from which tax-free distributions can be made to shareholders. Since the shareholders surplus account is intended to reflect only profits on which taxes have been paid, there is no justification for increasing the shareholders surplus account by the amount of capital gains offset by operating losses. The nature of the unjustified benefit can also be shown as follows: The offset of capital gains against the operating loss will normally result in a lower net operating loss carryover, which in turn increases the taxable income in a subsequent year which will be added to the shareholders surplus account. If capital gains were also added to the shareholders surplus account in the loss year, there would, in effect, be a double inclusion. Section 2 should be revised to amend section 815(b)(2)(A)(ii) to eliminate the addition to shareholders surplus account for capital gains for taxable years beginning after December 31, 1961.

Section 3 of H.R. 5739 would permit a life insurance company to subtract from its phase III tax base any amounts of the special deductions relating to nonparticipating contracts and group life and group health contracts which were previously added to the policyholder surplus account but from which the company derived no tax benefit.

Under present law, in computing its phase II tax (on underwriting income), a life insurance company is allowed (in addition to other deductions) the following three special deductions: (1) amounts paid as policyholder dividends; (2) 10 percent of the increase during the year in certain reserves for nonparticipating contracts or 3 percent of the premiums for the year attributable to

certain nonparticipating contracts, whichever is greater; and (3) 2 percent of the net premiums for the year attributable to group life insurance and group accident and health contracts.

There is a limitation, however, on these three deductions. In the aggregate, they cannot exceed the amount (if any) by which the gain from operations (phase II tax base without these three deductions) exceeds the taxable income for the year (phase I tax base), plus $250,000. If a company is allowed either the 2-percent deduction (item 3) or the 10-percent deduction (item 2), or both, the amount deducted must be added to a special policyholder's surplus account. (The amount of its deduction for policyholder dividends is not added to the account.) Then, if amounts are distributed from this surplus account in a later year (or if the account exceeds certain limitations or the company liquidates), the company must pay a tax on these amounts. This is the so-called phase III tax and is applicable only to stock companies. In effect, therefore, the 2-percent and 10-percent deductions may represent a deferral of tax rather than a straight deduction, since tax is due on the amount of these deductions in a later year when distributions are made from the policyholder's surplus.

The amount of the 2-percent and 10-percent deductions must be added to the policyholder's surplus account whether or not any tax benefits is derived therefrom. Where it creates or increases a net operating loss, it may be of no benefit in other years as a carryover or carryback because the company has a long series of loss years. Since the company must take the 2-percent and 10-percent deductions up to the amount of the $250,000 limitation, the deductions can create a loss of up to $250,000 a year. In applying the $250,000 limit the policyholder dividend deduction is allowed first, then the 2-percent deduction, and finally the 10-percent deduction.

The operation of present law in this area may be illustrated by the following example: Assume that a life insurance company has a gain from operations for the year (before taking into account the three special deductions) of $100,000; that it pays no policyholder dividends; and that its 2-percent and 10-percent deductions amount to $250,000 for the year. The result is that the company has a net loss from operations of $150,000 for which it is allowed a carryback or carryforward. However, assume that the company has a loss for all the years to which this loss could be carried over or back. In this case, although the company gets no benefit in the form of carryover or carryback from the $150,000 loss created by the 2-percent and 10-percent deductions, it must nevertheless add the full $250,000 (representing the total amount of these deductions) to its phase III tax base.

Section 3 of H.R. 5739 would amend section 815 to permit a life insurance company to subtract from the special policyholder's surplus account amounts previously added which had not served to reduce life insurance taxable income and which during the year became unavailable to reduce future taxable income. In the above example, this would mean that the life insurance company could subtract $150,000 from its special surplus account (phase III tax base) in the year that its net operating loss carryover expired (5 years, or, in the case of new companies, 8 years).

The theory behind the phase III tax is that it represents a deferred tax on amounts set aside in certain contingency reserves for which a deduction was allowed. This amendment, which is similar to the amendment contained in section 3 of H.R. 12380 (87th Cong., 2d sess.), is supported by the argument that it is inequitable to increase the policyholder's surplus account (which becomes the basis for a potential phase III tax) on amounts which do not serve to reduce life insurance taxable income.

The Department is not opposed to the enactment of H.R. 5739, provided section 2 is amended to completely eliminate the unjustified tax benefit described above.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY, *Assistant Secretary.*

The CHAIRMAN. Our first witness today is Mr. Robert Klayman, acting tax legislative counsel of the Treasury Department.

Take a seat, sir, and proceed.

STATEMENT OF ROBERT A. KLAYMAN, ASSOCIATE TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT, ACCOMPANIED BY GERARD BRANNON AND RICHARD SLITOR, OFFICE OF TAX ANALYSIS, TREASURY DEPARTMENT

Mr. KLAYMAN. Mr. Chairman and members of the committee, the Treasury Department appreciates this opportunity to explain its views on the bill H.R. 5739, a bill to correct certain inequities with respect to the taxation of life insurance companies.

I have with me Gerard Brannon and Richard Slitor of the Office of Tax Analysis of the Treasury Department.

Section 1 of H.R. 5739 deals with a provision in the Life Insurance Company Income Tax Act adopted in 1959 providing a longer loss carryover period for new life insurance companies.

Due to the full current deductibility of the special costs associated with writing insurance contracts, it is quite typical for a new life insurance company to go through a period of up to 8 years of losses when it is first organized.

For this reason, the Life Insurance Company Income Tax Act provides that a new life insurance company may have an 8-year loss carryover rather than a 5-year loss carryover. The 8-year loss carryover provision, however, was circumscribed by the requirement that it would not be available to any company which itself has a subsidiary company or which is a subsidiary of any other company. This restriction on the 8-year loss carryover was added out of a sense of caution in view of our general experience of trafficking in loss carryovers in other corporate situations.

Further study of this problem suggests to us that in the field of life insurance operations the trafficking in loss carryovers is not likely to be a significant problem. In any case, there are provisions in present law, dealing with trafficking in loss carryovers, which apply to all corporations, including life insurance companies.

For this reason, we are sympathetic to the aim of section 1 of H.R. 5739 which would extend this 8-year loss carryover privilege to all new life insurance companies whether or not they are subsidiaries of other companies, and whether or not they have subsidiary companies of their own.

This provision would have particular effect, for example, for a mercantile establishment that wishes to establish a life insurance subsidiary, possibly to take advantage of an established trade name or to utilize the selling facilities of the parent establishment.

If the life insurance subsidiary is organized and operated like a regular life insurance company, it is quite likely that its deductions will exceed its income during the first 8 years or so of its operation.

The parent corporation in this situation is precluded by law from filing a consolidated return with its life insurance subsidiary so that extending the loss carryover period for the subsidiary seems to be quite reasonable. It may be noted that the longer loss carryover will still do the subsidiary no good unless it does reach a point of producing taxable income against which to offset these losses.

The remaining part of the bill, sections 2 and 3, deals with the operation of the so-called phase III tax; that is, the tax that is im-

posed on the life insurance company at the time of the distribution of certain profits.

In general, the taxable income of life insurance companies is made up of three parts. In the first place a certain portion of the investment income is included in the tax base.

Over and above this, the life insurance company is required to calculate its total income which includes its underwriting income, and it must add to the tax base 50 percent of the difference between its total income and its taxable investment income. (If the total income is less than the taxable investment income, total income becomes the tax base.) Over and above this, the life insurance company is required to keep two profit accounts.

One account, which is called the shareholders surplus account, is made up generally of the taxable income minus the taxes previously paid. To emphasize the character of this account, I will refer to it as the tax-paid profit account.

Any dividends that the company pays are treated as first coming out of this tax-paid profit account.

The companies are also required to keep a policyholders surplus account, which is basically a running account of those portions of its total income which were excluded from the tax base by virtue of the fact that only 50 percent of the excess of total income over taxable investment income is required to be included in the tax base currently.

I will call this running account of the excluded 50 percent's the nontaxed profit account.

If the dividends paid by the life insurance company exhaust the tax-paid profit account, then any further dividends are treated as coming out of this nontaxed profit account; and this causes the money to be restored to the tax base and become taxable to the insurance company. Deferral is granted only so long as the money is required to be kept in the life insurance company to meet future contingencies. When the company by its dividends to shareholders indicates that the money is not needed to meet contingencies, then this money can be restored to the tax base.

Section 2 of the bill deals with a technical defect in the operation of phase III of the present law which provides an unwarranted benefit to life insurance companies.

Prior to 1961, life insurance companies always paid tax on any net capital gain separately, so they had a taxable computation separately from the net capital gain computation.

For this reason, the law provided that the tax-paid profit account would include both the taxable income after tax plus the capital gains after tax.

In 1961 the basic law was amended so as to include capital gains in the life insurance company's taxable income, and to permit the alternative of paying a separate 25-percent tax on capital gains if this results in a lower tax.

Unfortunately, the proper conforming amendment was not made at that time to prevent double counting of capital gains in the tax-paid profit account.

Thus, under the law as it stands now, a life insurance company can have a taxable income other than capital gain of, for example, $100,000 and a separate capital gain of say, $100,000.

The way the law reads the life insurance company would appear to have the privilege of adding to its tax-paid profit account $200,000 of taxable income arising from including the capital gain in taxable income plus, in addition, the capital gain itself.

Thus, it would show a tax-paid profit account of $300,000 less the tax actually paid, although it only received an income of $200,000 in a year.

The company in this situation could actually be distributing as dividends to stockholders a portion of its previously nontaxed profits but due to this overstatement of the tax-paid profit account this distribution would escape the phase III tax.

The House bill corrects this problem. Unfortunately, the House bill does not correct the analogous problem which occurs in the loss case. Let me change the figures just cited to assume that the company's ordinary accounts show a loss of $100,000 plus a capital gain of $100,000. Under the 1961 legislation, this company would show a zero taxable income, using the operating loss to offset the capital gain. This is what any other corporation would do in such a circumstance.

Under the present law, however, the company would add to its tax-paid profit account the $100,000 of capital gain. This addition would be made even though it is clear from the facts given that there were no tax-paid profits. The company reported on balance a zero income, offsetting the loss against the gain, and paid no tax.

It is clearly unrealistic to give the company a credit for $100,000 of tax-paid profits. If the company had from a previous year some nontaxed profits, it would be able to distribute these as dividends and, because of this distortion in the tax-paid profit account, it would avoid the phase III tax on the distribution. The Treasury Department believes that the committee should broaden section 2 of the bill to correct this overstatement of the tax-paid profit account in the loss case, by capital gains used to offset operating losses.

Section 3 of the bill, the final section, deals with the operation of the phase III tax and two special deductions.

When the Life Insurance Company Income Tax Act of 1959 was adopted by the Congress, it was decided to permit life insurance companies to take two special contingency deductions. Generally these are not legal liabilities of the companies but they are allowed as deductions.

One is an allowance equal to 2 percent of the premiums received on accident and health insurance and on group life insurance policies. The other is an allowance of 10 percent on the increase in reserves on nonparticipating insurance.

The decision was made in the Finance Committee in 1959 to add the amount of these two special deductions to the nontaxed profit account. This has the result that if the company by its dividends to the shareholder indicates that it is not necessary to hold these amounts for future contingencies, they would be restored to taxable income of the company when they are paid to shareholders.

