# TAX FORMULA FOR LIFE INSURANCE COMPANIES



# HEARINGS

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

EIGHTY-SIXTH CONGRESS

FIRST SESSION

ON

## H.R. 4245

AN ACT RELATING TO THE TAXATION OF LIFE INSURANCE COMPANIES

MARCH 3, 4, 5, 17, 18, AND 19, 1959

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# TAX FORMULA FOR LIFE INSURANCE COMPANIES

**TUESDAY, MARCH 3, 1959**

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

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

Present: Senator Byrd, Kerr, Frear, Long, Smathers, Anderson, Douglas, Gore, Talmadge, McCarthy, Hartke, Williams, Carlson, Bennett, Butler, Cotton, and Curtis.

Also present: Elizabeth B. Springer, chief clerk.

Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The purpose of this meeting is for consideration of H.R. 4245, the life insurance tax formula bill.

I submit for the record a brief analyses of the pending legislation.

(The brief analyses of H.R. 4245 is as follows:)

BRIEF ANALYSIS OF H.R. 4245

GENERAL TAX STRUCTURE PROVIDED FOR LIFE INSURANCE COMPANIES BY H.R. 4245

The bill imposes the regular 52-percent corporate income tax (30 percent on the first $25,000) on what is defined as "life insurance company taxable income." This is composed of three parts: Taxable investment income; one-half of the current underwriting income; and the other half of underwriting income when it is distributed to shareholders or made available to them. In addition a flat 25-percent tax is imposed on capital gains.

*Step 1—Taxable investment income*

Taxable investment income consists of interest, dividends, rents and other forms of investment income, less investment expenses, a special deduction for small business equal to 5 percent of net investment income (up to a maximum of $25,000), a deduction for investment income earned on pension plan reserves and a deduction for interest paid. However, the principal deduction is that for investment income needed with respect to life insurance reserves. This deduction involves the determination of an interest rate to be applied to a company's life insurance reserves. The interest rate provided by this bill is halfway between the actual earnings rate of the company and the rate it assumed in computing its own reserves (or the industry average assumed rate for the prior year, if higher). This deduction rate is then applied to the company's own reserves, after those reserves are adjusted to reflect the level they would have been at had this deduction rate been used in prior years.

*Step 2—One-half of underwriting gain (or whole loss)*

Under step 2 the life insurance company first determines its overall gain or loss from operations and then its step 1 tax base is deducted from this figure. The result is underwriting gain or loss. The gain from operations take into account both premium income and investment income. Deductions against this are allowed for claims paid to policyholders and beneficiaries, operating expenses, investment expenses, and additions made during the year to life insurance reserves. In addition, deductions are allowed for dividends paid to policyholders, an amount equal to 10 percent of the additions to life insurance reserves with respect to nonparticipating insurance and an amount equal to 2 percent of premium income from group insurance business (subject to certain restrictions).

If the gain from operations less taxable investment income results in an underwriting gain, one-half of this amount is added to the tax base determined under step 1. If the result is an underwriting loss the *entire* loss (but reduced for policyholder dividends and the 10 percent and 2 percent deductions referred to above) reduces the tax base otherwise determined under step 1.

*Step 3—Tax on portion of underwriting income not previously taxed at time of distribution or when made available to stockholders*

Under step 3 provision is made for taxing the half of the underwriting gain not taxed under step 2. It is included in the company's tax base at the time it is distributed to stockholders, or made available to them, or to the extent the amount so accumulated over a period of years exceeds 25 percent of life insurance reserves or 60 percent of the net premiums for the taxable year.

(The text of the bill as passed by the House of Representatives follows:)

[H.R. 4245, 86th Cong., 1st sess.]

AN ACT Relating to the taxation of the income of life insurance companies

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**SECTION 1. SHORT TITLE.**

This Act may be cited as the "Life Insurance Company Income Tax Act of 1959".

**SEC. 2. REVISION OF PART I OF SUBCHAPTER L.**

(a) Part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to life insurance companies) is amended to read as follows:

"PART I—LIFE INSURANCE COMPANIES



"Subpart A—Definition; Tax Imposed



**"SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.**

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

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

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

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

"(b) LIFE INSURANCE RESERVES DEFINED.—

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

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

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

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

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

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

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

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

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

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

"(4) DEFICIENCY RESERVES EXCLUDED.—The term 'life insurance reserves' does not include deficiency reserves. For purposes of this paragraph and subsection (c), the term 'deficiency reserves' means the total present value of the amounts by which—

"(A) the net premiums required for life insurance and annuity contracts, exceeds

"(B) the actual premiums and other consideration charged for such contracts.

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

"(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term 'total reserves' means—

"(1) life insurance reserves,

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

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

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

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

"(e) GUARANTEED RENEWABLE CONTRACTS.—For purposes of this part, guaranteed renewable life, health, and accident insurance shall be treated in the same manner as noncancellable life, health, and accident insurance.

"(f) BURIAL AND FUNERAL BENEFIT INSURANCE COMPANIES.—A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under this part but shall be taxable under section 821 or section 831.

"SEC. 802. TAX IMPOSED.

"(a) TAX IMPOSED.—

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

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

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

"(2) TAX IN CASE OF CAPITAL GAINS.—If for any taxable year beginning after December 31, 1958, the net long-term capital gain of any life insurance company exceeds the net short-term capital loss, there is hereby imposed a tax equal to 25 percent of such excess.

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

"(1) the taxable investment income (as defined in section 804) or the gain from operations (as defined in section 809(a)), whichever is the smaller,

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

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

"Subpart B—Investment Income



"SEC. 804. TAXABLE INVESTMENT INCOME.

"(a) IN GENERAL.—For purposes of this part, the amount of the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the net investment income (determined under subsection (c)), minus the policy and other contract liability deduction (determined under section 805).

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

"(1) INTEREST, ETC.—The gross amount of income from—

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

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

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

"(2) SHORT-TERM CAPITAL GAIN.—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

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

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

"(c) NET INVESTMENT INCOME DEFINED.—For purposes of this part, the term 'net investment income' means the gross investment income less the following deductions—

"(1) INVESTMENT EXPENSES.—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

"(A) one fourth of one percent of the mean of the assets (as defined in section 805(b)(6)) held at the beginning and end of the taxable year,

"(B) the amount of the mortgage service fees for the taxable year, plus

"(C) whichever of the following is the greater:

"(i) one-fourth of the amount by which the investment yield (as defined in section 805(b)(5), but computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(6)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

"(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

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

"(3) DEPRECIATION.—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

"(4) DEPLETION.—The deduction allowed by section 611 (relating to depletion).

"(5) TAX-FREE INTEREST.—The amount of interest which under section 103 is excluded from gross income.

"(6) PARTIALLY TAX-EXEMPT INTEREST.—In lieu of the deduction allowed by section 242 (relating to deduction for partilly tax-exempt interest), a deduction in an amount which bears the same ratio to the amount allowable under such section as—

"(A) the normal tax rate for the taxable year prescribed by section 11, bears to

"(B) the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

"(7) DIVIDENDS RECEIVED.—The deductions allowed by sections 243, 244, and 245.

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

"(A) There shall be excluded losses—

"(i) from (or considered as from) sales or exchanges of capital assets,

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

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

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

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

"(9) SMALL BUSINESS DEDUCTION.—An amount equal to 5 percent of the net investment income for the taxable year (computed without regard to this paragraph). The deduction under this paragraph shall not exceed $25,000.

"SEC. 805. POLICY AND OTHER CONTRACT LIABILITY DEDUCTION.

"(a) IN GENERAL.—For purposes of this part, the term 'policy and other contract liability deduction' means the sum of—

"(1) the deduction for the investment yield on adjusted life insurance reserves,

"(2) the deduction for the investment yield on pension plan reserves, and

"(3) the deduction for interest paid,

reduced by the adjustment provided in subsection (e).

"(b) DEDUCTION FOR INVESTMENT YIELD ON ADJUSTED LIFE INSURANCE RESERVES.—

"(1) IN GENERAL.—For purposes of this part, the deduction for the investment yield on adjusted life insurance reserves is the amount determined by multiplying—

"(A) the adjusted life insurance reserves, by

"(B) the deduction rate.

"(2) DEDUCTION RATE.—For purposes of this part, the deduction rate for any taxable year is the amount ascertained by dividing by 2 the sum of—

"(A) whichever of the following percentages is the higher—

"(i) the average rate of interest assumed by the taxpayer in calculating life insurance reserves (other than pension plan reserves), or "(ii) a percentage for such year to be determined and proclaimed by the Secretary or his delegate for the life insurance industry as the average rate of interest assumed in calculating life insurance reserves (other than pension plan reserves), plus

"(B) the investment yield rate (as defined in subsection (c)(1)). The percentage determined and proclaimed by the Secretary or his delegate under subparagraph (A)(ii) shall be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary or his delegate considers representative. If the percentage determined under subparagraph (A) exceeds the investment yield rate, the deduction rate for the taxable year is the investment yield rate.

"(3) ADJUSTED LIFE INSURANCE RESERVES.—For purposes of this part, the term 'adjusted life insurance reserves' means—

"(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

"(B) that percentage which equals 100 percent—

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

"(ii) reduced by that percentage which is 10 times the deduction rate.

"(4) AVERAGE INTEREST RATE ASSUMED.—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

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

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

"(5) INVESTMENT YIELD.—For purposes of this part, the investment yield for any taxable year is the net investment income for such taxable year computed without—

"(A) the deduction for tax-free interest provided by section 804(c)(5),

"(B) the deduction for partially tax-exempt interest provided by section 804(c)(6),

"(C) the deduction for dividends received provided by section 804(c)(7), and

"(D) the small business deduction provided by section 804(c)(9).

"(6) ASSETS.—For purposes of this part, the term 'assets' means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

"(A) real property and stock shall be the fair market value thereof, and

"(B) any other asset shall be the adjusted basis (determined without regard to fair market value on Decembr 31, 1958) of such asset for purposes of determining gain on sale or other disposition.

"(7) ADJUSTMENTS TO MEANS FOR CERTAIN TRANSFERS OF LIABILITIES.—For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the assets, taken into account in applying paragraphs (2), (3), and (4) shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This paragraph shall not apply to reinsurance ceded to the taxpayer or to another person.

"(c) DEDUCTION FOR INVESTMENT YIELD ON PENSION PLAN RESERVES.—

"(1) IN GENERAL.—For purposes of this part, the deduction for the investment yield on pension plan reserves is the amount determined by multiplying—

"(A) the pension plan reserves, by

"(B) the investment yield rate.

For purposes of this part, the investment yield rate is the percentage obtained by dividing (i) the taxpayer's investment yield for the taxable year, by (ii) the mean of the taxpayer's assets at the beginning and end of the taxable year.

"(2) PENSION PLAN RESERVES DEFINED.—For purposes of this part, the term 'pension plan reserves' means that portion of the life insurance reserves which is allocable to contracts—

"(A) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be (i) trusts described in section 401(a) and exempt from tax under section 501(a), or (ii) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

"(B) purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans meeting the requirements of section 401(a)(3), (4), (5), and (6), or the requirements of section 165(a)(3), (4), (5), and (6) of the Internal Revenue Code of 1939; or

"(C) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of section 401(a)(3), (4), (5), and (6).

"(3) SPECIAL TRANSITIONAL RULE.—For purposes of this part, the amount taken into account as pension plan reserves shall be—

"(A) in the case of a taxable year beginning after December 31, 1957, and before January 1, 1959, zero;

"(B) in the case of a taxable year beginning after December 31, 1958, and before January 1, 1960, 33⅓ percent of the amount thereof (determined without regard to this paragraph);

"(C) in the case of a taxable year beginning after December 31, 1959, and before January 1, 1961, 66⅔ percent of the amount thereof (determined without regard to this paragraph); and

"(D) in the case of a taxable year beginning after December 31, 1960, 100 percent of the amount thereof (determined without regard to this paragraph).

"(d) DEDUCTION FOR INTEREST PAID.—For purposes of this part, the deduction for interest paid is the sum of—

"(1) INTEREST ON INDEBTEDNESS.—All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

"(2) AMOUNTS IN THE NATURE OF INTEREST.—All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.

"(3) DISCOUNT ON PREPAID PREMIUMS.—All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

"(e) ADJUSTMENT TO PREVENT DOUBLE DEDUCTIONS.—The adjustment referred to in subsection (a) is the amount determined by multiplying—

"(1) the sum of the amounts deductible under paragraphs (5), (6), and (7) of section 804(c), by

"(2) the ratio—

"(A) the numerator of which is the sum of—

"(i) the deduction for the investment yield on adjusted life insurance reserves,

"(ii) the deduction for the investment yield on pension plan reserves,

"(iii) the deduction for interest paid, plus

"(iv) the small business deduction provided by section 804(c)(9), and

"(B) the denominator of which is the investment yield for the taxable year.

If the denominator referred to in paragraph (2)(B) is less than the numerator referred to in paragraph (2)(A), the adjustment under this subsection shall be the sum determined under paragraph (1).

"SEC. 806. CHANGE OF BASIS IN COMPUTING RESERVES.

