Calendar No. 1232

92D CONGRESS
2d Session

SENATE

REPORT
No. 92–1290

PERSONAL EXEMPTIONS FOR AMERICAN SAMOANS; ESTATE TAX TREATMENT OF ANNUITIES IN COMMUNITY PROPERTY STATES; GUARANTEED RENEWABLE LIFE, HEALTH, AND ACCIDENT INSURANCE CONTRACTS; ACCRUED VACATION PAY

OCTOBER 12, 1972.—Ordered to be printed

Mr. FANNIN (for Mr. LONG), from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 1467]

The Committee on Finance, to which was referred the bill (H.R. 1467) to amend the Internal Revenue Code of 1954 with respect to personal exemptions in the case of American Samoans, reports favorably thereon with amendments and recommends that the bill, as amended, do pass.

I. SUMMARY

H.R. 1467, as passed by the House, extends the present law definition of a "dependent" for purposes of claiming an income tax personal exemption to include "nationals" of the United States who otherwise would qualify as dependents but for the fact that they are not citizens of the United States. In addition, the bill as passed by the House provides that a national of the United States, even though not a resident of the United States, is not to be limited to one personal exemption (as he is under present law). In practice these changes will have application only to American Samoans. The committee has accepted this House-passed provision changing only the effective date, making it apply to taxable years starting after 1971 rather than after 1970.

The committee has also added three other amendments to the bill. The first of these relates to the estate tax treatment of annuities in community property States. This amendment removes a discrimination in existing estate tax law against spouses of employees in community property States who die before the employee spouse. Generally, an

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estate tax exclusion is provided for the proportion of the value of a survivor annuity to the extent it is attributable to the contributions of the employer. In a common law State where the nonemployee (often the wife) dies first, no value representing the employer's contribution is included in her estate tax base. However, in a community property State, as a result of the operation of community property laws, half of the value of the annuity in such a case is included in the estate tax base of the nonemployee spouse, even though attributable to employer contributions. This amendment overcomes this discrimination against nonemployee spouses in community property States.

The second amendment relates to guaranteed renewable life, health and accident insurance contracts. Generally, life insurance companies are allowed a 3-percent-of-premium deduction on nonparticipating contracts of life, accident and health insurance issued or renewed for periods of 5 years or more. This amendment makes clear that the period for which a contract is issued, or renewed, also includes the period for which a contract is guaranteed renewable. As a result, it will be clear that guaranteed renewable life, health and accident insurance contracts are eligible for the 3-percent-of-premiums deductions available to nonparticipating contracts issued for 5 years or more. The amendment is to be effective as of the general effective date of the Life Insurance Company Income Tax Act of 1959.

The third amendment extends for 2 years (until January 1, 1973) the provision of the Technical Amendments Act of 1958 which provides that a deduction for accrued vacation pay is not to be denied solely because the liability for it to a specific person has not been fixed or because the liability for it to each individual cannot be computed with reasonable accuracy. However, for the corporation to obtain the deduction, the employee must have performed the qualifying service necessary under a plan or policy which provides for vacations with pay to qualified employees and the plan or policy must have been communicated to the employees involved before the beginning of the vacation year. This is a continuation for 2 more years of the treatment which has been available for taxable years ending before January 1, 1971.

II. PERSONAL EXEMPTIONS IN THE CASE OF AMERICAN SAMOANS

Under existing law, the term "dependent" does not include any individual who is not a citizen of the United States, unless the individual is a resident of the United States or of a country which is contiguous to the United States, or of the Canal Zone or of the Republic of Panama.[1] In addition, a nonresident alien (except one who is a resident of a contiguous country—Canada or Mexico) who, because of earnings from U.S. sources, is required to file a U.S. tax return may claim only one exemption. A nonresident alien under the tax laws is

[1] In certain limited situations a dependency exemption may also be claimed for someone who is a citizen of the Philippine Islands (see the last sentence of sec. 152(b)(3)) but this is not a factor in the situations covered here.

defined as anyone who is neither a citizen nor resident of the United States.