It is this last provision that is involved in section 3 of the present bill. It is possible that a life insurance company could take one of these contingency reserve deductions for nonparticipating insurance reserves or for premiums on group life or accident and health insurance at a time when it was incurring losses. The additional deduction

would in this situation simply give rise to a loss carryover or a carryback and no current tax saving.

If the company has a long series of loss years, it is possible that the loss carryover and carryback would never be used against taxable income. At this point the company would be in a position that it added to its nontaxed profit account a special deduction which never was taken against taxable income. If the company's dividends to shareholders used up all of the tax-paid profit account, then further dividend distributions would be treated as coming out of the nontaxed profit account and would for this reason be added to the tax base.

This appears to be a harsh result to the extent the amount in the nontaxed profit account is simply a deduction that was never taken against taxable income.

Section 3 of the bill, therefore, provides that if an amount is added to the nontaxed profit account because of taking one of these special contingency deductions and if part or all of this deduction results in a loss and if the resulting loss carryover or carryback is never used against taxable income, then at the time when the carryover expires, which is normally 5 years after the loss year or 8 years in the case of a new company, the amount of a deduction which was not used may be subtracted from the nontaxed account, so it wouldn't give rise to taxation to the company.

We have no way of estimating precisely what will be the revenue effects of these provisions, but we would expect them to be negligible.

In summary, the Treasury Department is not opposed to the enactment of H.R. 5739, provided section 2 of the bill is amended to completely eliminate the unjustified tax benefit that has been described in the case where capital gains are offset by ordinary losses.

We urge the committee to amend the bill so as to correct this defect in section 2.

I would be pleased to attempt to answer any question that members of the committee may have.

The CHAIRMAN. Thank you very much.

Any questions?

Senator CARLSON. Mr. Chairman, if I may.

Mr. Klayman, in 1959 this committee spent considerable time on the taxation of life insurance companies and if I remember correctly, we wrote in a 10-year provision in the act and went to conference and we reached an agreement on 8 years.

Now, as I understand your proposal you want to extend this 8-year period of time to a new company, is that it?

Mr. KLAYMAN. Senator Carlson, at that time, the 8-year provision was adopted for new companies.

Senator CARLSON. What do you want to do?

Mr. KLAYMAN. Well, it was limited, so that it didn't extend to all new companies. It didn't extend to those new companies which were subsidiaries or which had subsidiaries. They had to be independent new companies. Now, what section 1 proposes to do, is to give this 8-year carryover to all companies that fall within the definition of new companies, regardless of whether they are subsidiaries or have subsidiaries.

It is just an extension of the 8-year treatment that is presently contained in the Life Insurance Act.

Senator CARLSON. Do I understand that the Treasury has no objection to that suggestion or the others that are in this proposal?

Mr. KLAYMAN. That is right, except that in section 2 of the bill, which is a correction of what we feel was an unintended defect, we think that the section does not go far enough in that it doesn't cover a case which involves the offsetting of capital gains against ordinary losses, and we think that section 2 should be broadened to cover that case.

If that were done we would have no objection to this bill.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Any questions?

Senator MORTON. Mr. Chairman, I may have just one or two questions, please.

As I understand it, all new life insurance companies will be able to use the 8-year operations loss tax carryforward under this bill.

Senator MORTON. And am I correct in understanding that a new life insurance company which is a wholly owned subsidiary of an investment company or an investment management company or any other corporation will get the same tax carryforward treatment as a new life insurance company which is not owned by another corporation?

Mr. KLAYMAN. That is correct, it will get the same 8-year loss carryover.

Senator MORTON. Is a life insurance company considered new for purposes of this bill only if it was incorporated within the immediately preceding 5 years?

Mr. KLAYMAN. It has to have the loss arising within its first 5 years in order to be considered a new company. Losses that arise after that first 5-year period would not be subject to the 8-year carryforward.

Senator MORTON. Could a life insurance company which has been dormant during the immediately preceding 5 years, could it qualify as a new company even though it might have been incorporated or authorized to do business for more than 5 years?

Mr. KLAYMAN. The question relates to when the 5-year period starts to run.

It starts to run, I understand, from the first day when the company was authorized to do insurance business.

Senator MORTON. In other words, a company may have been set up as a corporation and lie dormant and then it gets authority in the State of Kentucky and—or somewhere else to do business as a life insurance company it begins then?

Mr. KLAYMAN. That is right. If it wasn't authorized before that time it wouldn't start.

Senator MORTON. It is my understanding there is no problem under this bill about trafficking as you phrase it in tax losses since life insurance companies cannot file consolidated returns with noninsurance companies.

Mr. KLAYMAN. We didn't see any significant problems and if there are any we have some general nontrafficking provisions that could be applied in those situations.

Senator MORTON. Thank you, Mr. Chairman.

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

The next witness is Mr. Vester T. Hughes, Jr.

STATEMENT OF VESTER T. HUGHES, JR., OF JACKSON, WALKER, WINSTEAD, CANTWELL & MILLER

Mr. HUGHES. Mr. Chairman and members of the committee, my name is Vester T. Hughes, Jr., and I am engaged in the private practice of the law in Dallas, Tex.

I am here on behalf of a number of small companies including American Life Insurance Co. of Alabama, Birmingham, Ala.; Union Bankers Insurance Co., of Dallas, Tex.; Union Life Insurance Co., of Little Rock, Ark.; American Heritage Life Insurance Co., of Jacksonville, Fla.; Gibraltar Life Insurance Co., of Dallas, Tex.; and Legal Reserve Insurance Co., of Los Angeles, Calif.

These are all small companies. Some of them are members of the two large insurance associations, some of them are not.

I also work for a number of insurance companies which are small enough that they are not members of the large insurance company associations, and, therefore, I am speaking on behalf of small companies, by and large.

I have prepared a statement in this matter and request, Mr. Chairman, if I may, that this be inserted in the record and that I merely summarize my statement, because much of the material has already been covered by Mr. Klayman.

The CHAIRMAN. Without objection.

(The statement referred to follows:)

STATEMENT OF VESTER T. HUGHES, JR.

In the course of my law practice, I have represented a number of small life insurance companies in the Southeast, South, and Southwest, and from time to time life insurance companies located elsewhere. Some of these companies are members of the two large life insurance associations, the American Life Convention and the Life Insurance Association of America, and others are not members because of their size, the cost of such membership, etc.

By and large, the only companies which will be affected by the enactment of H.R. 5739 are small life insurance companies. Experience with the Life Insurance Company Income Tax Act of 1959 has demonstrated that there are certain imperfections and all of the provisions of H.R. 5739 are designed as corrective measures. Although only a relatively few companies will be affected, it is believed that adoption of H.R. 5739, as passed by the House of Representatives, will be helpful in achieving equitable and uniform taxation of life insurance companies, and will further the aims and objectives of the Life Insurance Company Income Tax Act of 1959.

I

EXTENSION OF AVAILABILITY OF 8-YEAR LOSS CARRYOVER PROVISIONS

The general rule under the present law is that a life insurance company, like a regular business corporation, is allowed a 3-year loss carryback and a 5-year loss carryover for losses sustained from its operations. However, the Life Insurance Company Income Tax Act of 1959 provided that an 8-year carryover period would be allowed to "new companies" which are defined as companies which have been in business for 5 years or less. Excepted from the 8-year carryover provisions applicable to "new companies" are certain "nonqualified companies" which were initially defined (1) to include life insurance companies owning a controlling interest (50 percent of the voting power of all classes of stock) in another company or a life insurance company controlled (50 percent of the stock of which is owned by another corporation) by another corporation, and (2) those who were parties to certain types of reorganizations. In 1962, this provision was modified so that control of, or by, a fire and casualty company would not cause a life insurance company to be treated as a "nonqualified" company.

The exception for "nonqualified new companies" enacted in 1959, and subsequently modified in 1962, was apparently designed to provide a safeguard for possible abuse situations. However, subsequent study indicates that the complete elimination of requirements relating to "nonqualified" life insurance companies would be in order. Life insurance companies typically sustain losses in the early years of operation and the period of such losses is frequently more than even the 8 years currently allowed to "new corporations." Procedures for establishing life insurance companies and those identified with either reorganizations or transfers of life insurance companies would indicate that it would be economically unwise for a new company to acquire another company (or for another company to acquire a new company) merely because of the 8-year carryover period. On the other hand, the denial of the 8-year carryover because of a 50 percent corporate affiliate has served to operate unfairly since the mere fact for such affiliation has not eliminated the need for a longer period of new companies. Congress recognized this in adopting the 1962 amendment and now it is urged that the nonqualification provision be eliminated in its entirety.

II

CAPITAL GAINS ADDITIONS TO SHAREHOLDERS SURPLUS ACCOUNTS

Under section 815 of the Life Insurance Company Income Tax Act of 1959, certain specified items are added to a company's shareholders surplus account. These items are life insurance company taxable income, capital gains, partially and wholly tax-exempt interest, an amount equivalent to the intercorporate dividend deduction, and the small business deduction. The amounts so added do not give rise to a tax at the corporate level when distributed.

Initially, under the 1959 act, the capital gains of a life insurance company were taxed entirely separately from its investment and underwriting income. This resulted in a life insurance company paying a tax on any capital gains it might have even though it had an operating loss far in excess of such gains. This inequitable result was corrected in 1962 when Congress enacted a provision which treated the capital gains of a life insurance company in the same manner as any other corporation.

Some concern has been expressed by the Treasury Department as to whether in the process of correlating the capital gains treatment of life insurance companies with that of other corporations (by providing that in given situations operating losses would offset capital gains) there may have been an inadvertent double inclusion of the same capital gain in the shareholders surplus account in given situations. While it is believed that the 1962 act did not cause this result, certainly a double inclusion was not intended, and there should be no objection to the proposed legislation, if there is even a possibility the 1962 amendment might be so construed. Accordingly, section 2 of the bill is supported as a clarifying amendment to the 1962 amendment.

Section 2 of H.R. 5739 specifically provides for the addition of capital gains to shareholders surplus one time, and only one time. It is believed that this result is correct. But it has now been suggested by the Treasury Department that capital gains which are offset by operating losses should not be added to the shareholders surplus account even once. However, the Treasury Department would still permit the profitable company to add capital gains to the shareholders surplus account. It is submitted that failure to include such a capital gain as an addition to the shareholders surplus account would discriminate against loss companies which are typically the small and new life insurance companies. Aside from the competitive disadvantages to a small company resulting from such treatment, it should be noted that a company with a loss suffers a detriment when this loss is used to absorb a capital gain. This is because its loss carryover is reduced by the amount of the capital gain. Accordingly, when ordinary income is generated at a later date, the loss is no longer available to offset such ordinary income. Furthermore, there is an increase in the policyholders surplus account (the tax-deferred account) and, hence, a future tax which would not otherwise exist.

In effect, the Treasury Department is requesting a "double elimination" of capital gains in the case of a loss company. Frankly, a double elimination is no more warranted in the case of a loss company than the double inclusion that is alleged to exist under present law.

Furthermore, the addition of capital gains to shareholders surplus (whether or not it has been offset by an operating loss) achieves the 1962 amendment

objective of equalization and correlation with regular corporations. This is borne out by the fact that Congress added partially and wholly tax-exempt interest, the amount of the deductions for intercorporate dividends, and the small business deductions to shareholders surplus; these amounts are no more "taxed" than a capital gain offset by an operating loss.