"If the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of this subpart the amount of such item—

"(1) as of the close of the taxable year shall be computed on the old basis, and

"(2) as of the beginning of the next taxable year shall be computed on the new basis.

"Subpart C—Gain and Loss From Operations



"SEC. 809. IN GENERAL.

"(a) GAIN FROM OPERATIONS DEFINED.—For purposes of this part, the term 'gain from operations' means the amount by which the sum of the items referred to in subsection (c) exceeds the deductions provided by subsection (d).

"(b) LOSS FROM OPERATIONS DEFINED.—For purposes of this part, the term 'loss from operations' means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of the items referred to in subsection (c).

"(c) GROSS AMOUNT.—For purposes of subsections (a) and (b), the following items shall be taken into account:

"(1) PREMIUMS.—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

"(2) DECREASES IN CERTAIN RESERVES.—Each item of net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

"(3) SHORT-TERM CAPITAL GAIN.—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

"(4) OTHER AMOUNTS.—All amounts, not includible under paragraph (1), (2), or (3), which under this subtitle are includible in gross income.

Except as provided in paragraph (3), there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

"(d) DEDUCTIONS.—For purposes of subsections (a) and (b), there shall be allowed the following deductions:

"(1) DEATH BENEFITS, ETC.—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

"(2) INCREASES IN CERTAIN RESERVES.—Each item of net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

"(3) DIVIDENDS TO POLICYHOLDERS.—The deduction for dividends to policyholders (determined under section 811(b)).

"(4) OPERATIONS LOSS DEDUCTION.—The operations loss deduction (determined under section 812).

"(5) SMALL BUSINESS DEDUCTION.—A small business deduction in an amount equal to the amount determined under section 804(c)(9).

"(6) RESERVES FOR CERTAIN NONPARTICIPATING CONTRACTS.—An amount equal to 10 percent of the increase in the reserves for nonparticipating contracts. For purposes of this paragraph, the term 'reserves for nonparticipating contracts' means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts).

"(7) GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE.—An amount equal to 2 percent of the premiums for the taxable year attributable to group life insurance contracts and group accident and health insurance contracts.

The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts. For purposes of this paragraph, the term 'premiums' means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

"(8) ASSUMPTION BY ANOTHER PERSON OF LIABILITIES UNDER INSURANCE, ETC., CONTRACTS.—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

"(9) OTHER DEDUCTIONS.—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

"(e) MODIFICATIONS.—The modifications referred to in subsection (d)(9) are as follows:

"(1) INTEREST.—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c).

"(2) BAD DEBTS.—Section 166(c) (relating to reserve for bad debts) shall not apply.

"(3) CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.—In applying section 170—

"(A) the limit on the total deductions under such section provided by the first sentence of section 170(b)(2) shall be 5 percent of the gain from operations computed without regard to—

"(i) the deduction allowed by section 170,

"(ii) part VIII (except section 248) of subchapter B,

"(iii) the adjustment provided by subsection (f),

"(iv) the deductions provided by paragraphs (3), (6), and (7) of subsection (d), and

"(v) any operations loss carryback to the taxable year under section 812; and

"(B) under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(b)(3) shall be applied.

"(4) AMORTIZABLE BOND PREMIUM.—Section 171 shall not apply.

"(5) NET OPERATING LOSS DEDUCTION.—The deduction for net operating losses provided in section 172 shall not be allowed.

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

"(7) DEDUCTION FOR DIVIDENDS RECEIVED.—In applying section 246(b) (relating to limitation on aggregate amount of deductions)—

"(A) the limit on the aggregate amount of the deductions allowed by sections 243(a), 244, and 245 shall be 85 percent of the gain from operations computed without regard to—

"(i) the adjustment provided by subsection (f),

"(ii) the deductions provided by paragraphs (3), (6), and (7) of subsection (d),

"(iii) the operations loss deduction, and

"(iv) the deductions allowed by sections 243(a), 244, and 245, but

"(B) such limit shall not apply for any taxable year for which there is a loss from operations.

"(f) ADJUSTMENT TO PREVENT DOUBLE DEDUCTIONS.—

"(1) AMOUNT OF ADJUSTMENT.—The total of the amounts allowable as deductions under subsection (d) shall be reduced by the amount determined by multiplying—

"(A) the sum of—

"(i) the amount of interest which under section 103 is excluded from gross income, "(ii) the deduction provided by section 242 (as modified by subsection (e) (6)), and

"(iii) the deductions provided in sections 243, 244, and 245 (as modified by subsection (e) (7)), by

"(B) the ratio—

"(i) the numerator of which is the sum of the required interest (as defined in paragraph (2)) plus the small business deduction provided by subsection (d) (5), and

"(ii) the denominator of which is the investment yield (as defined in section 805(b) (5)) computed without regard to the limitation in section 804(c) (1) (relating to deduction for investment expenses).

If the denominator referred to in subparagraph (B) (ii) is less than the numerator referred to in subparagraph (B) (i), the adjustment under this paragraph shall be the sum determined under subparagraph (A).

"(2) REQUIRED INTEREST.—For purposes of paragraph (1), the term 'required interest' means the total of—

"(A) the sum of the products ascertained under section 805(b) (4) (A);

"(B) the deduction for the investment yield on pension plan reserves (determined under section 805(c)); and

"(C) the deduction for interest paid (as defined in section 805(d)).

"(g) LIMITATION ON CERTAIN DEDUCTIONS.—

"(1) IN GENERAL.—The amount of the deductions under paragraphs (3), (6), and (7) of subsection (d) shall not (after the application of subsection (f)) exceed the amount by which—

"(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

"(B) the taxable investment income for the taxable year.

"(2) APPLICATION OF LIMITATION.—The limitation provided by paragraph (1) shall apply first to the amount of the deduction under paragraph (7), then to the amount of the deduction under paragraph (6), and finally to the amount of the deduction under paragraph (3).

"SEC. 810. RULES FOR CERTAIN RESERVES.

"(a) ADJUSTMENT FOR DECREASE.—If the amount of any item described in subsection (c) as of the beginning of the taxable year exceeds the amount of such item as of the close of the taxable year, the excess shall be taken into account as an item of net decrease referred to in section 809(c) (2).

"(b) ADJUSTMENT FOR INCREASE.—If the amount of any item described in subsection (c) as of the close of the taxable year exceeds the amount of such item as of the beginning of the taxable year, the excess shall be taken into account as an item of net increase referred to in section 809(d) (2).

"(c) ITEMS TAKEN INTO ACCOUNT.—The items referred to in subsections (a) and (b) are as follows:

"(1) The life insurance reserves (as defined in section 801(b)).

"(2) The unearned premiums and unpaid losses included in total reserves under section 801(c) (2).

"(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

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

"(5) Premiums received in advance, and liabilities for premium deposit funds.

In applying this subsection, the same item shall be counted only once.

"(d) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.—

"(1) IN GENERAL.—If the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

"(A) the amount of the item at the close of the taxable year, computed on the new basis, and

"(B) the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account for purposes of this subpart as follows:

"(i) if the amount determined under subparagraph (A) exceeds the amount determined under subparagraph (B), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) applies; or

"(ii) if the amount determined under subparagraph (B) exceeds the amount determined under subparagraph (A), 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) applies.

"(2) TERMINATION AS LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this paragraph shall be taken into account for the preceding taxable year.

"(3) EFFECT OF PRELIMINARY TERM ELECTION.—An election under section 818(c) shall not be treated as a change in the basis for determining an item referred to in subsection (c) to which this subsection applies. If an election under section 818(c) applies for the taxable year, the amounts of the items referred to in subparagraphs (A) and (B) of paragraph (1) shall be determined without regard to such election. If such an election would apply in respect of such item for the taxable year but for the new basis, the amount of the item referred to in subparagraph (B) shall be determined on the basis which would have been applicable under section 818(c) if the election applied in respect of the item for the taxable year.

"SEC. 811. DIVIDENDS TO POLICYHOLDERS.

"(a) DIVIDENDS TO POLICYHOLDERS DEFINED.—For purposes of this part, the term 'dividends to policyholders' means dividends and similar distributions to policyholders in their capacity as such. Such term does not include interest paid (as defined in section 805(d)).

"(b) AMOUNT OF DEDUCTION.—

"(1) IN GENERAL.—Except as limited by section 809(g), the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year—

"(A) increased by the excess of (i) the amounts held at the end of the taxable year as reserves for dividends to policyholders (as defined in subsection (a)) payable during the year following the taxable year, over (ii) such amounts held at the end of the preceding taxable year, or

"(B) decreased by the excess of (i) such amounts held at the end of the preceding taxable year, over (ii) such amounts held at the end of the taxable year.

For purposes of subparagraphs (A) and (B), there shall be included as amounts held at the end of any taxable year amounts set aside, before the 16th day of the third month of the year following such taxable year, for payment during the year following such taxable year.

"(2) CERTAIN AMOUNTS TO BE TREATED AS NET DECREASES.—If the amount determined under subsection (b)(1)(B) exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be an item of net decrease referred to in section 809(c)(2).

"SEC. 812. OPERATIONS LOSS DEDUCTION.

"(a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of—

"(1) the operations loss carryovers to such year, plus

"(2) the operations loss carrybacks to such year.

For purposes of this part, the term 'operations loss deduction' means the deduction allowed by this subsection.

"(b) OPERATIONS LOSS CARRYBACKS AND CARRYOVERS.—

"(1) YEARS TO WHICH LOSS MAY BE CARRIED.—The loss from operations for any taxable year (hereinafter in this section referred to as the 'loss year') ending after December 31, 1957, shall be—

"(A) an operations loss carryback to each of the 3 taxable years preceding the loss year, and

"(B) an operations loss carryover to each of the 5 taxable years following the loss year.

A loss from operations shall not be an operations loss carryback to any taxable year beginning before January 1, 1958.

"(2) AMOUNT OF CARRYBACKS AND CARRYOVERS.—The entire amount of the loss from operations for any loss year shall be carried to the earliest of the taxable years to which (by reason of paragraph (1) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (d)) for each of the prior taxable years to which such loss may be carried.

"(c) COMPUTATION OF LOSS FROM OPERATIONS.—In computing the loss from operations for purposes of this subsection—

"(1) The operations loss deduction shall not be allowed.

"(2) The deductions allowed by sections 243 (relating to dividends received by corporations) 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) as modified by section 809(e)(7).

"(d) OFFSET DEFINED.—

"(1) IN GENERAL.—For purposes of subsection (b)(2), the term 'offset' means, with respect to any taxable year, an amount equal to that increase in the operations loss deduction for the taxable year which reduces the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero.

"(2) OPERATIONS LOSS DEDUCTION.—For purposes of paragraph (1), the operations loss deduction for any taxable year shall be computed without regard to the loss from operations for the loss year or for any taxable year thereafter.

"(e) APPLICATION OF SUBTITLE A AND SUBTITLE F.—Except as provided in section 809(e), subtitle A and subtitle F shall apply in respect of operations loss carrybacks, operations loss carryovers, and the operations loss deduction under this part in the same manner and to the same extent as such subtitles apply in respect of net operating loss carrybacks, net operating loss carryovers, and the net operating loss deduction.

## "Subpart D—Distributions to Shareholders

"Sec. 815. Distributions to shareholders.

"SEC. 815. DISTRIBUTIONS TO SHAREHOLDERS.

"(a) GENERAL RULE.—For purposes of this section and section 802(b)(3), any distribution to shareholders shall be treated as made—

"(1) first out of the shareholders surplus account, to the extent thereof,

"(2) then out of the policyholders surplus account, to the extent thereof, and

"(3) finally out of other accounts.

For purposes of this subsection, the term 'distribution' includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include any distribution made by the corporation in its stock or in rights to acquire its stock.

"(b) SHAREHOLDERS SURPLUS ACCOUNT.—

"(1) IN GENERAL.—Each stock life insurance company shall for purposes of this part, establish and maintain a shareholders surplus account. The amount in such account on January 1, 1959, shall be zero.

"(2) ADDITIONS TO ACCOUNT.—The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1958, shall be the amount by which—

"(A) the sum of—

"(i) the life insurance company taxable income (computed without regard to section 802(b)(3)),

"(ii) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss,

"(iii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 809(e)(6)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(e)(7)), and the amount of interest excluded from gross income under section 103, and "(iv) the small business deduction provided by section 809(d)(5), exceeds

"(B) the taxes imposed for the taxable year by section 802(a), determined without regard to section 802(b)(3).

"(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.

"(c) POLICYHOLDERS SURPLUS ACCOUNT.—

"(1) IN GENERAL.—Each stock life insurance company shall, for purposes of this part, establish and maintain a policyholders surplus account. The amount in such account on January 1, 1959, shall be zero.

"(2) ADDITIONS TO ACCOUNT.—If the gain from operations for any taxable year beginning after December 31, 1958, exceeds the taxable investment income, there shall be added to the policyholders surplus account an amount equal to 50 percent of such excess.

"(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the policyholders surplus account for any taxable year an amount equal to the sum of—

"(A) the amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and

"(B) the amount by which the tax imposed for the taxable year by section 802(a) is increased by reason of section 802(b)(3).