Present law defines the term "United States" as including the States and the District of Columbia. As a result, unincorporated territories of the United States, such as the Virgin Islands, Guam, and American Samoa, are not treated as part of the United States. However, under the organic acts and subsequent legislation dealing with the Virgin Islands and Guam individuals born in these territories are citizens of the United States[2] and, therefore, may qualify as dependents or, where they are U.S. taxpayers, are not limited to one personal exemption.

Individuals born in American Samoa, however, are not citizens of the United States, although they are nationals of the United States.[3] Consequently, an American Samoan who has not become a naturalized citizen of the United States may not be claimed as a dependent for purposes of U.S. income taxation or, where he is the taxpayer, may claim only one personal exemption. This has created particular problems when an American Samoan is working in the United States either as a civilian or as a member of the Armed Forces of the United States. As a result of this treatment of American Samoans as nationals, in any computation of U.S. income tax liability, either when they are employed in the United States as civilians or as U.S. servicemen, they are precluded from treating their noncitizen parents or children as dependency exemptions and also are denied an exemption for their wives or husbands (since the law limits them to one personal exemption). Although the Federal income tax laws do not apply to American Samoa, individuals from that Territory who are working for a trade or business in the United States or are in the Armed Forces of the United States are called upon to pay the regular U.S. income tax with respect to their earnings while in the United States.

The committee believes that this disparity in treatment should be removed and that a national paying U.S. tax should have the opportunity to claim personal exemptions in the same manner as citizens of the United States.

To meet the problem described above the bill amends present law (sec. 152(b)(3)) to provide that a "national" of the United States, who is otherwise eligible, may be claimed as a dependent for purposes of computing taxable income. The term "national of the United States" is defined in the United States Code (8 U.S.C. 1101(a)(22)) as a citizen of the United States, or an individual who, though not a citizen, owes permanent allegiance to the United States. Noncitizen nationals include (according to 8 U.S.C. 1408) individuals born in outlying possessions[4] and individuals born outside of the United States and its outlying possessions of parents (both of whom are nationals but not citizens) who have resided in the United States or in one of its outlying possessions.

A second amendment (to sec. 873(b)(3)) is also made with respect to the deductions available to nonresident alien individuals. Present

[2] 8 U.S.C., secs. 1406, 1407.
[3] 8 U.S.C., secs. 1101(a)(22), 1408.
[4] An "outlying possession of the United States" is defined as American Samoa and Swains Island, which is administered as an integral part of American Samoa (8 U.S.C. sec. 1101(a) (29)).

law allows only one personal exemption for nonresident aliens who are not residents of a contiguous country. The bill amends this provision to provide that the provision limiting to one the number of exemptions which a nonresident alien may claim, is not to apply in the case of a national of the United States (as it presently does not apply in the case of a resident of a contiguous country—Canada or Mexico).

This provision shall apply to taxable years beginning after December 31, 1971.

III. ESTATE TAX TREATMENT OF ANNUITIES IN COMMUNITY PROPERTY STATES

Under existing law the gross estate of a decedent for Federal estate tax purposes generally includes the value of an annuity (or other payment receivable by any beneficiary) if the decedent at his death possessed the right to receive the annuity (or payment). However, an exception to this general rule (sec. 2039(c)) provides for the exclusion from the decedent's gross estate of the value of an annuity (or other payment) receivable by any beneficiary (other than the executor) to the extent it is not attributable to the decedent's own contributions, but only if it is payable under certain types of employee plans or contracts—in most cases qualified plans or contracts. The principal plans or contracts referred to in the exception are qualified employee pension, profit sharing, or stock bonus plans (meeting the requirements of sec. 401(a)), qualified employee annuity contracts purchased by an employer pursuant to a plan (described in sec. 403(a)) and retirement annuity contracts purchased for employees by tax-exempt schools or colleges or publicly supported educational, charitable or religious organizations (referred to in sec. 170(b)(1)(A) (ii) or (vi)).