Certainly, when the Select Committee on Small Business (by letter dated Mar. 19, 1962, to the chairman of the Ways and Means Committee) supported the 1962 change with respect to capital gains treatment, that committee did not feel that the change would ultimately result in a double detriment—which would be the case were capital gains eliminated from shareholders surplus altogether in those cases where an operating loss is present.

Thus, to summarize, section 2 of H.R. 5739, as passed by the House of Representatives, is an appropriate provision. The Treasury Department amendment, however, is a discriminatory provision which would adversely affect small loss companies. Accordingly, it is urged that this committee reject the Treasury Department amendment to section 2. It should be emphasized that there will be no ultimate loss of revenue for the Treasury if section 2, as passed by the House, is enacted into law.

III

TREATMENT OF CERTAIN DEDUCTIONS FOR PURPOSES OF ADDITIONS TO POLICYHOLDERS SURPLUS ACCOUNTS

Sections 809 (d) (5) and (d) (6) provide for deductions (1) of 10 percent of the annual reserve increases for nonparticipating contracts and (2) of 2 percent of the annual premiums on accident and health insurance contracts and group insurance contracts, respectively. Within certain limits, these deductions must be taken, notwithstanding the fact that they cause or enlarge a loss from insurance operations for the year in question. Likewise, the deductions thus taken are added to the policyholders surplus account (the tax-deferred account). Accordingly, the company will pay an income tax on these amounts at some point in the future.

As stated above, losses may be carried back for 3 years and forward for 5 years in the case of established companies and forward 8 years in the case of new companies. However, if a company continues to operate at a loss so that these special deductions cannot be used either in earlier or later years to reduce operating income, the company receives no benefit whatever from such deductions. Since an amount equal to such special deduction, even though never used to offset income, remains in the policyholders surplus account, it will nonetheless ultimately be taxed when distributed from that account.

The effect of section 3 of H.R. 5739 is to eliminate the requirement in the present statute that a tax be paid on these special deductions when they result in no tax benefit. Section 3 is a fair and equitable provision and corrects an unintended hardship created in 1959.

Thus, it is recommended that section 3 of H.R. 5739 be approved by this committee.

CONCLUSION

All three sections of H.R. 5739 are desirable and in keeping with the spirit Congress evidenced in enacting the Life Insurance Company Income Tax Act of 1959, as that act has been subsequently amended in 1962. Accordingly, it is recommended that H.R. 5739 be adopted.

Mr. HUGHES. First, I would like to speak to section 1.

Briefly, as the discussion immediately preceding has demonstrated, it goes to the extension of the 8-year carryover treatment to all new companies.

May I say on this point, it seems to me apparent that the extension of such treatment to all new companies will not result in any "trafficking" in life insurance companies. Moreover, the limitations of existing law are an impediment to the effective administration of a life insurance business in this respect.

In 1959 when the Congress passed the Life Insurance Company Income Tax Act of 1959, it was felt that a life insurance company, unlike other companies, would not be able to use its losses in the first

5 years and, therefore, a longer period would be called for. As was pointed out here earlier, this committee approved a 10-year carryover period, but the 8-year period was settled upon in conference.

In summary, it seems to me that the provisions of section 1 are sound and should be adopted. Accordingly, I urge your support of section 1.

If I may, I would like to take the sections of the bill out of order and deal with section 3 next. With regard to section 3, it seems to me quite appropriate to add the so-called special deductions to the policyholders surplus account where they produce a tax benefit. On the other hand, it is unduly burdensome on a company to have these items put into policyholders surplus when no tax benefit is derived.

It is my understanding, in an extreme case, the addition of these special deductions to the policyholders surplus account can cause a tax when a company is liquidated, even though the company never had one dollar of taxable income.

Finally, I would like to address myself to section 2 and to devote some time to this matter because of the proposed Treasury amendment to section 2, which Mr. Klayman has just stated. I disagree with the Treasury proposal.

In 1962, Congress modified the 1959 act by providing that operations losses could offset long-term capital gains of life insurance companies. This treatment exactly corresponds to the treatment accorded a regular business corporation taxable under the usual provisions of the Internal Revenue Code.

Now, the Treasury Department has stated that, inadvertently, a double benefit was granted when this provision was passed in 1962. If a double benefit was granted, that statement is correct. Personally, I feel that existing law could be construed so that there would be only one inclusion of a capital gain in the shareholders surplus account.

However, I have absolutely no objection to the amendment as it is proposed by the Ways and Means Committee and the House of Representatives, because if there could be a double inclusion in the shareholder surplus account of capital gains, this was never intended.

At the time the 1962 amendment was being considered, I worked with your staff, the staff of the Ways and Means Committee, the joint committee staff, and with members of both committees, and certainly no one ever intended to permit capital gains to be added twice. Therefore, so far as I am concerned, section 2, as passed by the House, is an appropriate amendment to make certain that there is no double benefit.

When the 1962 amendment was enacted, there was a detriment imposed upon small-loss companies. Many persons asked us why we would be interested in having a small company be able to offset its capital gains by operation losses, because the capital gains would be taxed at a 25-percent rate, whereas, if the operating loss were used at a future time, it would offset ordinary income taxed at a 52-percent rate. This was a positive detriment and it was so recognized at the time. Nonetheless, it seemed to the various small companies involved that it was better to suffer this potential future detriment than to pay a tax on a capital gain in a year when the company had operating losses.

So, this detriment was accepted with full knowledge of its existence. Moreover, everyone that I know of who considered the matter, and

understood that capital gains, whether or not offset, went into shareholder surplus, felt that this was not inappropriate. This was because the loss company had suffered the detriment of a smaller loss carryover.

As I recall, the 1959 act was trying to equate life insurance companies with regular business corporations. In this aspect it failed with respect to capital gains, and, in 1962, this was corrected. Now, if a regular corporation has a capital gain, and this is offset by an operating loss, when that amount is distributed it does not give rise to a tax at a corporate level. There is nothing that indicates that the mere offset has in any way been the cause of any benefit which should give rise to any later tax. Similarly, there should be no acceleration of tax in the case of a life insurance company.

The next aspect is that a number of additions are made to the shareholder's surplus account that are not taxed per se. For example, tax exempt interest is added to shareholder surplus, and it is not taxed. Likewise, the small business deduction and the dividends-received deduction is added to this account. If we take the Treasury's example of $100,000 of income from a capital gain, and $100,000 operating loss, we nonetheless might have additions to the shareholder surplus account of $25,000 for the small business deduction, and for example, $10,000 for tax-exempt interest, and $5,000 on the intercorporate dividend deduction. These amounts weren't taxed either. Actually, the Treasury complaint exists with respect to all of these items. However, the Treasury proposal is limited to only capital gains of loss companies.

I would like to emphasize to this committee that the Treasury position has not been supported by the Ways and Means Committee and I should add, too, that it was not supported in 1962 by the Select Small Business Committee, of the House of Representatives; moreover, yesterday, Congressman Patman, in a letter to Senator Long, stated his opposition to the Treasury position.

We are merely asserting that the Treasury proposal suffers from somewhat the same vice they are trying to cure. They are now suggesting a double exclusion for small loss companies in lieu of what they think could be a double inclusion. We think all companies should include capital gains one time. This is fair, both as far as the revenues are concerned and as far as the taxpayers are concerned.

The matter we are dealing with here does not cause a diminution in the amount of tax collected. It is a deferment only. It is within the spirit and the framework of the 1959 act. One inclusion of capital gains would be the same for loss companies and for gain companies, if the position I am asking this committee to adopt is accepted.

A gain company puts capital gains in shareholder surplus once. A loss company under the House bill would, likewise, put a capital gain in the shareholder surplus once. The loss company has affirmatively suffered a detriment when it no longer has the loss available for future carryover years when it is used against the capital gain.

Finally, I would like to point out to the committee that the House provision is retroactive. I see no objection at all to a retroactive provision such as section 2, as passed by the House, clarifying what I believe was the law after 1962 anyway; that is to say, a provision which allows the inclusion in shareholder surplus of a capital gain one time.

If the Treasury proposal were accepted, however, I think it would be grossly unfair to taxpayers who supported the 1962 amendment.

In summary, I believe that the objectives of the 1959 act would not be carried out by the Treasury proposal and, in particular, loss companies would be penalized. I urge you to oppose the Treasury amendment to section 2.

Thank you.

The CHAIRMAN. Thank you, sir; any questions?

Thank you, Mr. Hughes.

The next witness, Mr. Leonard L. Silverstein on behalf of Investors Syndicate Life Insurance & Annuity Co.

Please proceed, Mr. Silverstein.

STATEMENT OF LEONARD L. SILVERSTEIN, ON BEHALF OF INVESTORS SYNDICATE LIFE INSURANCE & ANNUITY CO.

Mr. SILVERSTEIN. My name is Leonard L. Silverstein. I am an attorney with offices in Washington, D.C., appearing on behalf of Investors Syndicate Life Insurance & Annuity Co., a Minnesota corporation. Investors Syndicate Life is a wholly owned subsidiary of Investors Diversified Services, a corporation engaged in investment management services in Minneapolis, Minn.

The purpose of this appearance is to urge that this commiteee approve subsection (a) of the bill, which grants an 8-year loss carryover to new life insurance companies, irrespective (unlike existing law) whether such new company is owned by, or owns, another corporation. If adopted, this amendment will remove a serious impediment to a fair and more accurate application of the loss carryover provisions, and indeed a potential impediment to the organization of new life insurance companies.

A brief reference to the context in which the loss carryover rules have been enacted demonstrates the appropriateness of this amendment.

The general concept of allowing the carryover of operating losses, from the year in which they were incurred to other taxable years, has been a part of the income tax system since 1918. Although the period of the carryover has been changed somewhat from time to time,[1] and although loss carrybacks were not, in general, available until 1942,[2] the carryover as a vehicle for ameliorating distortions in income measurement caused by application of the annual accounting requirements has long been firmly recognized by the Congress.

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[1] Sec. 204, Revenue Act of 1921, provided for the net operating loss carry forward for 2 taxable years. Sec. 206, Revenue Act of 1926, and sec. 117, Revenue Act of 1928, continued 2-year carry forward. Sec. 117, Revenue Act of 1932, reduced the carry forward to 1 year. Sec. 218(a), National Industrial Recovery Act of 1933, eliminated the net operating loss carryover. Secs. 26(a) and 27(b) of Revenue Act of 1938 provided a limited carryover in the form of an allowance in computing the dividends-paid credit. Sec. 211, Revenue Act of 1939, added sec. 122, IRC (1939), providing for a 2-year carry forward. Sec. 153, Revenue Act of 1942, instituted a net operating loss carryback of 2 years, in addition to the 2-year carry forward. Sec. 215(a), Revenue Act of 1950, added sec. 122(b)(1)(B) and sec. 122(b)(2)(C), creating a 3-year carry forward, for taxable years beginning after Dec. 31, 1947, and before Jan. 1, 1950. Sec. 172(b)(1), IRC (1954), provided for a 2-year carryback and 5-year carry forward for taxable years after Dec. 31, 1953. Sec. 203(a), Small Business Tax Revision Act of 1958, title II of Public Law 85-866, 85th Cong., 2d sess., amended sec. 172(b)(1)(A) to extend the carryback to 3 years, for taxable years after Dec. 31, 1957.