"(d) SPECIAL RULES.—

"(1) ELECTION TO TRANSFER AMOUNTS FROM POLICYHOLDERS SURPLUS ACCOUNT TO SHAREHOLDERS SURPLUS ACCOUNT.—

"(A) IN GENERAL.—A taxpayer may elect for any taxable year to subtract from its policyholders surplus account any amount in such account as of the close of such taxable year. The amount so subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

"(B) MANNER AND EFFECT OF ELECTION.—The election provided by subparagraph (A) shall be made (in such manner and in such form as the Secretary or his delegate may by regulations prescribe) after the close of the taxable year and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year. Such an election, once made, may not be revoked.

"(2) TERMINATION AS LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, then the amount taken into account under section 802(b)(3) for the preceding taxable year shall be increased by the amount remaining in its policyholders surplus account at the close of such preceding taxable year.

"(3) TREATMENT OF CERTAIN INDEBTEDNESS.—If—

"(A) the taxpayer makes any payment in discharge of its indebtedness, and

"(B) such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959,

then the amount of such payment shall, for purposes of this section and section 802(b)(3), be treated as a distribution in cash to shareholders, but only to the extent that the distribution referred to in subparagraph (B) was treated as made out of accounts other than the shareholders and policyholders surplus accounts.

"(4) LIMITATION ON AMOUNT IN POLICYHOLDERS SURPLUS ACCOUNT.—There shall be treated as a subtraction from the policyholders surplus account for the taxable year the amount by which the policyholders surplus account (computed at the end of the taxable year without regard to this paragraph) exceeds the greater of—

"(A) 25 percent of life insurance reserves, or

"(B) 60 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1).

The amount so subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

"(e) SPECIAL RULE FOR CERTAIN MUTUALIZATIONS.—

"(1) IN GENERAL.—For purposes of this section and section 802(b)(3), any distribution to shareholders in acquisition of stock pursuant to a plan of mutualization shall be treated—

"(A) first, as made out of paid-in capital and paid-in surplus, to the extent thereof,

"(B) thereafter, as made in two allocable parts—

"(i) one part of which is made out of the other accounts referred to in subsection (a)(3), and

"(ii) the remainder of which is a distribution to which subsection (a) applies.

"(2) SPECIAL RULES.—

"(A) ALLOCATION RATIO.—The part referred to in paragraph (1)(B)(i) is the amount which bears the same ratio to the amount to which paragraph (1)(B) applies as—

"(i) the excess (determined as of December 31, 1958) of the assets over the total liabilities, bears to

"(ii) the sum (determined as of the beginning of the year of the distribution) of the excess described in clause (i), the amount in the shareholders surplus account, plus the amount in the policyholders surplus account.

"(B) ADJUSTMENT FOR CERTAIN DISTRIBUTIONS.—The excess described in subparagraph (A)(i) shall be reduced by the aggregate of the prior distributions which have been treated under subsection (a)(3) as made out of accounts other than the shareholders surplus account and the policyholders surplus account.

## "Subpart E—Miscellaneous Provisions



### "SEC. 817. RULES RELATING TO CERTAIN GAINS AND LOSSES.

"(a) TREATMENT OF CAPITAL GAINS AND LOSSES, ETC.—In the case of a life insurance company—

"(1) in applying section 1231(a), the term 'property used in the trade or business' shall be treated as including only—

"(A) property used in carrying on an insurance business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in carrying on an insurance business, held for more than 6 months, which is not described in section 1231(b)(1)(A), (B), or (C), and

"(B) property described in section 1231(b)(2), and

"(2) in applying section 1221(2), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

"(b) GAIN ON PROPERTY HELD ON DECEMBER 31, 1958.—In the case of property acquired by the taxpayer before December 31, 1958, if—

"(1) the fair market value of such property on such date exceeds the adjusted basis for determining gain as of such date, and

"(2) the taxpayer has been a life insurance company at all times on and after December 31, 1958,

the gain on the sale or other disposition of such property shall be treated as an amount (not less than zero) equal to the amount by which the gain (determined without regard to this subsection) exceeds the difference between the fair market value on December 31, 1958, and the adjusted basis for determining gain as of such date. In the case of property having a substituted basis (within the meaning of section 1016(b)), the preceding sentence shall apply, but only if during the holding periods concerned the property or properties were held only by life insurance companies. For purposes of this subsection, the term 'property' does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in paragraph (1) of section 1221.

"(c) LIMITATION ON CAPITAL LOSS CARRYOVERS.—A net capital loss for any taxable year beginning before January 1, 1959, shall not be taken into account.

"SEC. 818. ACCOUNTING PROVISIONS.

"(a) METHOD OF ACCOUNTING.—All computations entering into the determination of the taxes imposed by this part shall be made—

"(1) under an accrual method of accounting, or

"(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(b) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—

"(1) IN GENERAL.—The appropriate items of income, deductions, and adjustments under this part shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

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

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

"(2) SPECIAL RULES.—

"(A) AMORTIZATION OF BOND PREMIUM.—In the case of any bond (as defined in section 171(d)) acquired after December 31, 1957, the amount of bond premium, and the amortizable bond premium for the taxable year, shall be determined under section 171(b) as if the election set forth in section 171(c) had been made.

"(B) CONVERTIBLE EVIDENCES OF INDEBTEDNESS.—In no case shall the amount of premium on a convertible evidence of indebtedness include any amount attributable to the conversion features of the evidence of indebtedness.

"(c) LIFE INSURANCE RESERVES COMPUTED ON PRELIMINARY TERM BASIS.—For purposes of this part (other than section 801), at the election of the taxpayer the amount taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

"(1) EXACT REVALUATION.—As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality assumptions and interest rates for both the preliminary term basis and the net level premium basis).

"(2) APPROXIMATE REVALUATION.—The amount computed without regard to this subsection—

"(A) increased by \$21 per \$1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

"(B) increased by \$5 per \$1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

If the taxpayer makes an election under either paragraph (1) or (2) for any taxable year, the basis adopted shall be adhered to in making the computations under this part (other than section 801) for the taxable year and all subsequent taxable years unless a change in the basis of computing such reserves is approved by the Secretary or his delegate.

"(d) SHORT TAXABLE YEARS.—If any return of a corporation made under this part is for a period of less than the entire calendar year (referred to in this subsection as 'short period'), then section 443 shall not apply in respect of such period, but—

"(1) the taxable investment income and the gain or loss from operations shall be determined, under regulations prescribed by the Secretary or his delegate, on an annual basis by a ratable daily projection of the appropriate figures for the short period,

"(2) that portion of the life insurance company taxable income described in paragraphs (1) and (2) of section 802(b) shall be determined on an annual basis by treating the amounts ascertained under paragraph (1) as the taxable investment income and the gain or loss from operations for the taxable year, and

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

"(e) TRANSITIONAL RULE FOR CHANGES IN METHOD OF ACCOUNTING.—

"(1) IN GENERAL.—If the method of accounting required to be used in computing the taxpayers' taxes under this part for the taxable year 1958 is different from the method used in computing its taxes under this part for 1957, then there shall be ascertained the net amount of those adjustments which are determined (as of the close of 1957) to be necessary solely by reason of the change to the method required by subsection (a) in order to prevent amounts from being duplicated or omitted. The amount of the taxpayer's tax for 1957 shall be recomputed (under the law applicable to 1957) taking into account an amount equal to $\frac{1}{10}$ of the net amount of the adjustments determined under the preceding sentence. The amount of increase or decrease (as the case may be) referred to in paragraph (2) or (3) shall be the amount of the increase or decrease ascertained under the preceding sentence, multiplied by 10.

"(2) TREATMENT OF DECREASE.—For purposes of subtitle F, if the recomputation under paragraph (1) results in a decrease, the amount thereof shall be a decrease in the tax imposed for 1957; except that for purposes of computing the period of limitation on the making of refunds or the allowance of credits with respect to such overpayment, the amount of such decrease shall be treated as an overpayment of tax for 1959. No interest shall be paid, for any period before March 16, 1960, on any overpayment of the tax imposed for 1957 which is attributable to such decrease.

"(3) TREATMENT OF INCREASE.—

"(A) IN GENERAL.—For purposes of subtitle F (other than sections 6016 and 6655), if the recomputation under paragraph (1) results in an increase, the amount thereof shall be treated as a tax imposed by this subsection for 1959. Such tax shall be payable in 10 equal annual installments, beginning with March 15, 1960.

"(B) SPECIAL RULES.—For purposes of subparagraph (A)—

"(i) No interest shall be paid on any installment described in subparagraph (A) for any period before the time prescribed in such subparagraph for the payment of such installment.

"(ii) Section 6152(c) (relating to proration of deficiencies to installments) shall apply.

"(iii) In applying section 6502(a)(1) (relating to collection after assessment), the assessment of any installment described in subparagraph (A) shall be treated as made at the time prescribed by such subparagraph for the payment of such installment.

"(iv) Except as provided in section 381(c)(22), if for any taxable year the taxpayer is not a life insurance company, the time for payment of any remaining installments described in subparagraph (A) shall be the date (determind without regard to any extension of time) for filing the return for such taxable year.

"(f) DENIAL OF DOUBLE DEDUCTIONS.—Nothing in this part shall permit the same item to be deducted more than once under subpart B and once under subpart C.

"SEC. 819. FOREIGN LIFE INSURANCE COMPANIES.

"(a) CARRYING ON UNITED STATES INSURANCE BUSINESS.—A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable on the United States business of such company in the same manner as a domestic life insurance company.

"(b) ADJUSTMENT WHERE SURPLUS HELD IN UNITED STATES IS LESS THAN SPECIFIED MINIMUM.—

"(1) IN GENERAL.—In the case of any company described in subsection (a), if the minimum figure determined under paragraph (2) exceeds the surplus held in the United States, then—

"(A) the policy and other contract liability deduction (determined under section 805 without regard to this subsection), and

"(B) the total of the amounts allowable as deductions under section 809 (determined without regard to this subsection), shall each be reduced by an amount determined by multiplying such excess by the investment yield rate (as defined in section 805(c)(1)).

"(2) DEFINITIONS.—For purposes of paragraph (1)—

"(A) The minimum figure is the amount determined by multiplying the taxpayer's total insurance liabilities on United States business by—

"(i) in the case of a taxable year beginning before January 1, 1959, 9 percent, and

"(ii) in the case of a taxable year beginning after December 31, 1958, a percentage for such year to be determined and proclaimed by the Secretary or his delegate.

The percentage determined and proclaimed by the Secretary or his delegate under clause (ii) shall be based on such data with respect to domestic life insurance companies for the preceding taxable year as the Secretary or his delegate considers representative. Such percentage shall be computed on the basis of a ratio the numerator of which is the excess of the assets over the total insurance liabilities, and the denominator of which is the total insurance liabilities.

"(B) The surplus held in the United States is the excess of the assets held in the United States over the total insurance liabilities on United States business.

For purposes of this paragraph and subsection (c), the term 'total insurance liabilities' means the sum of the total reserves (as defined in section 801(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), and (5) of section 810(c).

"(c) DISTRIBUTIONS TO SHAREHOLDERS.—In applying sections 802(b)(3) and 815 for purposes of subsection (a), the amount of the distributions to shareholders shall be the amount which bears the same ratio to the total amount of the distributions to shareholders (within the meaning of section 815) of the foreign life insurance company as the minimum figure for the taxable year (determined under subsection (b)(2)(A)) bears to the excess of the assets of the company over the total insurance liabilities.

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

SEC. 3. TECHNICAL AMENDMENTS AND PROVISIONS.

(a) CREDIT AND EXCLUSION FOR DIVIDENDS RECEIVED BY INDIVIDUALS FROM LIFE INSURANCE COMPANIES.—

(1) Section 34(c) of the Internal Revenue Code of 1954 (relating to denial of credit for dividends received by individuals) is amended by striking out paragraph (1) and redesignating paragraph (2) and (3) as (1) and (2), respectively.

(2) Section 116(b) of such Code (relating to denial of exclusion for certain dividends) is amended by striking out paragraph (1) and redesignating paragraphs (2) and (3) as (1) and (2), respectively.

(3) The amendments made by this subsection shall apply to dividends received after December 31, 1958, in taxable years ending after such date.

(b) CREDIT FOR FOREIGN TAXES.—Section 841 of such Code is amended by striking out "811," in the first sentence, and by striking out paragraph (1) and inserting in lieu thereof the following:

"(1) in the case of the tax imposed by section 802, the life insurance company taxable income (as defined in section 802(b)), and".

(c) CARRYOVERS.—

(1) Section 381(c) of such Code (relating to items of distributor or transferor corporations taken into account) is amended by adding at the end thereof the following new paragraph:

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

(2) Section 381 of such Code is amended by adding at the end thereof the following new subsection:

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

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

(d) ADJUSTMENTS TO BASIS.—

(1) Section 1016(a)(3) of the Internal Revenue Code of 1954 (relating to adjustments to basis) is amended by striking out "and" at the end of subparagraph (A), by adding "and" at the end of subparagraph (B), and by inserting after subparagraph (B) the following new subparagraph:

"(C) since February 28, 1913, and before January 1, 1958, during which such property was held by a person subject to tax under part I of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,".