The Internal Revenue Service has taken the position that, in community property States, the interest of a decedent spouse who is not the employee, in the annuity or plan of the surviving employee spouse, arises, to the extent of one half, as a result of the operation of the community property law. Since this is not as a result of any employee relationship on the part of the decedent spouse, the exclusion referred to above is not available. It has been noted, for example, that the statute (sec. 2039(c)) refers to "the decedent's separation from employment," a situation which does not occur in the case of the nonemployee spouse. Consequently, a community property interest possessed by a nonemployee decedent in an employee plan has been held by the Internal Revenue Service (Rev. Rul. 67–278) to be includable in the nonemployee decedent's gross estate.

The situation is quite different, however, in a common law State. In this case if an employee's wife predeceases her husband, she is considered to have no interest for estate tax purposes in a qualified plan or annuity, since she would acquire an interest in the annuity or plan only on the death of her husband.

The committee believes the treatment described above is discriminatory and should not be allowed to continue. It is of the view that the provision exempting from the estate tax interests in qualified annuity plans should have uniform application in both common law and community property States where the nonemployee spouse is the first to die.

This provision of the bill provides an exclusion from the gross estate for estate tax purposes of the value of any interest of a spouse in specified employee contracts, or trust or plan payments, where three conditions exist.

First, an employer must have made contributions or payments on behalf of an employee (or former employee) under an employee's pension, stock bonus, or profit-sharing plan, or trust which is qualified as an exempt plan for tax purposes (under section 401(a)), an employee's qualified retirement annuity contract (covered under a plan described in section 403(a)), or a retirement annuity contract purchased for an employee by an employer which is an educational organization (referred to in sec. 170(b)(1)(A)(ii)) or a publicly-supported educational, charitable, or religious organization (referred to in sec. 170(b)(1)(A)(vi)). Second, for purposes of the existing estate tax provision (sec. 2039(c)), the amount involved must not be considered as contributed by the employee. Third, the nonemployee spouse must predecease the employee spouse. Where these three conditions exist, the value of the nonemployee's interest is to be excluded from the gross estate of the decedent spouse to the extent the value is attributable to the contributions of the employer and to the extent the value arises solely by reason of the spouse's interest in the community income of the employee under the community property laws of the State.

This provision will have the effect of equating the estate tax treatment that occurs upon the death of a nonemployee spouse in a community property State with that resulting upon the death of a nonemployee spouse in a common law State. This can be illustrated by assuming that a decedent's surviving husband is employed by a company which has established a pension trust which meets the requirements for qualified status under the tax laws (sec. 401(a)). Assume that at the time of the decendent's death the employer has made contributions to the plan with respect to the employee in the amount of $40,000 and that the employee (while married) has made payments in the amount of $20,000. In this case, in a community property State, the payments contributed by the employer would not, under present law (sec. 2039 (c)), be considered as contributed on behalf of the decedent spouse and in any event the employer was not in an employment relationship with the decedent spouse. As a result the value attributable to the employer's contributions is not excluded from this spouse's gross estate for estate tax purposes. However, under this provision the amount of the spouse's community interest in the plan, to the extent attributable to the employer's contributions, would (under the new sec. 2039(d)) be excluded from her gross estate for estate tax purposes.

Thus, in the case of a deceased nonemployee spouse, the same result is obtained in a community property State as would occur under present law in the case of a deceased nonemployee spouse in a common law State. In the common law State where the nonemployee spouse dies first, no interest in an employee's annuity passes at the time of her death, and therefore none is includible in her gross estate. The entire interest in the annuity in this case remains with the surviving employee spouse.

This provision does not, in the case of the spouse in the community property State, provide any exclusion for her property interest in the plan to the extent it is attributable to the contributions of the employee spouse. Thus, in the foregoing example, the decedent's community interest in the plan which is attributable to contributions made by her surviving husband would be subject to inclusion in her gross estate, as under present law.

This provision is to apply not only to estates of decedents dying after the date of enactment of this bill but also in the case of estates for which the period for filing of a claim for credit or refund of an overpayment of estate tax remains open on the date of enactment of this bill. The amendment also provides that interest will not be allowed or paid on any overpayment of tax because of the application of this amendment if the refund is made before 180 days after the date of enactment.