[2] See, sec. 204, Revenue Act of 1918, which allowed a carryback from a taxable year which began after Oct. 31, 1918, and which ended prior to Jan. 1, 1920 (40 Stat. 1060 (1919)). With this single exception, however, the carryback principle was not introduced into the law until the Revenue Act of 1942.

As the years have progressed, this approach has been broadened, both in general terms and to take into account special industry considerations.

Thus, provisions for loss carrybacks have been progressively extended, from 1 to 2 years in 1954, and from 2 to 3 years in 1958. In 1954, moreover, this committee and Congress, removed the restrictions previously imposed limiting the amount of a net operating loss to so-called economic income.[3]

The special industry circumstances taken into account are several:

In 1962, for example, certain regulated transportation corporations were given the privilege of a loss carryover for 7 taxable years following the taxable year of the loss.[4] Commencing in 1963, the taxpayers certified under the Trade Expansion Act of 1962 have available a loss carryback for 5 years.[5] This year, Congress authorized a net loss carryover for 10 years in the case of a foreign expropriation loss.[6]

There are other provisions of similar import.[7]

As this recitation illustrates, this committee, and Congress have, in bona fide situations, afforded continuing and extended recognition to the usefulness of the operating loss carryover rules as a means of more accurately matching taxable income with taxable capacity.

With the exception of the section here under discussion, however, no provision of this nature has been restricted by reference to the question of whether the taxpayer suffering the loss owns, or is owned, by another corporate entity.

The reasons under lying this extraordinary and severe limitation are not clear.[8]

Apparently, there existed in the minds of the draftsmen some concern that an allowance for an extended loss carryover of a life insurance company which owns, or is owned by, another corporation, could give rise to problems of trafficking in loss carryovers.

We submit that these fears were and are entirely unfounded:

1. As the House report demonstrates, the Ways and Means Committee has concluded that whatever dangers, respecting loss corporation acquisitions, may have been envisioned when the restrictions in section 812(e) were first inserted, it is unlikely that these will occur in actual business practice. The Treasury, in subscribing to this amendment, reflects a similar view of the problem.

2. To a large degree, the present restrictions in the statute are ineffective even to meet the objectives to which they are ostensibly directed. Thus, only life insurance companies which are subsidiary or parent corporations may not utilize the extended carryover rules. In contrast, life insurance companies owned by partnerships, trusts, or individuals face no such restriction on operations. At the very least,

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[3] See, e.g., sec. 23(s), IRC (1939).

[4] Sec. 172(b)(1)(C), IRC (1954); added by sec. 1(a), Public Law 87-710, 87th Cong., 2d sess., p. 763, approved Sept. 27, 1962.

[5] Sec. 172(b)(1)(A)(ii), IRC (1954; added by sec. 1(a), Public Law 87-794, 87th Cong., 2d sess., p. 1021, approved Oct. 11, 1962.

[6] Public Law 88-272 (Feb, 26, 1964), sec. 210(a)(5) amended sec. 172, IRC (1954), to add subsec. (k) to apply in respect of foreign expropriation losses sustained in taxable years ending after Dec. 31, 1958. Sec. 172(k) was amended by Public Law 88-348 (June 30, 1964).

[7] See, e.g., secs. 1242 and 1244. More recently, in the case of individuals, further congressional recognition has been given to the concept of income averaging. Sec. 1301 et seq.

[8] See, e.g., hearings, Senate Finance Committee, H.R. 4245, S. Rept. No. 291, p. 44 (colloquy Senator Talmadge and Assistant to the Secretary of the Treasury David Lindsay).

therefore, the major impact of the existing law restrictions is one of form rather than of ultimate substance.

3. From a substantive standpoint, we note that a life insurance company cannot file a consolidated return with any other corporation (except with another life insurance company). Accordingly, any losses realized by a parent or subsidiary life insurance company, which is a parent or a subsidiary of another corporation, cannot be availed of by any other member of the same affiliated group (except another life insurance company). In effect, use of the carryovers, provided in section 812(e) is confined to the business which itself generated the losses.

4. Ample statutory[9] and judicial weapons are available to the Treasury and Internal Revenue Service to strike any transaction involving a sale, merger, or other event which may have been motivated by the existence of loss carryover attributes. In recent years, a favorable judicial trend more than adequately protects the Government in circumstances of this nature.[10]

5. Finally, we observe that it is improbable that any loss corporation problem will arise in this area—simply as a matter of the nature of the life insurance business. In fact, as the House report[11] clearly states:

"* * * [I]t is unlikely that life insurance companies will be acquired to obtain benefits of their initial losses, since the nature of their business is such that in subsequent years these losses can be expected to be more than offset by income arising from the same life insurance business."

In summary, we observe that the amendment incorporated by subsection (a) of this bill eliminates from the Code an unusual, as well as an unnecessary, restriction upon the right of a parent or subsidiary life insurance corporation to carry over its losses—incurred under bona fide business circumstances—to a point in time where they may be properly absorbed in the normal course of operations.

In short, the amendment achieves, as to life insurance, a fair and consistent application of traditional net operating loss concepts.

For the foregoing reasons, we urge adoption of subsection (a).

Thank you for this opportunity to appear.

The CHAIRMAN. Thank you, Mr. Silverstein.

The next witness is Mr. Bart A. Brown, Jr.

Take a seat, sir, and proceed.

STATEMENT OF BART A. BROWN, JR., OF KINCAID, WILSON & TRIMBLE, LEXINGTON, KY.

Mr. BROWN. Mr. Chairman, I am Bart A. Brown, Jr., from the Lexington law firm of Kincaid, Wilson & Trimble in Lexington, Ky.

First, I want to thank you and this committee for inviting me here to testify today. I appreciate your invitation and the opportunity of appearing before you.

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[9] Secs. 269 and 382, IRC (1954).

[10] *Arthur T. Beckett* (41 TC 386 (Dec. 20, 1963)); *J. G. Dudley Co., Inc. v. Commr.* (36 TC 1122, aff'd 298 (F. 2d) 750 (4th Cir., 1962)); *Frederick Steel Co.* (42 TC (No. 3) (Apr. 8, 1964)); *Julius Garfinkel & Co. v. Commr.* (40 TC 870, aff'd (14 AFTR 2d 5206) (2d Cir. 1962)).

[11] H. Rept. No. 1412, p. 4 (1964).

Next, I would like to introduce Mr. Joseph H. Keller, who is a certified public accountant from Louisville, Ky., in the national accounting firm of Ernst & Ernst.

Mr. Chairman, I have prepared a written statement and have submitted it for the record. I would appreciate it being made a part of the record and then I would like to comment on some matters covered in my memorandum.

(The statement referred to follows:)

STATEMENT OF BART A. BROWN, JR.

The phase 3 tax provided for by the Life Insurance Company Tax Act of 1959 was intended to be applied to income distributed by life insurance companies to stockholders 'ch had not previously been subjected to income taxes. It has now been foun that, due to a technical imperfection in the present statute, this tax has been imposed, under certain circumstances, upon distributions of a few small insurance companies having no earnings whatsoever or where all earnings have previously been subjected to income taxes. By means of section 3 of H.R. 5739, the House seeks to correct the inequitable situations which have arisen under the present law. However, under the House bill, the phase 3 tax will still be imposed, in one-type situation, upon future dividend distributions of insurance companies having no non-tax-paid earnings. Further, it provides no relief in those situations where the phase 3 tax has already been imposed on insurance companies having no earnings whatsoever or where all earnings have previously been subjected to income taxes. The House bill should be amended to provide relief in these situations.

A detailed explanation as to the bases for providing this relief is as follows:

Because of the difficulty in determining the true income of insurance companies on an annual basis, Congress, in enacting the Life Insurance Company Tax Act of 1958, permitted insurance companies to defer income taxes on certain portions of their earnings, including the amounts of the special deductions provided for by sections 809(d)(5) and 809(d)(6) of the Internal Revenue Code. The purpose for so doing was to allow the companies to temporarily retain these earnings tax free as a special fund to satisfy their obligations to fulfill policyholders' contracts. The amounts thus retained were considered placed in a special account for tax purposes, called the policyholders surplus account.

However, Congress believed it appropriate that, if at any time an insurance company either terminated its insurance business or concluded that the amounts set aside tax free to protect its policyholders were not necessary for such purposes and made dividend distributions of such amounts to its shareholders, then these previously nontaxed earnings of the insurance company should be considered as income of the company at the time of termination of its business or at the time of the dividend distributions and subjected to corporate income tax at that time. This is the phase 3 tax provided for by section 802(b)(3).

Thus, the intent of Congress in enacting the provisions relating to the policyholders' surplus account was to permit insurance companies to defer corporate income taxes on certain portions of their earnings until such time as these earnings were no longer retained by the companies as protection for their policyholders. Only at this time was the phase 3 tax to be imposed and then only upon previously non-tax-paid earnings of the insurance companies. See, in this connection, page 25 of the report of the Senate Finance Committee relating to the Life Insurance Company Tax Act of 1959 which specifically states that the phase 3 tax is only to apply to "income distributed by life insurance companies to stockholders in excess of the amounts already taxed on a current basis."

It has now been realized that, under certain circumstances, the effect of the transfer of the amounts of the special deductions to the policyholders surplus account has not resulted in a temporary tax deferment, as intended by Congress, but has actually resulted in, in some cases, an acceleration of income taxes and, in other cases, an imposition of income taxes where there are no corporate earnings.

For an insurance company engaged in a loss operation, the amounts of the special deductions provide no immediate tax benefits but merely increase existing loss carrybacks or loss carryforwards. To the extent the amounts of these special deductions cannot be fully used to offset past or future gains from operations, there is no tax benefit derived from these deductions. Nevertheless,

these deductions, under present law, are required to be added in full to the policyholders surplus account. This results in a phase 3 tax to the company on these amounts upon termination of its insurance business or when these amounts are deemed distributed as dividends to stockholders even though the deductions gave rise to losses which cannot be offset against gains. This, therefore, results in the inequitable imposition of income tax where there have been no earnings whatsoever or where there have been no non-tax-paid corporate earnings.

Examples of the two factual situations in which these inequities have arisen are as follows:

1. An insurance company, organized in 1954, incurred operations losses totaling $646,154, prior to the special deductions provided for by sections 809(d)(5) and 809(d)(6) as limited by section 809(f), for its years 1955 through 1960. In addition, the special deductions for 1959 and 1960 amounted to $116,738 and, although they increased the operations losses of the company by this amount, they produced no tax benefits for the company for these years. The amount of these special deductions were, of course, carried to the company's policyholders surplus account, giving the company a balance in this account of $116,738 at the end of 1960.

Then, at the end of 1961, this company, because of a cash shortage, found it necessary to reinsure its insurance in force and terminate its life insurance business. As a result of doing so, the amount of its policyholders surplus account is reduced to zero under section 815(d)(2). The reduction in this account of $116,738 is subject to tax under section 802(b)(3) and results in a tax of $55,203 to an insurance company that lost money in every year of its operations and whose actual losses for such period totaled $646,154.

2. The second situation involves a life insurance company that had been in existence for some time. As of December 31, 1957, it had accumulated earnings and profits of $3 million, all of which had been subjected to tax under prior tax laws. Beginning in 1958 and continuing through 1962, the company each year incurred an operations loss before special deductions which for the 5-year period totaled $1 million. The special deductions for each of these 5 years amounted to $250,000 and, although these amounts likewise increased the operations losses of the company by these amounts, they produced no tax benefit for the company through 1962. The amounts of the special deductions for the years 1959 through 1962 were carried to the company's policyholders surplus account and, as a result, additions to this amount through 1962 totaled $1 million.