(2) Section 1016(a) of such Code is amended by inserting after paragraph (16) the following new paragraph:

"(17) in the case of any evidence of indebtedness referred to in section 818(b) (relating to amortization of premium and accrual of discount in the case of life insurance companies), to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years;".

(e) BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.—Section 1232(a)(2)(C) of such Code (relating to bonds and other evidences of indebtedness) is amended to read as follows:

"(C) DOUBLE INCLUSION IN INCOME NOT REQUIRED.—This section shall not require the inclusion of any amount previously includible in gross income."

(f) CONFORMING CHANGES IN CROSS REFERENCES.—

(1) Sections 842 and 1504(b)(2) of such Code are each amended by striking out ", 811,". Section 891 of such Code is amended by striking out "811,".

(2) Section 1201 of such Code is amended by striking out "802(a)," in subsection (a), and by adding at the end of the section the following new subsection:

"(c) LIFE INSURANCE COMPANIES.—

"For alternative tax in case of life insurance companies, see section 802(a)(2)."

(3) Paragraph (2) of section 4371 of such Code (relating to tax on policies issued by foreign insurers) is amended by striking out "816" and inserting in lieu thereof "819".

(g) ESTIMATED TAX FOR 1958.—In the case of any taxpayer subject to tax under section 811 of the Internal Revenue Code of 1954 (as such section was in effect before the enactment of this Act), no addition to the tax shall be made under section 6655 of such Code (relating to failure by corporation to pay estimated tax) with respect to estimated tax for a taxable year beginning in 1958.

SEC. 4. EFFECTIVE DATE.

Except as otherwise provided in this Act, the amendments made by this Act shall apply only with respect to taxable years beginning after December 31, 1957.

Passed the House of Representatives February 18, 1959.

Attest:

RALPH R. ROBERTS, *Clerk*.

The CHAIRMAN. I submit for the record the report on this bill received from the Bureau of the Budget.

(The report referred to is follows:)

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
*Washington, D.C., March 11, 1959.*

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

MY DEAR MR. CHAIRMAN: This is in response to your request of February 23, 1959, for the views of this agency with respect to H.R. 4245, relating to the taxation of the income of life insurance companies.

The Bureau of the Budget concurs with the view expressed by the Treasury Department that H.R. 4245 provides an equitable, long-range basis for the taxation of life insurance companies.

This measure conforms to the recommendation of the President in the 1960 budget message, and we believe it should receive favorable consideration.

Sincerely yours,

PHILLIP S. HUGHES,
*Assistant Director for Legislative Reference.*

The CHAIRMAN. It is evident by the size of the audience that there is great interest taken in this pending legislation. We welcome you.

The first witness will be David A. Lindsay, Assistant to the Secretary of the Treasury.

## STATEMENT OF DAVID A. LINDSAY, ASSISTANT TO THE SECRETARY OF THE TREASURY; ACCOMPANIED BY RICHARD E. SLITOR, ECONOMIST, TAX ANALYSIS STAFF, TREASURY DEPARTMENT, AND RAYMOND F. CONKLING, ATTORNEY, LEGISLATION AND REGULATION DIVISION, CHIEF COUNSEL'S OFFICE, INTERNAL REVENUE SERVICE

Mr. LINDSAY. Thank you, Mr. Chairman.

I have on my right, Mr. Richard E. Slitor, of the tax analysis staff of the Treasury Department.

On my left, Mr. Raymond F. Conkling, of the Chief Counsel's Office.

I welcome this opportunity to appear before your committee and to present the views of the Treasury Department on H.R. 4245, the Life Insurance Company Income Tax Act of 1959.

The Treasury Department supports this important measure. We believe that it provides an equitable, long-range basis for the taxation of life insurance companies.

Before commenting on the proposed legislation in greater detail, I wish to express the appreciation of the Treasury Department for the careful and objective study which your committee and the Congress have given to this difficult area over the years. These studies and discussions have contributed greatly to the present understanding of the problems involved in the taxation of life insurance companies.

I would also like to say we appreciate the cooperation that we have received from representatives of the industry in coping with this difficult problem.

The formulation of a reasonable net income basis for taxing life insurance companies has been complicated by the fact that the industry comprises both stock and mutual sectors which represent alternative and competitive ways of conducting the life insurance business.

At the end of 1958 the life insurance industry had assets of around $107 billion. Its investment portfolios have been growing at a rate of about 6 percent annually. For 1958, the industry had net investment income of $3.75 billion, total income from premiums and investments of around $20 billion, and a net operating gain of some $1.2 billion. Insurance in force was on the order of $500 billion.

The number of life insurance companies has been increasing rapidly in recent years, having more than doubled since 1950. Of about 1,350 life insurance companies in operation in 1958, less than 200 were mutual and about 1,200 were stock companies.

Mutual companies hold about three-fourths of the assets of the industry, have about 63 percent of the insurance in force, and account for some 58 percent of the net operating gain after policy dividends. There have always been certain difficulties in applying the same tax formula to both stock and mutual companies, and it is important that the tax law should not damage the competitive situation of either type of company.

Since 1921, life insurance companies, both stock and mutual, have been taxed only on a portion of their net investment income, after deducting an allowance designed to cover the interest required to meet obligations to policyholders. The various tax formulas have ignored premium receipts and the underwriting profit which results when premiums exceed actual mortality costs, other policyholder claims or benefits, and related expenses. Capital gains and losses of life insurance companies have also been disregarded for tax purposes.

In 1947 the then applicable law, adopted in 1942, resulted in no Federal income tax on the life insurance business. In the last 10 years a series of stopgap formulas were adopted. The latest of these, adopted in 1955, taxes each life insurance company on a fraction of its net investment income after a reserve and other policy liability deduction of 87.5 percent on the first $1 million of net investment income and 85 percent on net investment income in excess of $1 million.

The 1955 stopgap formula was originally enacted for 1 year only and was extended on a year-to-year basis. For any year in which it is not extended, the 1942 formula automatically reapplies.

The present situation, therefore, is that in the absence of further legislation, the 1942 formula would apply to 1958 income, resulting in revenues of about $500 million. The 1955 stopgap, if extended, would produce $319 million.

The latest extension of the 1955 stopgap was adopted, as the committee will recall, in March of 1958, applicable to income for the calendar year 1957.

While the Treasury went along with the extension of the 1955 stopgap to 1957 income, it was made clear that recommendations for permanent legislation would be submitted by the Treasury Department in the near future. The Department has opposed a further extension of the 1955 stopgap.

In April of 1958 the Secretary of the Treasury in similar letters to the chairman of this committee and the chairman of the House Ways and Means Committee sbmitted suggestions for the development of a permanent tax formula for life insurance companies. These proposals became the basis of intensive study and helpful discussions within the life insurance industry.

In the April 1958 letter, the Treasury recommended that the Congress consider alternative methods for taxing life insurance companies, giving first consideration to a net operating gain or total income approach which would reach underwriting profits.

In the course of subsequent consultations with industry representatives, it was urged that a change to the total income approach would shift much of the burden of taxes to stock companies and permit mutual companies to avoid a share of the tax, thus placing stock companies at a competitive disadvantage.

Stock companies typically write nonparticipating life insurance contracts (with fixed net premiums and no dividends to policyholders) and have relatively lower reserves and higher surpluses than mutual companies. Mutual companies write participating life insurance contracts, charging higher premiums at the outset but distributing dividends to policyholders throughout the life of the policies.

Since the total income approach would start from net gain from operations after payment of dividends to policyholders, the stock companies have contended that the mutuals, by increasing the size of their dividends, would greatly minimize their tax burdens in a manner not available to the stock companies.

As a result of the conversations with industry representatives, stock and mutual alike, the Treasury suggested a combination formula which would combine elements of the net investment income and total income approaches. This suggestion was outlined by Under Secretary Scribner in his statement before the subcommittee of the Ways and Means Committee November 17, 1958. It invoked favorable response, some of which is reflected in the public hearings of the subcommittee.

The combination approach, with some constructive modifications, was adopted by the Ways and Means Committee and is contained in the bill now before your committee.

In brief, the bill would tax life insurance companies on an income base consisting of three parts: (1) the taxable investment income margin above interest needs, (2) one-half the excess of net-operating gain over the investment income margin (this part would comprise chiefly underwriting gain), and (3) to the extent distributed to shareholders, the other half of the underwriting gain on which tax was postponed in step 2.

There will be a more detailed description of each of these steps later in the prepared statement. I will continue with a short description of the overall bill.

Capital gains of life insurance companies would be taxed separately at a 25-percent rate, beginning in 1959. Gains would be measured with reference to the December 31, 1958, market value or cost, whichever is higher.

The bill differs from the present treatment in several important respects.

The proposed new formula provides an improved approach in measuring the deduction for interest needs and the taxable margin of investment income.

The deduction is determined with reference to the situation of the individual company rather than on the basis of a fixed percentage based on an industry average, as do the 1955 stopgap and 1942 formula.

The bill recognizes that underwriting gains are part of the income of life insurance companies. Trends in the industry toward group, credit, and term insurance which produce underwriting profits but relatively little investment income make it increasingly unrealistic to confine the tax base to investment income.

The bill also recognizes underwriting losses. If the net operating gain computed in step 2 is less than the investment income base, the net operating gain is the tax base. If there is a net operating loss, there would be no tax liability. Present law imposes a tax on investment income even if the company is operating overall at a loss.

Policy dividends would be deductible in computing net operating gain but not to the extent this would reduce the net operating gain below the taxable investment income. This is intended to keep the investment income tax as a kind of stabilizer or minimum to prevent mutual companies from deriving an undue tax or competitive advantage by deducting policy dividends.

The proposed recognition of only half the "underwriting gain" on a current basis takes account of the long-term nature of the insurance business and the resulting difficulty in making a final determination of profit in any 1 year. This approach postpones the tax on the other half of such income if it is kept in the company for the protection of the policyholders.

No tax is imposed on this other half until it exceeds certain limits or is paid in cash to stockholders.

For the assistance of small companies, the bill provides a special deduction equal to 5 percent of investment income, up to a maximum deduction of $25,000. This allowance is similar to the additional 2½-percent deduction on net investment income up to $1 million under the 1955 law, but is more liberal for the smaller companies.

For future years, H.R. 4245 also provides a special deduction for investment income on qualified pension plan reserves in computing the investment income-tax base. This deduction, equal to the actual earnings rate of the company on pension plan reserves, is made gradually effective in three steps, becoming one-third effective in 1959 and fully effective in 1961. This special treatment is in recognition of the existing exemption of qualified pension trusts and the fact that small-business employers frequently insure their pension plans through insurance companies rather than set up pension trusts.

It is estimated that H.R. 4245 would produce between $540 and $560 million revenue on the 1958 income of life insurance companies. This compares with the $500 million under the 1942 formula and $319 million under the 1955 stopgap, if extended. Some $500 million of the total would arise from the step 1 tax on investment income. The 1958 estimate takes no account of the tax on capital gains or distributions which might arise in future years.

Of the total estimated tax under H.R. 4245, about 72 percent would be paid by the mutuals and 28 percent by the stock companies. This represents a small shift of burden percentagewise to stock companies. However, it brings the shares of tax more closely in line with the shares of business in force.

Basically, H.R. 4245 embodies a net operating gain or total net income approach. The following more detailed discussion indicates how the bill provides for arriving at a tax on the net operating gain in three steps, with features which help meet the special problems encountered in the taxation of the income of life insurance companies.

### PHASE I: DETERMINATION OF TAXABLE MARGIN OF INVESTMENT INCOME

One of the major features of H.R. 4245 is an improved formula for measuring the taxable portion of net investment income. In general outline, the proposed formula appears to afford the best available approach in determining the amount of investment income subject to tax after deducting all interest needed for solvency and competitive requirements.

Under both the 1955 stopgap and the 1942 formula, the deduction for required interest is a specified percentage of investment income, fixed by statute or determined on the basis of an industrywide ratio of interest needs to earnings. This percentage deduction is 85 percent under the 1955 stopgap, and about 75½ percent under the 1942 formula for 1958. Under each of these formulas the percentage deduction is the same for each company regardless of its own experience or situation.

H.R. 4245 provides a deduction for investment income required to meet reserve and other policy contract obligations in a manner which reflects each individual company's surplus position and the relationship between its earned and assumed rates of interest.

Part of this deduction is for interest paid on policyholder deposits, policy-dividend accumulations, and similar indebtedness. Past formulas have subjected this deduction like the reserve interest needs to an averaging process.

The most important part of the deduction for required interest is for reserve interest needed to build up life insurance and annuity reserves. In this important area the bill provides that the deduction is computed as a certain percentage, termed a "deduction rate," of each company's adjusted insurance reserves. This deduction rate is the mean of the actual rate earned by the company on its investments and the rate of interest assumed by the company in computing its reserves (or the industry assumed rate, if higher). In no case is the deduction rate to be higher than the earned rate.

In applying the deduction rate, the policy reserves are adjusted to the extent the deduction rate differs from the actual assumed rate used in computing reserves. This adjustment is designed to make the reserves consistent with the deduction rate used. If the deduction rate is higher than the assumed rate, as would almost always be the case, the reserves are adjusted downward.