IV. DEDUCTION FOR PREMIUMS ON GUARANTEED RENEWABLE LIFE, ACCIDENT, AND HEALTH INSURANCE POLICIES

Under present law, the deductions allowed (under sec. 809(d)) in computing the gain from operations of life insurance companies include a deduction for an amount equal to 3 percent of the premiums attributable to nonparticipating contracts of life, accident, and health insurance issued or renewed for periods of 5 years or more.

A guaranteed renewable contract is a policy of insurance under which the premiums may be adjusted by classes on an annual basis in accordance with the experience under the type of policy involved. The Internal Revenue Service has taken the position that since the insurance company can increase the premiums for all policies in a class, these contracts are analogous to 1-year renewable contracts and therefore are not issued for periods of 5 years or more (Rev. Rul. 65-237, C.B. 1965-2, 231). Taxpayers on the other hand contend that the purpose of the 5-year requirement is to limit the 3-percent-of-premiums deduction to contracts on which there is a long-term risk and that guaranteed renewable contracts are subject to the same types of long-term risks as noncancellable contracts. Further, for purposes of the life insurance provisions (sec. 801(e) of the code), guaranteed renewable life, health, and accident contracts are treated in the same manner as noncancellable life, health, and accident insurance contracts.

This controversy has led to litigation and is presently being contested in the Court of Claims. (See *Commissioner* v. *Pacific Material Life Insurance Company*, 413 F. 2d 55 (9th Cir. 1969) reversing 48 T. C. 118 (1967)).

The committee believes that the intent of the 3-percent-of-premiums deduction was to give taxpayers a cushion against long-term risks. While guaranteed renewable contracts permit a limited adjustment of premiums according to class experience, guaranteed renewable contracts are subject to substantial long-term risks since the contracts may only be canceled by the insured. As a result, the committee's amendment resolves the above controversy by making clear that guaranteed renewable contracts are eligible for the 3-percent-of-premiums deduction.

Under the committee amendment, the period for which a contract is guaranteed renewable is taken into account in determining the period for which a contract is issued or renewed. As a result, if a contract which is guaranteed renewable to age 60 is issued to an individual age 35, the contract is viewed as being issued for 25 years, the first year it is issued and the 24 years for which it is guaranteed renewable. When the contract is renewed by the same individual at age 57, the premiums on the contract are still to be included in computing the 3-percent-of-premiums deduction, since the contract is treated as being issued initially for a period of 25 years.

Since the committee has concluded that it was the intent of Congress in the Life Insurance Company Income Tax Act of 1959 to treat guaranteed renewable contracts in the same manner as noncancellable contracts, it believes it is appropriate to resolve the controversy for past as well as future years. As a result, the committee amendment is effective as of the general effective date of the Life Insurance Company Income Tax Act of 1959; that is, it will apply to taxable years beginning after December 31, 1957. The amendment also provides that interest will not be allowed or paid on any overpayment of tax because of the application of this amendment if the refund is made before 180 days after the date of enactment.

V. ACCRUED VACATION PAY

Under the 1939 Code, deductions for vacation pay could be taken when these expenses were paid or accrued, or paid or incurred, depending upon the method of accounting, "unless in order to clearly reflect income the deductions should be taken as of a different period." Under the above quoted portion of this provision, it was held by the Internal Revenue Service that vacation pay for the next year could be accrued as of the close of the year in which qualifying services were rendered, provided all of the events necessary to fix the liability of the taxpayer for the vacation pay under the employment contract have occurred by the close of the current year. In determining whether the events necessary to fix the liability of the taxpayer for vacation pay had occurred, the fact that the employee's rights to a vacation (or payment in lieu of vacation) in the following year might be terminated if his employment ended before the scheduled period was not regarded as making the liability a contingent one instead of a fixed one. It was held that the liability in such a case was not contingent since the employer could expect the employees as a group to receive the vacation pay; only the specific amount of the liability with respect to individuals remained uncertain at the close of the year.[5]

[5] GCM 25261, C.B. 1947-2, 44; I.T. 3956, C.B. 1949-1, 78.