Many years prior to 1958, this company established a fixed policy for distributions of cash dividend distributions each year to its shareholders. Although it lost money in the years 1958 through 1962, this company was able to continue its dividend policy because of its pre-1958 accumulated earnings and profits and did continue to pay its yearly dividends in these years.

The true source of the yearly cash dividend payment for the years 1958 through 1962 was, of course, the pre-1958 earnings of the company upon which tax had previously been paid. However, under section 815(a), most of the dividend for each of the years 1959 through 1962 (each year the company's shareholders surplus available for dividend payments was, of course, relatively small) is deemed paid out of the policyholders surplus account. These yearly dividends, together with the taxes resulting therefrom, serve to reduce the amount of the policyholders surplus account each year thereby giving rise to the tax imposed by section 802(b)(3). The taxes in this situation are imposed upon distributions of an insurance company which had no non-tax-paid earnings.

With the intention of correcting some of the imperfections in the present statute, the House has enacted section 3 of H.R. 5739. The effect of this amendment to existing law is to provide that, if any amount added to the policyholders surplus account for any year increases, or creates, a loss from operations and part or all of that loss cannot be used in any other year to reduce the company's taxable income, then the policyholders surplus account for the last year to which this loss may be carried is to be reduced by the amount of the unused loss or, if lesser, the amount in the policyholders surplus account.

However, in cases involving facts as described in example 1 above, section 3 of H.R. 5739, while providing relief for the future, gives no relief in those cases where the phase 3 tax has already been imposed. In addition, this amendment furnishes no relief, either past or future, as to the factual situation described in example 2 above.

In enacting the provisions relating to policyholders surplus and the phase 3 tax, it was not intended by Congress that a phase 3 tax be imposed on an insurance company having no earnings whatsoever or having no non-tax-paid earn-

ings such as exists under present law as it relates to the two previously described examples. Further, existing law as applied to these two factual situations raise the serious constitutional question of imposition of an income tax where there are no corporate earnings whatsoever or no non-tax-paid corporate earnings at the time the tax is imposed.

Section 3 of H.R. 5739 should be amended to correct these inequities and to conform the law relating to policyholders surplus and the phase 3 tax to the intention of Congress in enacting these provisions of the Life Insurance Company Tax Act of 1959, that is, that the phase 3 tax may, at the election of the taxpayer, only apply with respect to insurance companies having non-tax-paid earnings. This can be accomplished by amending section 3 of H.R. 5739 to make it effective as of December 31, 1958, and by amending section 815(a) to provide that distributions to shareholders after December 31, 1958, may be treated as made from policyholders surplus, and thus subject to the phase 3 tax, only to the extent of the policyholders surplus that has been used by the company in the year of distribution or in any prior year to reduce its income taxes which would have been otherwise due.

The Treasury Department has indicated that this amendment will result in a negligible loss of revenue.

Mr. BROWN. I would like to address my remarks to only section 3 of the bill. As Mr. Klayman has stated, and as is reflected in the report of the House Ways and Means Committee, this section is intended to correct certain inequities that have arisen under the 1959 act.

As Mr. Klayman has previously told you these inequities have been occasioned by a technical defect or imperfection in existing law. Now, these defects affect only a very few very small insurance companies. While we support, and we do support, section 3 of the present bill, however, unfortunately, section 3 does not correct the major inequities that have arisen under the present law. We urge that this committee reconsider section 3 and amend it to correct all the inequities.

The effect of this technical imperfection has been, in a few cases involving small insurance companies, to impose an income tax where there is not and there never has been any income whatsoever, or in other cases where there is no income on which income taxes have not already been paid.

In other words, this imperfection has in a few cases created an income tax where there is no income.

There are essentially two situations in which this has occurred. I would like to describe these situations briefly for this committee, and then suggest a matter which this committee might consider for providing adequate and complete relief as to the inequities that have been created.

I might mention here that unfortunately these situations were not brought to the attention of the House Ways and Means Committee during its consideration of this bill.

Consequently, this is the first time the factual situations I am about to describe have been related and have been considered by any congressional committee.

This first situation is represented by a small Texas company that was organized in 1954 and continued in the insurance business until 1960.

In 1960, as a result of operating losses, it found itself running short of cash and was disposed to sell its insurance business and get out of the insurance operations. This company lost money during each and every one of its 6 years of operations. The losses totaled some $650,000. This company was forced under existing law to take the

special tax deductions that Mr. Klayman mentioned, which totaled for this particular company some $118,000.

Senator GORE. You say forced to take tax deductions?

Mr. BROWN. Yes, the special deductions.

Senator GORE. Did that result in the company paying more taxes?

Mr. BROWN. Yes, sir, it did.

Since the company lost money it, of course, derived no tax benefit from these deductions. But when——

Senator GORE. What are you saying then, that the company had to pay taxes on income that it did not have?

Mr. BROWN. That is correct, Senator.

Senator GORE. Is that by way of a setaside, reserves? How did that come about? If you did not have income how did you have tax liability?

Mr. BROWN. When this company went out of business, due to this imperfection in present law, it is forced to pick up as income this $118,000 of special deductions and tax of some $55,000 is imposed on this company.

Senator GORE. You haven't answered my question, though.

If the company showed no income on its books how did it have a tax liability?

Mr. BROWN. Senator, the only way I can answer that is to say that——

Senator GORE. I thought the tax would apply to income.

Mr. BROWN. The tax should apply to income, but because of this defect in the law——

Senator GORE. What defect are you talking about?

Mr. BROWN. The defect relating to the phase III tax that these deductions the company is forced to take provide no tax benefit and yet——

Senator GORE. That is a different proposition, you are talking about two different things.

I am asking you how it is that a tax was applied to your company when the company had no income. Are you saying it had no income because of certain bookkeeping operations or certain provisions of the law or did it actually have an actuarial loss?

Mr. BROWN. Senator, actually this company lost $650,000 during its years of operations.

Senator GORE. What about the single years?

Mr. BROWN. Each and every year resulted in a loss.

Senator GORE. But you paid income tax each and every year?

Mr. BROWN. I am sorry, I didn't hear you, Senator.

Senator GORE. Did the company pay an income tax, a corporate tax on income each and every year?

Mr. BROWN. No, Senator, it did not pay tax in any year except in the year when it went out of business, and in the year it went out of business it had to pick up as income this $118,000 of special tax deductions that had previously provided no tax benefit.

This is where the inequity is created. The deductions provided no tax benefit and yet they give rise to income.

Senator GORE. Are you saying, as I understand it, that that provided no tax benefit because you had not had income from which it could be deducted?

Mr. BROWN. That is correct.

Senator GORE. Now when you added this deduction back did this mean that at this particular time you had taxable income?

Mr. BROWN. Yes. You cannot offset this $118,000 by the operations losses.

Senator GORE. How much taxable income did the company have?

Mr. BROWN. It had $118,000.

Senator GORE. So it seems to me what you are really saying is that you were not able to take advantage of the loopholes or advantages, favoritism or special provisions, however you described them, because you did not have the income from which to deduct it.

Mr. BROWN. Well, Senator, I don't think that is exactly correct.

Senator GORE. How does it differ? How am I incorrect in arriving at that conclusion?

Mr. BROWN. Well, Senator, what we are saying is that here is a company that lost $650,000.

Senator GORE. I have heard you say that.

Mr. BROWN. During 6 years of operation.

Senator GORE. You said it had no taxable income during those periods.

Mr. BROWN. It actually had $650,000 of taxable loss.

Senator GORE. Was this a bookkeeping loss or an actual loss?

Mr. BROWN. Actual loss.

Senator GORE. Proceed.

Senator MORTON. If I could interrupt there for a moment, as I get this picture you had $650,000 of loss over the 5 or 6 or 7 years this company was in operation.

In no year did you show a profit?

Mr. BROWN. That is correct, Senator.

Senator MORTON. You were required to put $116,738, however, into the policyholder surplus account?

Mr. BROWN. That is correct, sir.

Senator MORTON. Which, if you had been making a profit that would have gone in and you would not have paid a tax at the time you put it in the account?

Mr. BROWN. That is correct.

Senator MORTON. So when you liquidated this company in 1960 or 1961 you had to, of course, write this off, and they made you pay the tax on that $116,000 which you had put into the policyholder surplus account?

Mr. BROWN. That is correct, Senator.

Senator MORTON. But you actually incurred or this company actually incurred a loss, an actual loss, not a bookkeeping loss, in each and every year of its operation?

Mr. BROWN. That is correct, Senator.

Senator MORTON. Actually it did in fact sell itself, or reinsure, it took its outstanding insurance and said, "We are losing money, we haven't got the cash," reinsured it and some other company took over its life insurance policies?

Mr. BROWN. It is completely out of business having lost $650,000 and yet it finds itself with a tax bill of $55,000.

We submit that a tax under these circumstances was never intended by Congress at the time the 1959 act was put into effect. It simply is not fair, it is not equitable to impose a tax where there is no income.

The second situation is represented by a small Kentucky company. When the 1959 act went into effect this company had a large accumulated surplus. The company had been in existence for some 55 years, and these profits had been built up over that period of time.

These profits had been subjected to tax under the tax laws that existed prior to 1958.

So, consequently all of this represented taxpaid profits of the company.

Also this company had a long history of yearly dividend payments to its stockholders.

Now, shortly after the 1959 act went into effect this company decided to expand its business. In making this decision it realized that it would lose money for the next several years of its operations. Nevertheless, management decided to go ahead with this expansion program.

During the next 2 years the company actually lost $4.5 million. Because, however, of its pre-1958 earnings, this company was able to continue its prior dividends policy, and paid dividends during these loss years, out of the pre-1958 earnings at the time.

Now, this particular company during the 2 years in which it lost $4.5 million, took special deductions under existing law totaling some $500,000.

These deductions, of course, saved the company nothing in taxes because it had already lost $4.5 million during those years.

This half million dollars was, of course, transferred to the policyholders surplus accounts.

For tax purposes because, again, of the defect in existing law, this company is deemed to have paid dividends during its two loss years out of the policyholders surplus account of a half million dollars, and this $500,000 in policyholders surplus account is, again, subject to the phase III tax.

This company ends up paying a quarter of a million dollars, approximately, in income taxes for 2 years in which it lost four and a half million dollars.

This particular company, a company with no nontax paid accumulated earnings, loses for 2 years four and a half million dollars, yet finds itself subject to income taxes for these same 2 years of over a quarter of a million dollars.

Upon what income were these taxes imposed in these 2 years? Well, the answer to this is the company had no income upon which tax had not previously been paid. There was no income upon which tax should have been paid.

Again this is a situation that was never intended by Congress. Yet this is precisely the situation as it exists under present law.

Senator GORE. Mr. Chairman, may I ask a question there?

Are you saying that this situation which you have described arises because the life insurance company is required to take advantage of the section 3 set-asides for reserves and that though it is extremely beneficial to most companies that in the case of the company you have cited where there was no taxable income, the company was required to take advantage, so to speak, of a provision which is generally favorable to the industry, but in this case was not favorable because of an unsuccessful operation?