The adjustment of reserves is carried out on the basis of a statutory rule, the validity of which has been demonstrated by industry experience. Under this rule, for each 1 percentage point by which the deduction rate exceeds the assumed rate, the reserves are reduced by 10 percent.

The use of a deduction rate which combines an assumed rate and the actual earnings rate of the company not only takes account of interest needed to maintain solvency. It also recognizes that competition within the industry generally requires companies to build into their premium structure a credit to policyholders for interest which is somewhat greater than the more conservative rate generally assumed in building up reserves.

In computing the deduction rate, the industry average assumed rate is permitted as a possible relief measure to avoid a possible tax penalty on a company that has been more conservative than the industry consensus. On the other hand, in permitting a company to use its own assumed rate, where this is higher than the industry average, the bill provides for unusual needs of individual companies.

Since the deduction rate is a combination of the earned and assumed rate, the effect of varying reserve interest assumptions on the deduction rate would appear to be minor. Consequently, this provision of the bill serves to minimize the problem of possible reserve manipulation for tax reasons.

PHASE 2: EXCESS OF NET OPERATING GAIN OVER THE TAXABLE MARGIN OF INVESTMENT INCOME (CHIEFLY UNDERWRITING GAINS)

The second phase of the proposed tax formula deals with a problem presented by past formulas based on investment income only, namely, the omission from the tax base of underwriting gains.

Important changes within the life insurance industry since 1921 have increasingly outmoded the old formulas based on the concept that the only income of life insurance companies is their investment earnings. Between 40 and 50 percent of the life insurance now in force involves relatively little investment income. Yet it may produce substantial underwriting profit or loss.

Phase 2 of the bill reaches such underwriting profits by means of a simple and direct procedure. The company would first compute its net operating gain from all sources. Net operating gain would represent gross receipts from all sources less all expenses and all additions to reserves and benefit payments to policyholders.

From the amount of net operating gain thus determined, the company would deduct the taxable investment income computed in phase 1, since this amount has already been included in the company's tax base. The excess would represent primarily underwriting profit, plus whatever excess of investment income over interest requirements was not reached in step 1.

After determining the excess of the net operating gain over taxable investment income, the company would add one-half of the excess to its taxable investment income base to arrive at the combined tax base under phases 1 and 2. The 50-percent reduction in the so-called underwriting gain for purposes of current taxation takes account of the point on which the life insurance industry has insisted that it is difficult, if not impossible, to establish with certainty the true net income of a life insurance company on an annual basis. This uncertainty is said to reflect the long-term nature of the contracts and the resulting need to retain what may temporarily appear as income in the current year as surplus or contingency reserves.

The 50-percent reduction also has the effect of applying a reduced rate of tax on underwriting gains so long as they are kept in the company for the protection of policyholders. Consequently, the incentive to alter reserves and adopt other changes in business or accounting practice merely for tax purposes is correspondingly reduced.

If the net operating gain is less than the taxable investment income or if there is an actual net operating loss, the bill provides for the appropriate recognition of underwriting losses. The amount by which the net operating gain is less than the taxable investment income margin may be subtracted in full from the step 1 income base. If there is a net operating loss for the year there would be no tax liability.

This feature of the bill should be of particular importance to small new companies, which characteristically have net operating losses in the early years when the business is being established. These small new companies have been required in the past to pay tax on their inevstment income regardless of the fact that they may have had an overall loss situation.

The bill also provides for a 3-year carryback and a 5-year carryforward of net operating losses in a manner comparable to that applicable to corporations generally.

PHASE 3. TAX UPON DISTRIBUTIONS OF STOCK COMPANIES

The third step provided under the bill provides a supplement for the partial tax on underwriting gains under step 2. One-half of the underwriting gains are taxed currently under step 2 but tax is postponed on the other half in view of the uncertainty as to the ultimate earnings results. Tax is deferred on this portion of the underwriting gain so long as it is kept in the company for the protection of policyholders or until it is accumulated beyond stated limitations.

The tax on distributions would apply under any of the following conditions: (1) If the company pays cash dividends or cash distributions to stockholders which are in excess of the amounts of investment income and underwriting income which have previously been taxed, (2) if the cumulative amount on which tax is postponed exceeds 25 percent of life insurance reserves or 60 percent of the net premium income, whichever is greater, or (3) if the company ceases to be a life insurance company.

There are further provisions for equalization of stock and mutual companies.

One of the major considerations in the formulation of an equitable long-range formula for the taxation of life insurance companies is the comparative treatment of mutual and stock companies.

Throughout the development of this legislation, stock companies have been concerned that the mutuals, by increasing the size of their dividends, might greatly minimize their tax liabilities in a manner not available to the stock companies. To meet this objection, the bill has provided that policy dividends may be deducted from the step 2 tax but are not allowed to reduce the investment income base.

The portion of the tax base established in step 2 consists chiefly of underwriting gain arising primarily from the excess of premiums paid over mortality cost and other expenses. Consequently, it represents moneys contributed by the policyholders themselves which it would be inappropriate to tax if returned to the policyholders. On the other hand, the investment income base represents income received from third parties which it would be inappropriate to exempt after a reasonable allowance is made for the amount of interest required to build up policy reserves and meet other interest obligations on a sound and competitive basis.

Because of the redundant premiums charged by mutual life insurance companies, they have an additional cushion besides their surplus with which to meet possible adverse operating experience. Stock companies, with their lower initial premiums, do not have this cushion and, consequently, must maintain a larger surplus. In recognition of this situation, the bill provides a deduction of 10 percent of the net increase in reserves on nonparticipating life insurance contracts. This special deduction is limited to the step 2 or underwriting gain portion of the tax base. It would not be permitted to reduce the net investment income base.

OTHER FEATURES OF THE BILL

In computing the net operating gain, the companies are allowed a special deduction of 2 percent of net premiums on group life and group accident and health insurance business. This allowance is patterned after the reserve requirements of two States for purposes of strengthening the financial safety of companies conducting this kind of business.

The bill also permits companies using the preliminary term method of computing reserves to determine their income tax as if they were on the stronger net level premium reserve basis. This feature would generally be of assistance to smaller companies.

In view of the more adequate taxation which the bill provides of the entire net operating gain from all sources, it also extends the generally applicable individual dividend-received credit and exclusion to stockholders of life insurance companies.

### CONCLUSION

The income tax liability under H.R. 4245, as compared with the liability under past formulas, would be more in accordance with the true taxable capacity of life insurance companies. The bill would remove the inequities and inadequacies of the past formulas which have required some companies to pay tax although they had no true net earnings while imposing a disproportionately low tax based on investment income in the case of other companies with large profits.

The staff of the Treasury will be ready to assist the committee at its request in its further consideration of the bill and related aspects of its work on the taxation of life insurance companies.

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

As I understand it, step 1 is expected to bring in revenue of $500 million. Step 2 brings in a revenue of between $45 million and $60 million.

Mr. LINDSAY. That is correct.

The CHAIRMAN. You have no estimate of the revenue from step 3?

Mr. LINDSAY. Step 3 does not come into operation for 1958, so there would be no revenue from step 3 at all in 1958.

In future years, the amount of revenue would depend on the speed with which certain companies reached the limitations and the dividend distribution policies of companies in general. It could not at the most exceed $50 million, and it would probably be much less than that.

The CHAIRMAN. The fact, then, is that with the exception of next year the total tax revenue will approximate $600 million.

Mr. LINDSAY. For 1959?

The CHAIRMAN. No; for the years after the step 3 becomes operative.

Mr. LINDSAY. After step 3 becomes operative, it would increase the revenue yield above $550 million. Whether it would go so far as reaching $600 million is a matter of conjecture. I would doubt it.

The CHAIRMAN. I understood yesterday when you gave us a briefing, that you thought it would be approximately $50 million.

Mr. LINDSAY. That is the maximum amount from step 3.

The CHAIRMAN. So, therefore, it is estimated at $550 million–$560 million for this year; is it not?

Mr. LINDSAY. Yes.

The CHAIRMAN. Then it will be $600 million on a permanent basis.

Mr. LINDSAY. I imagine in future years there would be more revenue from step 1 and step 2 as well as from step 3.

The CHAIRMAN. That will be due to the improvement and changes of conditions. I am speaking of the conditions as they exist today.

Mr. LINDSAY. As they exist today——

The CHAIRMAN. So it is actually a $600 million bill.

Mr. LINDSAY. That is counterbalanced, however, by the fact that starting in 1959, the special provision for pension business comes into play, which would cost about $20 million in 1959, and an additional $20 million in 1960, and an additional $20 million in 1961.

The CHAIRMAN. That compares with $319 million under the stopgap legislation, which expired on January 1 of this year. Then the insurance companies were taxed 15 percent on their invested income. The 1942 act, which is in effect today, if not disturbed, it would bring in $500 million.

Mr. LINDSAY. That is correct, Mr. Chairman.

The CHAIRMAN. And on the basis of 25 percent or approximately 25 percent of tax on investment income.

Mr. LINDSAY. That is correct.

The CHAIRMAN. This legislation provides for 25 percent on investment income. I want to get those facts clear.

Senator Kerr, do you have any questions?

Senator KERR. Why do you think $50 million will be the maximum ultimate under step 3, Mr. Lindsay?

Mr. LINDSAY. Well, $50 million represents half the excess of gains from operations over investment income—the $100 million would represent the whole. The first figure represents half. We receive roughly $50 million in phase 2 and the balance not taxed represents another $50 million. If all of that was distributed out as dividends, there would be an additional tax of $50 million. I do not believe it would all be distributed out.

Senator KERR. That is $50 million?

Mr. LINDSAY. $50 million.

Senator KERR. What is the present relative situation with reference to income of companies in that particular category as compared, say, to 10 years ago?

Mr. LINDSAY. Are you talking about the net operating gain or the investment income?

Senator KERR. The net operating gain.

You referred here to the vast change in the general structure and operation of the insurance business as compared to 1921.

Mr. LINDSAY. Today, about 40 to 50 percent of the insurance in force is term insurance of one kind or another, whereas some years ago that was a very small percent.

Senator KERR. If you were to chart the gain in the percentage of the total which that character represents in the business, would it not be a very sharply rising curve?

Mr. LINDSAY. Yes, it would be a very sharply rising curve.

Senator KERR. If that angle of increase continues, would it not increase both the 50 percent or the revenue from the 50 percent that would be currently taxed, as well as the amount which would be received under step 3?

Mr. LINDSAY. Yes, I think that that is correct, Senator Kerr.

Senator KERR. So that your estimate of $50 million limit to be collected under step 3 is calculated on the basis of what the 1958 business was.

Mr. LINDSAY. That is correct, yes.

Senator KERR. And not on the basis of what, in your judgment, the trend and the amount of business done will very likely be.

Mr. LINDSAY. That is correct, sir. I do not assume, however, that many companies would be distributing out dividends sufficient to trigger that step 3 tax. That step 3 tax might be deferred for some years in many cases.

Senator KERR. You have got the triggers built in, though, have you not?

Mr. LINDSAY. Yes, the triggers are built in, but are——

Senator KERR. Are they not self-executing under this bill? [Laughter.]

Mr. LINDSAY. The bill does not require the company to distribute a dividend in cash.

Senator KERR. No, but what about——

Mr. LINDSAY. The ceilings?

Senator KERR. What about these ceilings.

Mr. LINDSAY. The ceilings are on the liberal side, and for an insurance company that has long-term risks, the chances are the ceiling would not come into play.

Senator KERR. Well, I agree with that. I think the ceiling of the 25 percent of life insurance reserves is either very liberal or very extensive. In fact, I think it is such that it constitutes no ceiling at all, does it, in your judgment?

Mr. LINDSAY. Well, it would constitute a very real ceiling for a company dealing only in short-term business and having no reserves.

Senator KERR. I am talking about the kind of company that you were talking about which wrote much business in the long-term contracts.

Mr. LINDSAY. I do not think that ceiling would be an important factor for that kind of company.

Senator KERR. In your judgment, do you think that ceiling is too high?

Mr. LINDSAY. I think we certainly should reconsider the ceilings.

Senator KERR. In other words, if you are going to call it a ceiling, you ought to make it a ceiling.

Now, the 60 percent of the net premium is a very real ceiling, is it not?

Mr. LINDSAY. Yes, that is a real ceiling, and that ceiling, of course, would benefit a company even with short-term life insurance business without any reserves at all.

Senator KERR. For how long?

Mr. LINDSAY. It depends on the company. Some companies might hit the ceiling within 2 years, and others 5 years.

Senator KERR. In your judgment, what would be the average, not of the number of companies, but of the companies with reference to the amount of that class of business they write?

Mr. LINDSAY. Three to five years, I would say, for companies that do not have long-term business.

Senator KERR. What about a company which writes both short-term and long-term, that is, policies with reference to which no reserves or small reserves are required, and also policies with reference to which substantial reserves are required? Would that company have an advantage over—would this bill discriminate against companies whose business was limited primarily to term insurance or insurance with small reserve requirements?