In 1954, Congress enacted a provision (sec. 462) which provided for the deduction of additions to reserves for certain estimated expenses. Reserves for vacation pay, including accrual on a completion of qualifying service basis, would have been deductible under this provision and as a result it was concluded that it was no longer necessary to maintain the administrative position described above with respect to vacation pay. As a result, in Revenue Ruling 54–608 (C.B. 1954–2, 8), the Internal Revenue Service revised its position on the deductibility of vacation pay. In this ruling, it held that no accrual of vacation pay could occur until the fact of liability with respect to specific employees was clearly established and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. It was thought that taxpayers accruing vacation pay under plans which did not meet the requirements of the strict accrual rule set forth in this ruling would utilize this new provision (sec. 462) providing for the deduction of additions to reserves for estimated expenses. This ruling was initially made applicable to taxable years ending on or after June 30, 1955.

Because the provision relating to the reserve for estimated expenses was later repealed, the Treasury Department in a series of actions postponed the effective date of Revenue Ruling 54–608 until January 1, 1959.[6] These actions rendered Revenue Ruling 54–608 inapplicable to taxable years ending before January 1, 1959.

Congress, in the Technical Amendments Act of 1958 (sec. 97), further postponed the effective date of Revenue Ruling 54–608 for two more years, making it inapplicable to taxable years ending before January 1, 1961. Subsequently, Congress in five actions (P.L. 86–496, P.L. 88–153, P.L. 88–554, P.L. 89–692, and P.L. 91–172) further postponed the effective date of Revenue Ruling 54–608. The fifth of these laws postponed the application of the ruling until January 1, 1971.

The application of Revenue Ruling 54–608 results in the denial of a deduction in a year where the accrual of vacation pay has not been clearly fixed with respect to specific employees. With the provisions for reserves for estimated expenses no longer a part of the law, this creates hardships for taxpayers who have been accruing vacation pay under plans which do not meet the requirements of the strict accrual rules set forth in this ruling. For such taxpayers if this ruling were to go into effect, they would have one year in which they would receive no deduction for vacation pay. This would occur since the current year's vacation pay deductions would have been accrued in the prior year and the next year's vacation pay does not meet the tests of accrual of this ruling.

Since the repeal of the provision relating to the reserve for estimated expenses in 1955, the House and Senate committees have indicated that this problem needed to be studied before permanent legislation could be prepared. This problem has been studied and it is anticipated that a permanent solution can be considered next year. In the meantime, it is necessary to continue the existing rules until next year. Accordingly, this amendment postpones for 2 more years the effective date of Revenue Ruling 54–608. As a result, deductions for accrued vacation

[6] The last of these postponements was made in Revenue Ruling 57–325, C.B. 1957–2, 302. July 8, 1957.

pay, if computed by an accounting method consistently followed by the taxpayer since 1958, will not be denied for any taxable year ending before January 1, 1973, solely because the liability to a specific person for vacation pay has not been clearly established or because the amount of the liability to each individual cannot be computed with reasonable accuracy.

VI. EFFECT ON THE REVENUES OF THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect on the revenues of the bill. The committee estimates that the provision of the bill that treats nationals of the United States (for purposes of American Samoa) as eligible to be claimed as dependents will result in a revenue loss of $100,000 annually in each of the next three years. It is estimated that the provision of the bill that deals with the estate tax treatment of annuities in community property States will result in revenue losses in the next three years, but the losses are expected to be small. The provision of the bill dealing with guaranteed renewable health insurance contracts is estimated to result in an annual revenue loss of about $2 million; however, the first year revenue loss is estimated to be about $15 million because of the prior applicability of the provision. The provision of the bill dealing with the deductibility of accrued vacation pay will not reduce revenues from present levels since it continues existing rules. The Treasury Department agrees with this statement.

VII. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).