Mr. BROWN. Yes, I think that is correct. This is a company that has lost money and what was intended as a tax deferment device by the Congress has actually served to create a tax where there is no income.

Senator GORE. It seems to me you have stated it in one sentence quite clearly and I thank you for it.

Now, do you propose that it be optional as to the set-asides? What do you actually propose as a solution to this?

Mr. BROWN. Senator, at the time the phase III tax was considered in 1959 in connection with the Revenue Act of 1959, the Senate Finance Committee report said it is intended that the phase III tax should apply only with respect to——

Senator GORE. Intended as what?

Mr. BROWN. That the phase III tax was only intended——

Senator GORE. Phase III, yes.

Mr. BROWN. Was only intended to apply to distributions of previously nontaxed income.

In other words, the income has to be earned, and this income which has not been earned should not be subjected to the phase III tax, and that is what we propose.

Senator GORE. Mr. Chairman, does the Treasury—is the Treasury going to testify for the bill?

The CHAIRMAN. They have already testified.

Senator GORE. Today? Since I was unfortunately unable to be here during the Treasury's testimony would I be permitted to submit a few questions and elicit from the Treasury a response for the record?

The CHAIRMAN. Is the Treasury still here; the Treasury representatives?

Senator GORE. I will submit these questions for the record and elicit answers.

The CHAIRMAN. All right, go ahead, Mr. Brown.

Mr. BROWN. Mr. Chairman, there is one further point I would like to cover, and that is the question as to whether relief is provided under section 3 in H.R. 5739 as to the factual situations that I have just mentioned.

As to the first example, section 3 does provide relief as to the future. Yet it provides no relief for the small Texas company whose situation I have just cited, where this tax has already been imposed or for other companies similarly situated during the years 1959 through 1963.

As to example 2, section 3 of H.R. 5739 provides no relief either past or future as to companies in this situation.

We believe that imposition of taxes under these circumstances upon companies without income is not fair, is not equitable, and was never intended by Congress.

Consequently, we urge then that this committee correct these inequities and conform the law relating to the phase III tax to the original intention of Congress, that is that the phase III tax should be imposed only with respect to non-tax-paid earnings.

I have talked with representatives of the Treasury Department concerning our proposals, and have been advised that the revenue loss resulting from these proposals or such an amendment would be negligible.

I would be happy to answer any questions.

The CHAIRMAN. Any questions?

Senator MORTON. Mr. Brown, I got your factual situation in Texas, I think, straight in my own mind. Now, the second one that you bring us, as I understand it, a company had been doing business for a half century, it had accumulated a surplus of some $3 million on which taxes had been paid.

Mr. BROWN. That is correct.

Senator MORTON. Then it decided to go into an expansion program and in a business of this nature you lose money in the first—when you start a new one or you go into a big expansion program and for a couple of years it lost money, after making this managerial decision.

Then, however, since they had a surplus previously earned on which taxes had been paid they elected to continue the dividend policies, and they did continue to pay dividends although for 2 years they were very much in the red, but because of the passage of the 1958 act which said that these dividends which were actually from the policy, what do they call it, policy shareholders——

Mr. BROWN. Policyholders surplus.

Senator MORTON. They were subject to tax because of the amendments adopted in 1959.

Mr. BROWN. That is correct.

Senator MORTON. Yet they had already, they came from funds on which a tax had already been paid.

Mr. BROWN. That is correct.

Because of a fiction they are deemed to have come out of policyholders surplus but in reality these came out of pre-1958 taxpaid earnings.

Senator MORTON. I think that clarifies me, Mr. Chairman.

The CHAIRMAN. Any further questions?

Senator MCCARTHY. Is this a closely held stock company?

Mr. BROWN. No, Senator.

Senator, at the time we are talking about, they had approximately 3,000 to 4,000 stockholders. Because of the continued expansion program and further stock issues they now have perhaps 15,000 stockholders.

Senator MCCARTHY. When the stockholders obtained dividends was that carried out when the number of stockholders were small?

Mr. BROWN. Yes, Senator.

Senator MCCARTHY. Is there any relationship to the prospective expansion or not. Was there any point in their paying out of this fund before the expansion program was carried out.

Mr. BROWN. Senator, I think the decision to pay dividends resulted from the fact that realizing that the company was going to lose money for a number of years, and there would be some shareholder dissatisfaction, in order to keep the stockholder dissatisfaction at a minimum the company continued its prior dividend policy, again a management decision.

Senator MCCARTHY. Would the shareholder surplus fund have been used for any purpose other than payments of dividends at any time in the operation of the company? Was this in the nature of a reserve under special conditions against other losses or was it not?

Mr. BROWN. Senator, that is the purpose of it as a special contingency reserve.

Senator McCARTHY. Not just for the payment of dividends but to meet other conditions?

Mr. BROWN. No. For the protection of policyholders.

Senator McCARTHY. The fact is the dividend policy did weaken the financial structure of the insurance company at a point when they were running some risk in their expansion.

How much did they pay out in the way of dividends over that short run?

Mr. BROWN. About a half million dollars a year, Senator.

Senator McCARTHY. For how many years?

Mr. BROWN. It has been continuous since 1959. Senator, there were some changed variations from year to year but they averaged around a half million dollars a year.

Senator McCARTHY. So they ran $3 million down to what?

Mr. BROWN. Actually, Senator, I don't know the beginning accumulated earnings and profits of this company as of pre-1958 earnings.

Senator McCARTHY. You can find out?

Mr. BROWN. Yes, I would be happy to.

Senator McCARTHY. Will you submit that for the record so we have a picture of the nature of the operation that was carried on?

I have no further questions.

(The information referred to follows:)

KINCAID, WILSON & TRIMBLE,
Lexington, Ky., July 30, 1964.

Re H.R. 5739.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Committee on Finance,
New Senate Office Building,
Washington, D.C.
(Attention: Mrs. Elizabeth B. Springer).

DEAR SENATOR BYRD: This is in reply to your request that I submit for the record of the hearings of the Senate Committee on Finance on H.R. 5739 an analysis of the uncommitted surplus of the Kentucky insurance company referred to in example 2 of my oral testimony.

The 2 years of this company to which I referred in which it incurred actual losses from operations yet was compelled, because of its dividend policies, to pay income taxes under present law were 1961 and 1962. While in my oral testimony I referred to these actual losses from operations for tax purposes as totaling some $4,500,000 for these 2 years, I have now found that these actual losses, for tax purposes were $1,629,729 and $2,273,808, or a total of $3,903,537. I would, therefore, like to correct my testimony to this extent. This change as to the amount of the loss for tax purposes does not in any way affect the results referred to in my testimony as to this company having no non-tax-paid income, incurring losses and yet, under existing law, paying income taxes because of its dividend policy.

The following is the analysis of the uncommitted surplus of this company for 1961 and 1962 which you requested:

	1961	1962
Balance of account at beginning of year	$3,934,221.52	$4,719,425.61
Taxable items: Gain (loss) from operations, for accounting purposes	[1] (1,450,377.60)	[1] (2,202,895.05)
Total	2,483,843.92	2,516,530.56
Nontaxable additions:		
Unrealized gain (loss) from revaluation of securities owned	262,323.85	(183,691.85)
Paid-in surplus	3,311,361.48	1,235,169.89
Total	6,057,529.25	3,568,008.60
Nontaxable deductions:		
Cash dividends paid	916,730.30	445,510.70
Increase in nonadmitted assets	56,334.83	40,315.17
Increase in mandatory securities valuation reserve	365,038.51	(84,503.09)
Total	1,338,103.64	401,322.78
Balance of account at end of year	4,719,425.61	3,166,685.82

[1] These are losses from operations for accounting purposes while the actual losses for these years for tax purposes were $1,629,729 and $2,273,808, respectively. These variances result from the differences in handling principally tax-exempt interest and dividend income for accounting purposes and tax purposes.

I hope that this information will be sufficient for the purposes of the committee. If additional information is desired, I will be happy to obtain it for you.

Very truly yours,

BART A. BROWN, JR.

(The questions previously referred to submitted by Senator Gore to the Treasury Department and replies thereto follow:)

ANSWERS TO QUESTIONS SUBMITTED BY SENATOR GORE

1. Q. How many amendments to the 1959 act have thus far been approved by the Congress?

A. In all, 10 substantive amendments have been made. This does not include conforming amendments in the life insurance section occasioned by substantive amendments in other parts of the law. These amendments include one in 1961, changing the effective date on a provision providing special treatment for certain distributions related to mutualization of stock companies. In 1962 one amendment was adopted that extended to individual accident and health insurance premiums the same special deduction previously allowed with respect to group accident and health insurance premiums. Also in 1962 a bill containing a number of insurance amendments was passed. This bill did the following things: (1) It extended the effective date for the provisions in the 1959 act relating to variable annuities. (2) It provided special treatment with respect to the pension business conducted through segregated asset accounts. (3) It provided for the alternative computation of taxes on capital gains. (4) It reversed the order in which certain special deductions were taken so as to minimize additions to the policyholders surplus account. (5) It extended the 8-year loss carryover privilege to a new company which was a subsidiary of a casualty insurance company. (6) It provided under limited circumstances that the stock of a subsidiary casualty insurance company could be spun off without incurring phase III tax. In addition, two life insurance amendments were included in the Revenue Act of 1964. One extended further the effective date with respect to certain mutualization distributions; the other removed the provision requiring the accrual of bond discounts.

2. Q. How many amendments favored by Treasury are now being actively considered?

A. One amendment specifically urged by Treasury is involved in the present bill. Another has been discussed in connection with a bill that might be intoduced in the House. It might be added that in the context of systematically improving the Life Insurance Company Income Tax Act by removing both unintended benefits and unintended hardships, the Treasury is in favor of the provisions that remove unintended hardships on particular companies.

3. Q. How many amendments are now actively in the mill, or in the talking stage, which are favored by the industry?

A. In addition to the two provisions in H.R. 5739, there are five amendments favored by the industry which are under discussion in connection with the introduction of a possible bill in the House. Particular companies may have talked to Members of Congress about other possible amendments.

4. Q. Does Treasury expect to recommend any additional amendments this year or next?

A. The Treasury has participated in the discussion of a bill for possible introduction in the House to which we referred earlier. It is quite possible that an overall bill could come out of those discussions which the Treasury would support.

5. Q. Would it be advisable to consider all these amendments at once, rather than one or two each year?

A. There are advantages in considering a number of related amendments at one time. Their interrelationships may be analyzed more carefully than when considered piecemeal. The committee will have a better opportunity to recall the overall pattern of the life insurance provisions, and thus evaluate the individual proposals in relation to the whole system of life insurance company taxation. A group of life insurance amendments were handled in this way in 1962. However, the House did consider the amendments in the present bill as appropriately separable, and the Treasury concurs in this judgment.