Mr. LINDSAY. I do not know that it would discriminate against such companies. I would think that it is fair to say that the deferral of half of the excess of gain from operations in step 2 is mainly necessary where you have a long-term risk.

If you are dealing with a risk of 1 year and then the risk disappears, the deferral is less necessary.

Senator KERR. Let us say you have two companies, one of which writes three-fourths long-term and one-fourth short-term. Another company writes three-fourths short-term and one-fourth long-term. Is the 25 percent ceiling here with reference to the building up of reserves to cover long-term obligations such as would result in a situation where the company with three-fourths short-term and one-fourth long-term would be discriminated against by this 60 percent of the net premium limitation?

Mr. LINDSAY. Company No. 2, with the three-fourths short-term and one-fourth long-term would hit a ceiling more quickly than company No. 1.

Senator KERR. And the other one might never hit the ceiling?

Mr. LINDSAY. The other one might never hit the ceiling.

Senator KERR. In your judgment, does that constitute a discrimination?

Mr. LINDSAY. It depends on the purposes of the deferral of part of the income tax. If it is designed to take care of the problem of long-term risks, I do not think it is a discrimination.

Senator KERR. Do you not think that the provision to take care of the long-term risk should be limited to what is necessary to take care of the long-term risk in the event you decide or it is decided that this is a sound principle, and not of sufficient proportions, first, to take care of the long-range reserve requirements and, second, to provide a ceiling which would neutralize or nullify the 60 percent of net premium with reference to, let us say, 10 percent or 15 or 25 percent of the total business written on a short-term basis?

Mr. LINDSAY. I think of the two ceilings, that the ceiling which makes the most sense—and I am not now speaking of the percentages that were used in the bill—is a ceiling based on reserves rather than a ceiling based on premiums, because it is through the reserves that you have a measure of the long-term risk.

I am not so sure I was responsive to your question.

Senator KERR. I am not, either. [Laughter.]

And I am not critical, because I know you have done a terrific job on this thing, and it is moving out into unexplored territory, and I must say that your contribution is not only very valuable, but very necessary, because it is a situation in which, so far as I am concerned, I could get lost mighty easily.

In your statement, Mr. Lindsay, the deduction is determined with reference to the situation of the individual company, rather than on the basis of a fixed percentage based on an industry average as to the 1955 stopgap and the 1942 formula.

That is not entirely correct, is it? Is the company permitted under this bill in the fixing of its taxable investment income to measure the deduction for interest needs solely on the basis of its own experience?

Mr. LINDSAY. If the industrywide experience would give it a larger deduction, it would take that under the bill.

Senator KERR. I gathered, or I got the impression, that you told us when we were trying to halfway catch up with you in the matter of understanding this bill, that there would be some $40 or $45 million difference in the revenue that would be produced by the bill as written, and in the bill if it were amended to permit each company's taxes to be fixed on the basis of its individual experience.

Mr. LINDSAY. You are referring there to its individual earnings experience alone, I take it.

Senator KERR. That is right.

Mr. LINDSAY. Basing the deduction rate on the actual earned rate of the company with a 5-year average; is that what you are referring to?

Senator KERR. Yes, sir. Well, that was the example used as a standard of measuring the actual rather than the assumed income of the company, what its own experience had been.

Mr. LINDSAY. Yes.

That kind of a formula, of course, gets away entirely from reserve assumptions, and assumed rates of interest, and there is much to be said for it.

It would cost revenue, and also perhaps realistically, if a company was going to revalue its reserves it would not pick its earned rate, but something between its earned rate and its assumed rate, so we think the formula in the bill has merit.

I might say that basing the deduction on investment income on the company's individual earnings was a suggestion that came from the industry, and I think it was the first suggestion that showed the way to get away from these industrywide formulas which are somewhat arbitrary and unfair.

The modification of that in the bill that picks a mean between the assumed rate and the earned rate was developed in the Treasury and accepted by the Ways and Means Committee. I don't think it was overly enthusiastically received by the industry, however.

Senator KERR. That is understandable, isn't it?

I mean, if you were the taxpayer, wouldn't you feel that the experience of your own earnings base would be a more equitable one on which to fix a tax liability than one which would be in part determined by the experience of others?

Mr. LINDSAY. Yes, I do. But I don't think the bill now looks at the experience of others except as a relief measure.

Senator KERR. Well, then, how is it that if the bill were written so that the company could use its own experience it would produce $40 million less revenue?

Mr. LINDSAY. If I was a taxpayer I would think that the fairest one was the formula that produced the least revenue, I would imagine. [Laughter.]

Senator KERR. Well, as a representative of the Treasury, if that formula is the one that is actually the experience of the taxpayer, would you not think that it had an element of fairness to it?

Mr. LINDSAY. Yes, and I do think this: that picking a fair formula and the right formula for a permanent bill is more important than the immediate revenue effect.

Senator KERR. I agree with that. And this is to be in its present form, if enacted into a permanent bill?

Mr. LINDSAY. Right.

Senator KERR. In your statement, you say:

> This is intended to keep the investment income tax as a kind of stabilizer or minimum to prevent mutual companies from deriving an undue tax or competitive advantage by deducting policy dividends.

Now, how long have the mutual companies been operating on the basis of policy dividends?

Mr. LINDSAY. For many, many years since their inception.

Senator KERR. Well, how long?

Mr. LINDSAY. Since before 1921. I don't know myself.

Senator KERR. Was it before 1921?

Mr. LINDSAY. A hundred years, perhaps.

Senator KERR. I say, wasn't it before 1921?

Senator MCCARTHY. About 1740.

Senator KERR. I am really asking for information, and I am not a bit proud. I would be glad to get it from any authoritative source, how long have they been following that practice?

Mr. LINDSAY. I have the 1958 Life Insurance Fact Book, and there are some historical dates appearing on page 115.

The first date here is 1759.

Senator KERR. I thought it had been a matter of centuries, neither years nor decades, and therefore, it is a situation that is about as deeply rooted in our economy as any operation we have, isn't it?

Mr. LINDSAY. Yes.

Senator KERR. Now, am I right in believing that this bill, as written, while it is written as a tax bill, would, in effect, operate to make a very great basic change in that situation that has prevailed for 200 years, and that it might be accurately described, in part, as a bill to equalize competitive positions between structures of different basic principles, as much as being a tax bill?

Mr. LINDSAY. Let me divide that question into two parts.

Senator KERR. Very good. That will do me a favor.

Mr. LINDSAY. First is a basic change made in this bill.

The 1942 formula would produce $500 million of revenue based on investment income alone, which could not be reduced at all by any dividend paid to policyholders.

Senator KERR. Well, now, I understand that that is true. But we covered that yesterday. Do you know anybody who has ever officially approved the 1942 formula since it was enacted?

Mr. LINDSAY. I don't know of anybody. Maybe at the time somebody supported it.

Senator KERR. Haven't the Treasury and Congress both repeatedly, on the basis that they couldn't approve it, enacted legislation year after year?

Mr. LINDSAY. That is correct. The 1942 formula is not a sound formula.

Senator KERR. So that in referring to the 1942 act, we would really be making quite a drastic change in attitude if we did so on the basis that it was a sound standard or formula from which to operate; wouldn't we?

Mr. LINDSAY. Yes. But any investment income formula since 1921 would be such as not to permit a deduction of dividends to policyholders to reduce the taxable margin of investment income. That is true under the stopgap formula, and it is true under the 1950 formula.

I would like to point this out: I believe in 1958 there were about $1,400 million of dividends paid to policyholders. About nine-tenths of that amount gets the full benefit of the deduction under this bill, so that very few mutuals in effect would be paying a tax under phase 2 because those deductions reduce or eliminate phase 2.

Now, according to our latest calculations with the industry representatives, perhaps about $140 million, or 10 percent of that total is wasted and not utilized to reduce the step 1 measure of the tax.

Senator KERR. You don't mean it is wasted. You mean it is just not significant in the determination of tax liability.

Mr. LINDSAY. Well, that excess amount of dividends paid to policyholders does not reduce the investment income base.

Senator KERR. But I mean the term, the word "wasted."

Mr. LINDSAY. Perhaps the wrong word was used.

Senator KERR. Yes.

Mr. LINDSAY. It would probably be fair to say that a very large portion of the dividends paid to policyholders is a readjustment in the price of premiums. Although this is a point which is disputed by some, probably part of it represents a return on the earnings of investment, maybe in the order of 10 percent. It is very hard to compute exactly what amount of the dividends paid represents a return on investment as opposed to a return of capital.

It is our belief that step 1 catches that amount as reasonably as can be done.

Senator KERR. But on step 2, if the application of it—step 1 would result in a greater income under step 2 than under step 1 under this bill, you tax half of the excess immediately and the other half, if it ever exceeds a certain limit or goes in the form of dividends.

Mr. LINDSAY. Yes.

Senator KERR. Yet, if there is a deficit you give no credit against phase 1.

Mr. LINDSAY. We do, except to the extent that the deficit is attributable to dividends paid to policyholders.

Senator KERR. Well, now, how else would there be a deficit?

Mr. LINDSAY. Excess expenses over premiums, losses.

Senator KERR. Well, that would be a very insignificant part of the total, would it not?

Mr. LINDSAY. Well, for some companies it is large.

Senator KERR. Well, I mean, but insofar as the effect of the bill is concerned, that would be an insignificant item, relatively?

Mr. LINDSAY. Relatively, yes, that is correct. To the company affected, however, it is a very important aspect of the bill.

Senator KERR. Well, now, that is true with reference to the company affected that is in that $140 million operation, too, isn't it, that is a very effective item so far as they are concerned? I mean, if we are going to judge the bill on that basis alone, there would be significance either way, wouldn't there?

Mr. LINDSAY. Yes.

Senator KERR. I would like for a little more detailed explanation of this paragraph in your statement:

For the assistance of small companies, the bill provides a special deduction equal to 5 percent of investment income, up to a maximum deduction of $25,000.

Mr. LINDSAY. The 1955 stopgap law contains a special deduction designed to help the smaller companies. There is no similar provision in the 1942 formula.

Under the 1955 stopgap there is a deduction of 2.5 percent of the net investment income up to $1 million, which, in effect, means that there is a maximum deduction of $25,000.

This is changed so that the deduction will be 5 percent of the first $500 million of investment income, still leaving——

Senator ANDERSON. Five hundred million?

Mr. LINDSAY. Five hundred thousand—still leaving an overall ceiling in the deduction of $25,000, but by increasing the percentage and reducing the amount of investment income to which it can apply, you spread the benefit more equitably among the smaller companies.

Senator KERR. Does that mean that 5 percent of the investment income up to a certain amount is not taxable? Is that what that means?

Mr. LINDSAY. Yes, it is a deduction from investment income.

Senator KERR. It doesn't mean that the first $25,000 of investment income is free of taxes?

Mr. LINDSAY. No. It is a deduction from investment income up to $25,000.

Senator KERR. But in order for a company to get that much of a deduction, it would have had to have made $500,000?

Mr. LINDSAY. Yes.

Senator KERR. Then, I am sure they won't object to that, but isn't it kind of a play on words to say that that is for the assistance of small companies?

Mr. LINDSAY. Well, it is designed to assist small companies.

Senator KERR. Suppose a company makes $5 million, they still get that deduction?

Mr. LINDSAY. They still get that deduction, but it is relatively unimportant because of the ceiling of $25,000.

Senator KERR. Well, if you wanted to really make it effective, wouldn't you increase the percent of deduction with reference to the first part of the $500,000, instead of making it 5 percent only on whatever amount they earned up to $500,000?

Mr. LINDSAY. Well, that is the direction we moved in the bill, moving it from 2.5 to 5 percent.

Senator KERR. But we don't move very fast, do we? [Laughter.]

Mr. LINDSAY. Just doubled. [Laughter.]

Senator KERR. Now, I would appreciate a little more detailed explanation of earnings on pension plan reserves.

Mr. LINDSAY. Relating to qualified pension plans?

Senator KERR. Relating to the earnings on the pension plan reserves.

Mr. LINDSAY. Under the bill——

Senator KERR. First, let me ask you this:

Are those earnings taxable to an insurance company now under the 1942 formula?

Mr. LINDSAY. Yes, they are.

Senator KERR. What other financial institutions in the same endeavor are subject to the same tax treatment?

Mr. LINDSAY. Banks and trust companies also deal with qualified pension plans, but the pension trusts are completely exempt, so I would say no other——

Senator KERR. So——

Mr. LINDSAY. Institution is taxed——

Senator KERR. So, generally speaking, there are three kinds of financial institutions handling these, what do you call them, trustee pension plans?

Mr. LINDSAY. Trusteed pension plans.

Senator KERR. One is insurance companies, banks, and trust companies.

Mr. LINDSAY. Insurance companies and trust companies.

Senator KERR. And generally speaking, that is the only group now handling those?

Mr. LINDSAY. Generally speaking.

Senator KERR. And only the operation of insurance companies are taxed.

Mr. LINDSAY. That is correct.

Senator KERR. And in this you attempt to recognize that discrimination and remove it gradually?

Mr. LINDSAY. Remove it gradually, starting in 1959.

Senator KERR. Well, is it possible that it may have already prevailed too long, and that we should approach it more rapidly than the provisions of the bill would accomplish?