6. Q. How has the 1959 act worked out thus far? What revenues are being generated?

A. On the whole, it appears that the 1959 act has proved to be sound and effective legislation. Its basic objectives have been to assure an adequate revenue contribution by the life insurance industry as a whole, to adjust the tax liability of the individual company in accordance with its taxable capacity reflected in its surplus margin of investment income in excess of policy reserve interest obligations and its underwriting profits, and to maintain the competitive balance between the stock and mutual sectors of the business. Forbearance was exercised in the legislation in the light of the long-range character of life insurance risks and in the interest of not impairing the capacity of life insurance companies to meet their obligations to policyholders. As in the case of any new and complex piece of legislation, administrative and compliance problems have been encountered but are being worked out. One of the major problems in the implementation of the statute is the litigation which has arisen with regard to the treatment of tax-exempt interest and (by implication) the intercorporate dividend deduction under the statutory formula in the light of the so-called exception clauses of sections 804(a)(6) and 809(b)(4). If this litigation (decided in favor of the Government in the *Atlas* case by the Federal District Court of the Northern District of Oklahoma but adversely by the 10th Circuit Court of Appeals) should ultimately be resolved in a manner which sets aside the statutory formula, the operation of the 1959 legislation would be gravely impaired.

The income tax liabilities of life insurance companies as shown in Statistics of Income for the period 1958–62 under the new law are tabulated below, the 1957 tax liability under the 1955 formula being shown also for purposes of comparison:

	Millions
1957 (prior law)	$294.4
1958 (1959 Act)	455.3
1959	[1] 555.9
1960	529.4
1961	576.6
1962 (preliminary, unpublished)	631.6

[1] Includes 1-time adjustment of 1957 tax liabilities due to transition from cash to accrual method of reporting investment income. This adjustment is payable at the taxpayer's option in installments over 10 years.

While the $455 million tax liability for 1958 reported in Statistics of Income falls short of the $500 million target for that year set by this committee at time of the adoption of the legislation, it should be noted that the $455 million represents a preaudit figure. Rough estimates indicate that additional amounts of the liability in the $25 to $50 million range are now involved in audit and assessment procedures.

If the pending litigation in the *Atlas* case should ultimately be resolved adversely to the Government, it is estimated that reduction of tax and resulting refunds to life insurance companies would total about $400 million for the 1958–64

period. The annual reduction from the adjustment formula approved by the 10th Circuit Court of Appeals would amount to roughly $75 million at current levels. It is further estimated that in future years the revenue loss which might result under the 10th Circuit formula could reach some $112 to $125 million a year by 1970 even if there were no significant acceleration in acquisitions of State and local bonds and corporate stocks by the life insurance industry. If such acquisitions were accelerated so that such investments amounted to 25 percent of life insurance company portfolios, compared with their present level of about 8 percent, the life insurance industry's income taxes would be reduced by an estimated 40 percent or roughly $325 million annually within the next few years.

7. Q. How is the revenue broken down between mutuals and stock companies?

A. In 1958, for which Statistics of Income tabulations permit an exact breakdown, about one-third of the total industry tax was reported by domestic legal reserve stock companies and the remaining two-thirds by mutual companies and certain other special classes of companies.

8. Q. What revenue has been generated from phase 3?

A. The following tabulation of Statistics of Income data on withdrawals from the policyholders surplus account is accompanied by estimates of the revenue arising from phase 3 for particular years. These estimates take account of the fact that owing to the statutory transition rules, one-third of the phase 3 tax was in effect applicable in 1959, two-thirds in 1960, and the entire amount in 1961 and subsequent years:

[In millions of dollars]

	Withdrawals from policyholder's surplus account	Estimated tax effect
1959	29.6	5
1960	23.2	8
1961	8.2	4

9a. Q. What segment of the industry favors section 1 of H.R. 5739?

A. To benefit from section 1 of H.R. 5739, a company must meet several conditions. It must have been first authorized to do insurance business after 1959. It must be a subsidiary of another company and the parent company must be other than a casualty insurance company. (New companies which are subsidiaries of casualty insurance companies already have this 8-year loss carryover privilege.) Finally, to benefit from section 1 the company must have a series of losses covering more than the first 5 years of its operation.

9b. Q. How many companies would be affected at the present time?

A. In view of the combination of circumstances required to be effected by section 1, it is likely that fewer than 10 companies would be affected at the present time.

9c. Q. How many life insurance companies are now owned by other types of corporations?

A. The most common situation in which a life insurance company is a subsidiary of another corporation is the case where the parent corporation is a casualty insurance company. This arrangement has become quite popular in recent years because of the trend toward the issuance of package insurance policies covering a variety of risks. This particular type of affiliation is not involved in section 1, since an amendment adopted in 1962 provided for the 8-year loss carryover for a new life insurance company which was a subsidiary of a parent casualty insurance company. As was indicated above, it is believed that a very few life insurance companies are subsidiaries of corporations other than casualty insurance companies.

9d. Q. How many are credit life companies?

A. A number of finance corporations do have life insurance subsidiaries which are primarily involved in writing credit life insurance. This particular kind of life insurance does not involve long-term risks so that a credit life insurance company is very unlikely to have any succession of loss years when it is newly organized. As a practical matter, the credit life insurance companies have no interest in section 1 of the bill.

10a. Q. Is it true that section 2 of H.R. 5739 corrects an error brought about by an amendment to the 1959 act adopted in 1962? Could such errors be minimized by getting all proposed changes to the 1959 act together in one package?

A. There was no public hearing on the amendments in 1962. For this reason there is no written record of just what was intended by the proponents of the amendment at that time. The Treasury technicians who worked on this matter do not recall any deliberate intention that a company which had a capital gain which was not subject to tax could still add to this to its taxpaid surplus account. The amendment in 1962 was included in a package of life insurance amendments.

10b. Q. How did the error occur in the first place?

A. The 1962 amendment involved a change in the definition of a term. What we believe to be an error arose from a failure to make a conforming amendment in another section where this defined term was used.

10c. Q. How many companies are affected by section 2 of H.R. 5739?

A. The Treasury Department made the recommendation for the change in section 2. As we read the present law, an unintended benefit would be potentially available to all stock companies, although it would not have any immediate significance until the companies became subject to the phase III tax. To the best of our knowledge, relatively few stock companies are presently subject to the phase III tax. The broadening of section 2 which the Treasury recommended to the Senate Finance Committee was recommended before we knew whether or not any companies would be affected. Potentially, it can have an effect for a stock company that has a combination of overall losses plus capital gains in a particular year. Even here the effect of the amendment would only come in when the company becomes subject to a phase III tax. We have heard of no situations where this recommendation would have specific effect other than the cases to which Mr. Vester Hughes has referred in testimony to this committee.

11a. Q. How many companies are affected by section 3 of H.R. 5739?

A. As indicated in the Treasury statement before the committee, we have no way of estimating precisely what will be the revenue effects of this section. However, we believe that the revenue effects will be negligible. We are informed that relatively few companies, perhaps half a dozen, have been identified as being affected. The loss carryover and carryback period is adequate, except in unusual situations, eventually to assure full utilization of losses against earnings. Rough calculations furnished by reliable industry sources indicate, however, that a number of companies, perhaps in the order of 100, might at some time be adversely affected by the present law.

11b. Q. Are any credit life companies involved?

A. Credit life companies are less likely than life insurance companies generally to have a persistent and chronic loss experience which would lead to expiration of loss carryovers without benefit.

11c. Q. Without the adoption of section 3 of this bill, will companies actually pay a tax for years in which losses are actually sustained, or would it be a fairer estimate of this situation to state that a company, by existing law, may be denied use of one of several ways of reducing taxes for profitable years?

A. Without the adoption of section 3, companies which showed artificially greater losses because of special deductions they were required to claim in loss years would in effect be required to pay a tax on the amount of the special deductions at some future time owing to expiration of the loss carryover period without actual utilization of the deductions.

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

The committee will adjourn.

(By direction of the chairman, the following is made a part of the record:)

EAST ORANGE, N.J., *July 28, 1964.*

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.:

As one of the smaller life insurance companies which would be affected, we strongly support H.R. 5739 now before your committee. We urge passage of this act.

COLONIAL LIFE INSURANCE CO. OF AMERICA,
WILLIAM C. BROWN, *Senior Vice President.*

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., July 28, 1964.

Senator RUSSELL LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: I am writing you with reference to H.R. 5739, a bill upon which your committee is holding a hearing on July 29, 1964. This bill amends the Internal Revenue Code of 1954 in order to correct certain inequities with respect to the taxation of life insurance companies.

My particular interest as a member of the Select Committee on Small Business is section 2 of H.R. 5739. Section 2 corrects a possible inequity in existing law by making it clear that all life insurance companies include capital gains in their shareholders surplus accounts (phase III) only once. As such, this is a proper provision because no life insurance company, whether large or small, should be permitted to add this item of phase III account but once.

It has been brought to my attention, however, that the Treasury Department is prepared to request that your committee amend section 2 so that only profitable companies (usually the long-established and large companies) will be permitted to add capital gains to phase III. The effect of the Treasury Department amendment would be to deny the loss companies (which are usually the small, new companies) the right to add capital gains to their phase III account. On its face this certainly appears to be discriminatory. Moreover, the effect of the discrimination is that the small new company is penalized as compared to the larger, more profitable life insurance company.

As you know, the Select Committee on Small Business supported H.R. 10223 (87th Cong.) in a letter dated March 19, 1962, to Mr. Mills, chairman of the House Ways and Means Committee. H.R. 10223 provided (1) that all life insurance companies should be taxed on capital gains in the same manner as all other corporations and (2) that the small loss life insurance companies would be permitted to add any such capital gains to their shareholder surplus accounts. The provisions of H.R. 10223 were enacted into law as section 3(b) of Public Law 87-858.

I would certainly like to urge you and your committee, particularly because of my interest in small business, to reject the proposed Treasury amendment. In particular, I am concerned about the adverse effects the Treasury proposal may have on the small life insurance company.

I would urge you to approve section 2 of H.R. 5739, as passed by the House of Representatives.

Sincerely yours,

WRIGHT PATMAN.

JOINT STATEMENT OF THE LINCOLN NATIONAL LIFE INSURANCE CO., OF FORT WAYNE, IND., AND THE LINCOLN NATIONAL LIFE INSURANCE CO., OF NEW YORK

The Lincoln National Life Insurance Co., of Fort Wayne, Ind., and its wholly owned affiliate, the Lincoln National Life Insurance Co., of New York, respectfully urge the Finance Committee to report favorably upon the three modifications in the present tax treatment of life insurance companies as set forth in H.R. 5739, as amended. While we support the bill in all of its provisions, this statement has particular applicability to the extension of the availability of the 8-year loss carryover provision.

The Lincoln National Life Insurance Co., of Fort Wayne, Ind., is an Indiana corporation, organized in 1905 and licensed and authorized to do business in all of the States except New York. The Lincoln National Life Insurance Co., of New York, on the other hand, is licensed only in the State of New York. It is a newly formed company (July 1960) and has just completed its fourth full year of operations. Like any newly established life insurance company, it has sustained a surplus loss in each of the years that it has been in business.

In the case of new life insurance companies, the need for a loss carryforward provision longer than 5 years has been consistently recognized, and an 8-year carryforward was provided in the Life Insurance Income Tax Act of 1959 except that this longer period did not apply in the case of a company owned and controlled by another corporation. Because there were so many other problems to consider, the special problems of affiliate companies did not receive full consideration at the time of the passage of the 1959 act. The matter, however,

received further attention 2 years ago when Congress made the 8-year loss carryforward available to a life insurance company owned and controlled by a stock or mutual fire and casualty insurance company.