Mr. LINDSAY. I think this provision in the bill probably takes care of it pretty well. It permits a period of time for other insurance companies to get into this kind of business.

Senator KERR. Is the thought that if you are going to cut the dog's tail off, that you would hurt him less by doing it an inch at a time? [Laughter.]

Mr. LINDSAY. Certainly, it would benefit the companies engaged in this business more——

Senator KERR. If the principle is wrong, why eliminate it gradually, Mr. Lindsay, or why be gradual in the elimination? If it is a discrimination, isn't it possible that it has already prevailed too long?

Mr. LINDSAY. We think a 3-year gradual phasing in of this provision is fast enough to take care of the competitive situation and without losing too much revenue all at once.

Senator KERR. Do you think in order to make it entirely fair, that you ought to make whatever tax is retained after 1958 should apply to all that are engaged in a similar business?

Mr. LINDSAY. You mean have it apply to 1959 in full?

Senator KERR. No; I mean if you are going to have it apply to insurance companies in 1959, why not have it apply to the trust companies in 1959?

Mr. LINDSAY. You mean tax the trust companies?

Senator KERR. Yes.

Mr. LINDSAY. That would be another way of approaching this problem, one we have not considered.

Senator KERR. Well, frankly, I don't know of any justification to apply a tax to one group engaged in a line of business and not apply it to a competitive group engaged in that same line of business.

On the basis of sound tax principles, do you know of any reason why you should?

Mr. LINDSAY. No; I think we should avoid it, and I think this bill attempts to avoid it.

Senator KERR. Let's say that that is the assumption we are dealing under, or proceeding under, and agreeing in that, then should not we do it immediately rather than in a phasing out process?

Mr. LINDSAY. We could. It would be done at a cost of $60 million instead of $20 million, and I think there is a balancing of the cost and the benefits to be received.

Senator KERR. Let's see; you do it in how many years?

Mr. LINDSAY. Three.

Senator KERR. Three years. And when it is accomplished, the reduction in revenue will be $60 million?

Mr. LINDSAY. That is correct.

Senator KERR. How much do we reduce the first year?

Mr. LINDSAY. One-third, which is a reduction in revenue of $20 million.

Senator KERR. So your net gain in revenue that year is $40 million?

Mr. LINDSAY. Yes.

Senator KERR. And the second year you reduce two-thirds of it?

Mr. LINDSAY. Two-thirds.

Senator KERR. So your net gain that year is $20 million?

Mr. LINDSAY. That is correct.

Senator KERR. The third year none?

Mr. LINDSAY. Right.

Senator KERR. I think your assistant is rising there to correct you and me both. If he is, I want to get in on it.

Mr. SLITOR. I was merely pointing out that the proposed exemption for pension plan business operates primarily under the phase 1 tax base.

Senator KERR. It is not any less painful by reason of its being under one phase or the other. [Laughter.]

Or is it?

Mr. SLITOR. No, sir; but it doesn't have the effect of wiping out the net operating gain in step 2, as I thought you were suggesting.

Senator KERR. No, no. At the moment I was just exploring the basis of the continuation of the tax which is being phased out because of its being discriminatory, and I was just trying to get into the record the amount of money that we, if we approve this bill, will say is sufficient to justify the discrimination.

In other words, if we approve this bill as is, instead of eliminating this discrimination entirely, to begin with, aren't we saying that for a return of $60 million we are doing something that we ought to do but we are doing it gradually instead of immediately.

Mr. LINDSAY. That is a very fair statement.

Senator KERR. Well, we may be in shape, of course, where $60 million is enough of a consideration to get us to do gradually what we ought to do immediately, that is what it reduces itself to, doesn't it?

Mr. LINDSAY. Yes, sir.

Senator KERR. I didn't find it, if it is in your statement I didn't catch it.

Isn't there something in your bill where you are taking about 8 years in which to catch up on a tax that you feel they owe on some part of earnings already had and which you are letting them pay out over a period of 4, 5, 6 or 7 or 8 years?

Mr. LINDSAY. That is the accrual. At present life insurance companies are paying taxes on a hybrid basis in some cases.

Senator KERR. On a what?

Mr. LINDSAY. Hybrid basis, part cash basis and part accrual. This bill puts them all on the accrual basis for tax purposes. That may mean an adjustment in some cases where items that ordinarily wouldn't have been included in 1958, because of the cash basis, would be included on the accrual basis, and if the adjustment increases the tax over a certain amount it can be paid over a period of 10 years.

Senator KERR. How much do you estimate that would be?

Mr. LINDSAY. About $4 million a year, I am advised.

Senator KERR. A total of $40 million?

Mr. LINDSAY. Yes.

Senator KERR. And you propose to collect the $4 million a year?

Mr. LINDSAY. Let me say also to the extent that the accrual relates to years prior to 1958, which it might, we apply the rates effective under the stopgap rather than the larger rates effective——

Senator KERR. But that is in determining the liability, not in prescribing the time of payment?

Mr. LINDSAY. Yes, that is correct.

Senator KERR. Now, in order to ease the pain that we may have here by reason of losing this $60 million, if we decided to lose it, would there be some compensation to the Treasury if we fixed it so that that liability for the $40 million would be payable in that first and second year, rather than in a 10-year period?

Mr. LINDSAY. There would be compensation as far as a revenue is concerned, but I think we would be really creating a hardship for a number of companies, where some companies would be paying for the cost of the benefit extended to another company. It is a bunching of income problem here when you shift your methods of paying the tax.

Senator KERR. Don't you think that there is just as real a hardship to a company in the business of operating a trustee pension plan that sees itself over a period of years having been losing its position because it was subject to tax and somebody else wasn't, and now you say you are going to rescue him, but you are going to wait until they go down three times, or maybe just before they go down the third time, and pull them out and then next year you are going to let them go down twice, and then after that year you won't push them in at all? [Laughter.]

Mr. LINDSAY. Well, each year looks better than the last to them over this 3-year phasing in.

Senator KERR. But in the meantime, that which hasn't been removed and results in their loss of business, it becomes more or less academic to them, doesn't it?

Mr. LINDSAY. It would.

Senator BENNETT. Will the Senator yield for an observation?

Senator KERR. Yes.

Senator BENNETT. This business of spreading accumulated liability resulting from a change from the cash to the accrual basis, this pattern of spreading it out over the future is a standard pattern that has applied to other forms of taxation. There have been other circumstances where in order to get uniformity the Treasury has said every taxpayer must report on an accrual basis hereafter, and the Treasury has given those taxpayers a spread forward in order to prevent bunching up of that liability in a single year.

So this, in this bill, is the application of a pattern that has been existing for some time whenever this problem presents itself.

Is that fairly accurate?

Mr. LINDSAY. Yes, both the 1954 code and again the Technical Amendments Act of 1958, section 481, provided for such a spread.

Senator KERR. I wanted to say to the Senator, I was not putting myself in the posture of favoring any action the Treasury recommended——

Senator BENNETT. I understand.

Senator KERR. That would ease the pain to the taxpayer. I was just seeking an alternative which might be an acceptable gesture to the Treasury to persuade them to more appropriately ease the pain of the taxpayer in this other situation.

Senator BENNETT. I understand, but since the question was discussed, I felt that the Senator would be willing—this relation of accrual in this situation and the relation of accrual to other situations might properly belong in the record.

Senator KERR. Thank you.

In your statement you say: "The 1958 estimate takes no account of the tax on capital gains or distributions which might arise in future years."

Do you have an estimate of how much the gain from that will be when it becomes effective after, I believe, 1959 or after 1958, whichever one of the cases it is?

Mr. LINDSAY. Well, this last sentence refers to both the capital gains tax and also to the third step.

Now on the capital gains tax——

Senator KERR. My question is limited to the capital gains tax.

Mr. LINDSAY. On the capital gains tax we have no estimate. You will recall that the bill provides for a new March 1, 1913, basis rule brought up to date in 1958, so that a company selling property which it has held for many years and which has appreciated in value prior to 1958 would not have to pay a tax on that prior appreciation.

Now perhaps in the long haul, in the future some appreciable revenue will come from the capital gain provision. But in the early years we doubt that there would be much revenue involved.

Senator KERR. Don't you think that that will be the source of considerable revenue?

Mr. LINDSAY. Not immediately. The capital gains tax would be based only on appreciation occurring after 1958, and even so, it would not come in——

Senator KERR. Well, 1958 wasn't such a good year. I am sure that you regard it as a measure of tax revenue or you would not have recommended it to be in the bill.

Mr. LINDSAY. It was put in the bill more in terms of principle rather than in the belief that it really would produce a tremendous amount of revenue.

Senator KERR. Then you think that the capital gains revenue will not be consequential?

Mr. LINDSAY. It is hard to predict whether it will or not.

Senator KERR. Thank you very much.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Lindsay, in connection with that same question on capital gains, would the capital losses likewise be deductible?

Mr. LINDSAY. As in the case of other companies they would offset capital gains and be carried over.

Senator WILLIAMS. I understand from your statement, these gains would be measured in reference to the December 31, 1958, market value or cost, whichever is higher?

Mr. LINDSAY. That is correct.

Senator WILLIAMS. That December 31, 1958, value was practically at an alltime high, was it not, so far as securities are concerned?

Mr. LINDSAY. Well, it was the situation that existed for the first year in which this bill is intended to apply. Since the companies were never taxed on capital gains before, we thought we ought to tax them only on appreciations occurring after the date of the first year.

Senator WILLIAMS. I am not questioning that, but just pointing out that you are freezing them at the higher of either cost or of Decemer 31, 1958, price, which likewise was very high; is that correct?

Mr. LINDSAY. That is correct.

Senator WILLIAMS. Now suppose company X had securities, we will say, that cost $1,000.

The market from the present level could conceivably drop, and maybe they had a valuation as of December 31, 1958, we will say, of $3,000.

If they sell them at $2,000, they would still have $1,000 profit, but they would have $1,000 as a loss—a $1,000 loss for tax purposes; is that correct?

Mr. LINDSAY. No. The way this operates there would be no loss under those circumstances. It follows the March 1, 1913, rule; it must be a real loss before there can be a loss.

Senator WILLIAMS. It must be a real loss, that is the question I wanted answered. What basis do you use for the depreciation on capital assets in determining valuation?

Mr. LINDSAY. Adjusted cost; adjusted basis.

Senator WILLIAMS. If an asset is depreciated completely out, how would that figure?

Mr. LINDSAY. Well, for depreciation, adjusted cost is used, not the new step-up fair market values, if I understand your question correctly, and if it is depreciated down to nothing, its cost for depreciation purposes would be zero.

Senator WILLIAMS. In this bill—perhaps I did not catch it in your statement here—how do you feel about the tax liability on wholly owned insurance companies by credit unions?

Mr. LINDSAY. Those companies will be dealt with under phases 1, 2, and 3; phase 1 would have very little application to them, and 2 and 3 would force them to pay a tax.

Senator WILLIAMS. How are they treated under the 1942 formula or the stopgap formula?

Mr. LINDSAY. Under 1942 or stopgap, assuming those companies have very little or no investment income, they would be tax free, in a sense.

Senator WILLIAMS. How much revenue do you figure you are picking up in that direction?

Mr. LINDSAY. I am not sure of the amount. We do not have a firm revenue estimate.

Senator WILLIAMS. The question is often advanced, or the proposal has been suggested or advanced that this bill is not fair either to the mutual companies, and then the stock companies come in and say it is not fair to them.

Could you give us the percentage of revenue that was paid under the stopgap formula by the mutual companies, and the percentage of revenue that came from the stock companies, and then the same percentage broken down as to this bill?

Mr. LINDSAY. Under the stopgap, and also the 1942 formula, the mutual companies would pay roughly 75 percent of the tax, and the stock companies about 25 percent of the tax.

We have calculated under this bill that the mutuals would pay about 72 percent of the tax, and the stock companies about 28 percent of the tax.

I use these percentages with caution. It is possible that it would be 70 percent and 30 percent rather than 72 percent and 28 percent. It is a guess, but that is our estimate.

Senator WILLIAMS. What change do you make in the definition of investment income?

Mr. LINDSAY. One very important change is that we permit the companies to take the dividends received deduction, as other corporations.

Eighty-five percent of the dividends received the companies are permitted to deduct, so they are only taxed on 15 percent of dividends from other corporations.

Secondly, there is a change in a ceiling for deductions of investment expenses relating to mortgage fees, because it has been believed that companies that invest in mortgages have higher expenses than the present ceiling in the statute will allow; so there is a change in that ceiling.

I believe a difference between the 1942 formula and the proposed bill is the additional deduction for small business. Some sort of formula like that also appeared in the 1955 stopgap.

The accrual basis of taxing the insurance companies is another change.

Senator WILLIAMS. Do you have any change in your treatment of underwriting profits?

Mr. LINDSAY. The underwriting profit is the whole basis of phases 2 and 3.

Senator WILLIAMS. That is what I was coming to.

You are recommending that average income, averaging reserve basis should be used. Could you explain why you want it average on an industrywide basis rather than on a historical record of each individual company?