We see no reason to deny the 8-year loss carryforward merely because the life company affiliate is owned by another life company rather than a stock or mutual fire and casualty insurance company or by any other company carrying on a business venture which is not fire and casualty insurance. The amendment proposed in this part of H.R. 5739 will operate to create equity between different types of affiliate ownership, and will not, in our opinion, bring about the formation of affiliate companies for the purpose of dealing in tax losses. A new life insurance company is expected to sustain losses in its early years but if sound management exists, the base for future gains is being laid, and the consequent tax liabilities arising therefrom cannot be avoided by the writing of business in an affiliate company.

There are several valid business reasons for the formation of affiliate or subsidiary life insurance companies by an existing life insurance company:

(1) Differences in the statutes and the regulatory requirements of the several States.

(2) The possible desirability of using different agency and sales organizations and techniques in different States or regions.

(3) It provides an opportunity to offer some differences in the product lines of the two companies.

The recent change in the tax law relative to the filing of consolidated returns and the removal of the additional 2-percent tax heretofore imposed has not completely solved the problem of affiliated life insurance companies. While it is expected that this change will be helpful, the regulations as they relate to the consolidated returns of life insurance companies have not been fully completed and the full tax implications of consolidation are difficult to assess. Secondly, when affiliation exists and both companies, parent and subsidiary, are newly expanding life insurance companies, losses are likely to occur in the operations of both companies. In this situation the privilege of filing consolidated returns may be of little or no assistance. Moreover, consolidated returns cannot be filed when the majority ownership is less than 80 percent.

For the reasons set forth herein approval of H.R. 5739, as amended, is respectfully requested.

Statement of American Life Convention & Life Insurance Association of America

The American Life Convention & the Life Insurance Association of America are two associations with a combined membership of 323 life insurance companies which have in force over 95 percent of the legal reserve life insurance written in the United States.

We favor the enactment of H.R. 5739. All of its provisions are designed to eliminate imperfections in the Life Insurance Company Income Tax Act of 1959. Two of the provisions (secs. 1 and 3) were proposed by life insurance companies. The third provision (sec. 2) arises from a Treasury proposal. For the most part these provisions will affect only a few companies. They are wholly meritorious, however, and we urge their acceptance.

EXTENSIONS OF AVAILABILITY OF 8-YEAR LOSS CARRYOVER FOR NEW COMPANIES

Under present law life insurance companies, like other corporations, are allowed a 3-year loss carryback and a 5-year loss carryover. An 8-year carryover, however, is allowed to new companies, defined as companies which have been in business for 5 years or less. Then the act provides that a new life insurance company shall be "nonqualified" for this longer carryover if it controls or its controlled by another corporation. In 1962, Congress amended this nonqualification rule to make it inapplicable to a new life insurance company which controls or is controlled by a fire or casualty insurance company. Section 1 of H.R. 5739 would eliminate the nonqualification provision in its entirety.

We believe that this proposed amendment is eminently sound. Congress has consistently recognized that new life insurance companies are likely to operate at a loss during their early years. This was the reason for the inclusion of the 8-year carryover provision in the 1959 act. Presumably Congress at that time felt that there might possibly be need for the nonqualification provision to prevent other corporations from acquiring life insurance companies merely to ob-

tain the long-term loss carryover. It has since become clear, however, that no such need exists. Congress recognized this fact in part when it adopted the 1962 amendment. It should now eliminate the nonqualification provision entirely.

ADDITIONS OF CAPITAL GAINS TO SHAREHOLDERS SURPLUS ACCOUNT

Section 815 of the 1959 act provides for the addition of specified amounts to the shareholders surplus account. One such amount is the life insurance company taxable income. Another is capital gains. Under the 1959 act the capital gains of a life insurance company were taxed entirely separately from other income of the company. Hence there was no comingling of life insurance company taxable income and capital gains. In 1962, the capital gains treatment was changed to provide for both a regular method and an alternative method of computation, to conform more nearly with the treatment accorded other corporations. Consequently, there is now a comingling of life insurance company taxable income with capital gains. The Treasury Department feels that the 1962 amendment resulted unintentionally in a double inclusion of capital gains in the shareholders surplus account, once as a part of life insurance company taxable income and a second time as capital gains.

The purpose of section 2 of H.R. 5739 is to eliminate this double inclusion. We agree with Treasury that there should be no such double inclusion.

REDUCTION OF POLICYHOLDERS SURPLUS ACCOUNT FOR CERTAIN UNUSED DEDUCTIONS

Section 809(d)(5) provides for a deduction equal to 10 percent of the reserve increases for the taxable year for nonparticipating contracts. Section 809(d)(6) provides for a deduction of 2 percent of the premiums for the taxable year on accident and health insurance contracts and group life insurance contracts. These deductions must be taken, up to a certain amount, even though they may create or enlarge a loss from operations for the taxable year. The deductions so taken must also be added to the policyholders surplus account, as provided by section 815, and thereafter amounts taken from that account are subject to tax.

The loss caused by such deductions may, of course, be carried backward for 3 years or forward for 5 years (8 years in the case of a new company). However, if the company continues to operate at a loss, so that these amounts cannot be used in any of the other years to offset a gain from operations, the company will receive no tax benefit whatever from these deductions. Nevertheless, under present law these amounts will remain in the policyholders surplus account and will be subject to tax when taken from that account.

The purpose of section 3 of H.R. 5739 is to eliminate this imperfection in the present statute. We think it is clear that this inequitable result was never intended by Congress and should be remedied. The provisions of section 3 appear adequate for that purpose. We, therefore, recommend their adoption.

For the foregoing reasons we urge the enactment of H.R. 5739. If we can be of any assistance to the committee or can provide any information on these matters, we shall be glad to do so.

SHIPLEY, AKERMAN & PICKETT,
Washington, D.C., July 28, 1964.

Re H.R. 5739, to amend the Internal Revenue Code of 1954 with respect to the taxation of life insurance companies.

Hon. HARRY F. BYRD,
U.S. Senator, Chairman, Senate Finance Committee, Senate Office Building, Washington, D.C.

DEAR CHAIRMAN BYRD: We have an interest in the above bill because of our work in the securities field. Some companies regulated under the Investment Company Act of 1940 own insurance companies as wholly owned subsidiaries, in order to permit participation in the growing trend toward offering life insurance and mutual fund shares in a single program. This encourages family protection, thrift, and investment in the free enterprise system by persons of moderate means, and thus serves the national interest.

Presently the Life Insurance Company Income Tax Act of 1959, as amended, provides an 8-year operations loss carryover for new life insurance companies, but only if they are not affiliated with another company (other than a fire or

other casualty insurance company). Affiliated life insurance companies are nonqualified if 50 percent of the voting stock is held by another corporation, or vice versa, and a life insurance company is considered "new" only if it was first authorized to do business within the immediately preceding 5 years.

The 8-year loss carryover was denied to these affiliated new life insurance companies apparently on the erroneous theory that it was necessary to discourage "trafficking" in losses, i.e., acquisition of these companies to obtain the long-term loss carryover. In practice it is highly unlikely that this might happen, since the same business which gives rise to losses in the early life of an insurance company assures profitability in later years. With early losses more than offset by later income from the same life insurance business, no losses are likely to remain for use against gains from other noninsurance-type operations. In any event, a life insurance company may not file a consolidated return with other companies, so early losses can only be offset by later income of the life insurance company itself.

H.R. 5739 corrects the above inequity by making the 8-year net operations loss carry forward available to any new life insurance company, whether or not it is affiliated with another corporation through common stock ownership of 50 percent or more. The bill does this by simply deleting from the present law all references to "nonqualified" corporations in the definition of a new life insurance company.

Since the bill was reported unanimously by the House Committee on Ways and Means, and the U.S. Treasury Department has advised it has no objection, and for the reasons outlined herein, we strongly urge that the bill be reported by the Senate Finance Committee in its present form.

Respectfully submitted.

CARL L. SHIPLEY.

STATEMENT OF RICHARD W. LAMBOURNE, PRESIDENT, LIFE INSURANCE CO., OF CALIFORNIA, SAN FRANCISCO, CALIF., RE H.R. 5739

I am president of Life Insurance Co. of California, a new company which commenced business in January 1963. Our company is a wholly owned subsidiary of Insurance Securities, Inc., an investment management company.

It is our belief that this bill as a whole is desirable legislation, because it corrects inequities in the existing law.

We are particularly interested in the provision which would eliminate the discrimination which now exists between new life insurance companies like ours, which are subsidiaries of corporations other than fire and casualty companies, and all other new life insurance companies. The Internal Revenue Code now provides that new life insurance companies may carry forward losses from their first 5 years' operations for 8 years, rather than the more usual 5 years provided for other corporations. This was in recognition of the fact that for new life insurance companies, the net operation 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.

However, the existing code provision denies this 8-year loss carryforward right to life insurance companies which own or are owned by a company carrying on a business other than that of fire or casualty insurance. We feel that it is most inequitable for a new life insurance company such as ours to be denied the 8-year loss carryforward provision simply on the basis of the ownership of our stock. Our operations are just as likely to give rise to losses in the early years of our business as those of any new life company which has no affiliation or is affiliated with a fire and casualty company.

It is our belief that the tax laws should treat similar businesses similarly, and that this bill, which would end discrimination as between new life insurance companies, should be passed. We hope it will have your support.

TEXAS INDEPENDENCE LIFE INSURANCE CO.,
Abilene, Tex., July 26, 1964.

Re H.R. 5739, section 3.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance of U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: I am writing you regarding the above House bill.

I am the president of the Texas Independence Life Insurance Co. and our home office is Abilene, Tex.

Texas Independence Life was organized in 1952 and began operating as a capital stock company in 1955. The year ending December 31, 1963, reflects our insurance in force in the amount of $4,235,000. Our capital structure is $108,000 with a surplus fund in the amount of $48,000.

Texas Independence Life was audited by the Internal Revenue Service for the years 1958, 1959, 1960, and 1961. We have losses for all of these years. These losses were created by virtue of special deductions. The year 1958 reflects, as audited, a loss in the amount of $26,695.99. This loss was added to our surplus fund.

We are interested in the above bill as this loss will not be reflected to offset any gain in operations in future years. There are inequities in the 1959 tax bill to damage and impair future operations of small companies such as ours. We are hurt by the loss and hurt again in future years as these funds are distributed to our stockholders out of a policyholder surplus for which we will have received no tax benefit. We are in need of an equity, instead of an inequity, to qualify our $26,695.99.

We trust this letter will benefit all companies that will be damaged without the passage of this bill.

Respectfully,

NORMAN E. BONDS, *President.*

OCCIDENTAL LIFE INSURANCE CO. OF CALIFORNIA,
Los Angeles, Calif., July 27, 1964.

Hon. HARRY FLOOD BYRD,
U.S. Senate,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: I urge your support of H.R. 5739.

The building of a healthy life insurance company is a long and costly process. Under the American economic system, vigorous competition is essential to avoid Government control of such an industry. Therefore, I respectfully submit it is in the interest of the Federal Government to take all reasonable steps to encourage the formation and healthy growth of new life insurance companies. H.R. 5739 will accomplish this at virtually no immediate revenue loss to the Federal Government by giving a slightly longer loss carryover to insurance companies.

Such encouragement of healthy new companies today is almost certain to result in a healthier insurance industry and increased revenue for the Federal Government in future years.

Respectfully yours,

O. L. FROST, JR.,
Second Vice President.

(Whereupon, at 11:20 a.m., the committee adjourned, subject to call of the Chair.)