Mr. LINDSAY. You are referring to the measure of the taxable income in step 1?

Senator WILLIAMS. Yes.

Mr. LINDSAY. The average of the industry is only used if that exceeds the individual company's own assumed rate.

If we looked alone at the individual company's assumed rate, it would be true that a conservative company with a low assumed rate would be taxed more harshly than a company that was less conservative with a high assumed rate.

We tried to take account of that by providing that the company that has an assumed rate that is less than the industry average may pick the industry average.

It is in there as a relief measure.

Senator WILLIAMS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. I was just very much interested in the answer you gave to Senator Williams.

The one point of argument that seems to be coming into our offices is that the use of this assumed rate is not as satisfactory as the use of a 5-year average rate that many companies have proposed.

What is your answer as to why the Treasury likes this assumed rate rather than a 5-year actual average?

Mr. LINDSAY. The 5-year actual average assumes that the company needs what it has actually earned.

We assume it needs something between what they actually assumed they needed for solvency purposes and what they have actually earned.

Senator ANDERSON. But is it not the function of the board of directors of an insurance company to assume what they need?

Mr. LINDSAY. It is.

Senator ANDERSON. I am trying to find out why the Treasury pits its judgment against what the insurance companies decide they need.

Mr. LINDSAY. We look at the company's own judgment and take it into consideration.

The company assumes that it needs 2 percent for meeting its obligations, and we take that into account in trying to compute what the deductions should be to make sure that they could meet their obligations.

Now, it is true that two different companies, with operations that are exactly the same, with different reserve assumptions, will be taxed differently; not as great as would be the case if we did not have this mean between the earned rate and the assumed rate, but nevertheless there would be differences, and that is one of the reasons many do urge very persuasively that much is to be said for a formula that looks only at the earned rate for the 5-year average.

Senator ANDERSON. Does a formula which looks only at the earned rate tend to reward the company that is conservative in its investment operations?

Mr. LINDSAY. I do not know that that is true. I think there is an advantage in having high earnings, but I do not think it would have anything to do with their reserve assumptions.

I am not sure I answered your question.

Senator ANDERSON. Well, obviously these companies that are asking for the use of the 5-year average rate have something in mind.

Mr. LINDSAY. Well, part of it is the overall impact of the tax burden, because that would reduce the tax in step 1, to some extent, in the order of, perhaps, $50 million.

The figures are debatable.

Senator ANDERSON. In actuality that $50 million would probably be a reward for having a very conservative method of doing business, as against a more gambling type.

In life insurance, which is protection and savings, is it not desirable to do that?

Mr. LINDSAY. I think the tax law should be as neutral as possible in regard to conservative and unconservative practices as between different companies.

Senator ANDERSON. In your statement there is one sentence:

> On the other hand, in permitting a company to use its own assumed rate where it is higher than the industry average the bill provides for unusual needs of individual companies.

What do you mean by unusual needs of individual companies?

Mr. LINDSAY. Perhaps we should have said individual needs of the company. But presumably if a company was unconservative and had smaller reserves than many others in proportion to its business it really does rely on a higher assumed rate to meet its obligations, and ought to be allowed to take that into account in the deduction rate instead of being tied to the industry average.

Senator ANDERSON. It doesn't involve anything peculiar in the way they are doing their business, though?

Mr. LINDSAY. No.

Senator ANDERSON. You have a reference to these small companies. Much of the mail and most of the telegrams that come in are from smaller companies saying how badly they are being treated. I just wondered if the Senator from Oklahoma did not make a fairly good suggestion when he said if you are going to give them benefits up to this $25,000 why not make it take effect a little more rapidly so these small companies would think they had some help?

Do you strongly feel it ought to be $500,000 before they get $25,000?

Mr. LINDSAY. No——

Senator ANDERSON. Could it not as well be a hundred thousand dollars or $200,000?

Mr. LINDSAY. We support the bill. There are many provisions that are certainly worth further examination and consideration, and if the committee wishes to apply a more rapid rate for the assistance of small companies, I am sure that it would be acceptable to the Treasury.

Senator ANDERSON. I am only trying to point out some suggestions. As you may recall, I had some mild objections to the bill last year. [Laughter].

Mr. LINDSAY. I know that.

Senator ANDERSON. And I tried to point out that it was a retroactive tax rebate of $124 million, $115 million of which went to the 50 large mutuals and 25 large stock companies.

Now there were 1,100 more companies that shared in the $8 million, and they are relatively small companies. Some of them are pretty fair sized. If these 50 large mutuals and 25 large stock companies pay 90 or 95 percent of all the taxes, and you are trying to help the little ones, I like very much what you said in response to a question from Senator Kerr—and I hope I do not misquote you—that picking the right formula to produce a good fair bill is more important than a device to raise revenue.

If these small companies are protesting pretty strongly and feel they are being hurt, would it bother the Treasury very much if you said that this $25,000 could be earned out of the first $200,000 and instead of it being 5 it became 12 and 15 percent?

Mr. LINDSAY. I don't believe it would bother us very much but we would like to consider that further with the committee.

Senator ANDERSON. When you get down to trying to write the final bill, you sometimes take into consideration the people that are doing most of the screaming. I think most of them are these relatively small companies.

Is there anything sacred about $500 million?

Mr. LINDSAY. No.

Senator ANDERSON. I don't mean it that way, I am sorry; this time I said $500 million. The $500,000——

Senator KERR. You are talking about revenue.

Senator ANDERSON. Yes. This bill may achieve $540 million or $565 million. Mr. Lindsay, we would all like to see it get $500 million, that is from taking into consideration of the budget. But Senator Kerr referred to this pension situation. Is there anything sacred about $500 million except the budget has used that as an estimate of what this bill is going to return?

Mr. Lindsay, don't you go back to the statement you made that we ought to have a good fair bill and a right formula rather than shoot for the $500 million?

Mr. LINDSAY. I stay with that statement that a fair formula is more important than the exact revenue it provides. But I do think the revenue it produces is an element of what is a fair formula. [Laughter.]

Senator ANDERSON. I can only say, Mr. Lindsay, that all of us have a great respect for you. We all think you have made a fine contribution, but I do think in my mind you walked straight around the building that time. [Laughter.]

The two things are completely inconsistent and I judge from the look on your face that you recognize it. But I am very happy to have you speak frankly about it.

I want to say to you that I was very pleased by the statements you made that the goal was a good fair bill. Personally, I am a little like Senator Kerr and I do believe that the pension situation is driving business away from insurance companies into banking. I said to one of the members of the committee that I have had that come up in a little business with which I formerly was quite actively connected. We were ready to take out a pension program with an insurance company, and one of the directors said we had better take it out with a bank, it will be cheaper. Of course, he happened to be chairman of the board of directors of a bank [laughter]; he had an interest in it in a way.

But you have seen figures that indicate that only in 1950 the percentage of trustee plans against insured plans was about 50-50. Now only a little bit later it is about 45-55, and I understand that somebody from the Securities and Exchange Commission has estimated by 1965 it will be 20 from insurance companies and 80 percent trustees through banks. Most of the big businesses can probably do a pretty good job of their own trustee plans. But a small businessman, in the type of community that I live in, may not have the facilities for running his own program. I hate to see that type of business, which is so important to employees, move away from insurance companies if they want to take it. I personally follow the suggestion the Senator from Oklahoma was making: If it is right eventually to do it, and you are trying to get a bill that is right in its principles, we had better do it now even though we don't get the $560 million immediately

Mr. Chairman, I would enjoy questioning the witness for a great amount of time but I think he has made a good presentation and I think we had better go to other things.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. No questions.

The CHAIRMAN. Senator Smathers.

Senator SMATHERS. Not at the moment, Mr. Chairman.

The CHAIRMAN. Senator Butler.

Senator BUTLER. Mr. Lindsay, I want to call your attention to the tax-exempt interest provisions in the bill.

While in the first phase you deduct tax-exempt interest, you bring it back in the second phase and really tax it, do you not?

Mr. LINDSAY. We exclude tax-exempt interest in both phases of the bill, but we do make an adjustment to the deductions to avoid a double benefit or a double deduction.

Senator BUTLER. When you speak of a deduction to avoid a double benefit, you are in reality saying that you are charging a part of the operating expense against tax-free interest?

Mr. LINDSAY. Yes, I think that is probably a fair statement.

Senator BUTLER. Do you do that to any other taxpayer?

Mr. LINDSAY. With respect to tax-exempt income generally, yes; but not with respect to tax-exempt interest.

Senator BUTLER. Why do you tax that interest even partially?

Mr. LINDSAY. Because we think it is right. I cited a very simple example in the first step, it is an exaggerated example, but supposing there was a $100 of investment income and a 75-percent deduction so that only the balance would be taxed.

If $50 of the $100 was exempt interest and the other $50 was taxable interest, we should not deduct 75 from 50. We should reduce the 75 proportionately it seems to us. We are still giving benefit to the fact there is an exemption there.

Senator BUTLER. But you don't do that to any other taxpayer and, of course, it has no effect whatever on a company that does not hold municipal bonds. Haven't there been some decisions of the Supreme Court that would render such a provision in this bill unconstitutional?

Mr. LINDSAY. I think this question might very well be litigated.

Senator BUTLER. Do you feel that Congress should leave this provision in the bill with the chance that it will be litigated and probably taken out of the bill?

Mr. LINDSAY. There is a similar type of adjustment in the 1955 stopgap and also in the 1942 formula. This is done in a different way——

Senator BUTLER. Neither one of those acts have been tested, but this is the type of bill that may bring a contest because the tax bite is more secure.

Mr. LINDSAY. I feel that we should determine with the best advice we can, as to whether or not we today think such a provision is unconstitutional, and if we believe it is not, and if we believe the provision is right, we ought to include it in the bill.

Senator BUTLER. Well, there have been two cases, that you certainly know about, that would strongly suggest that the taxation of this interest in any respect may violate the Constitution of the United States.

There is another phase of this question that I don't want to get into at the moment, but if you start to partially tax municipal bond interest in the hands of life insurance companies, why shouldn't you take the next step and tax it in the hands of the individuals?

Mr. LINDSAY. There are many provisions in this bill that we could not and would not want to apply to an individual or another kind of a business. This bill is tailormade pretty much to the life insurance business and the special adoption——

Senator BUTLER. Well, it should not be tailored so as to embody doubtful legal provisions. I think we should have a bill which is a good bill and I think we should have a bill that has no such provision in it.

I feel, as I have said, that the Supreme Court has been critical of this Congress for legislating in areas such as this. In addition we cannot rely upon the Supreme Court of the United States reversing two previous decisions on this point, and I feel that the Treasury should give this serious consideration.

The CHAIRMAN. Has the Senator concluded?

Senator TALMADGE. I would like to bring up two points upon which we have received inquiry in our office: One is in reference to new and small companies which have been started in the last 2, 3, or 4 years. The general trend in the insurance business, due to the high acquisition cost of insurance, is for beginning companies to lose money of the first 5, 6, 7, 8, or 10 years.

Some of these companies take the position that they ought to have a greater carry-forward ratio to take advantage of the provisions of this bill inasmuch as they can't carry back the losses beyond 1958.

Would there be any objection by the Treasury on that point?

Mr. LINDSAY. Well, that is a question that would be of equal interest to any new business, any corporation. Here we are attempting to put the insurance industry on the same basis as other corporations with a 3-year carry back and a 5-year carry forward.

I think that a very long period of carry forward raises administrative problems, also problems of acquisition of loss companies and the like. We would certainly consider that but I would not like to endorse it now.

Senator TALMADGE. You are proposing a new provision to tax insurance companies on their so-called underwriting profits. Some have had underwriting losses all these years and paid taxes on investment income at the same time. Is there any reason why they should not be allowed, when they get into more profitable years, to carry forward their losses to those profitable years to take care of their underwriting losses when they began?

Mr. LINDSAY. Well, it depends on how far you would want to carry the thing, Senator Talmadge. I think it is fair to point out that these new companies that are operating under a loss, if they have investment income today they are paying a tax even though they are deficit companies whereas under this bill they would be permitted to have a loss and not be taxed and to carry over the loss for at least 5 years.

Senator TALMADGE. But shortly they hope to be in a profitable bracket. What they would like to do is to exercise those profits that they hope to make in years to come against the losses that have already taken place and in some instances paid taxes on.

Senator ANDERSON. But they won't know, will they?

Mr. LINDSAY. But they won't pay a tax if they have a loss under this provision.

Senator TALMADGE. Under the present law there are taxes on investment income even though they are losing money.

Mr. LINDSAY. Yes; that is one reason we want to see a change.

Senator TALMADGE. Their contention is, as they move into profitable years on their operating gain they ought to be able to apply these profits against losses sustained in the formative years when they had operating losses but paid taxes on investment.

Mr. LINDSAY. That is right.

Senator TALMADGE. Do you see any objection to that?

Mr. LINDSAY. We have strong reservations on it, but we would like to explore it further.

Senator TALMADGE. You explore it and give us your thoughts on it.

Mr. LINDSAY. Yes.

Senator TALMADGE. Fine.

There is one other thing in following up the question that Senator Butler asked, I have had reports in my office that very strongly contend under this proposed insurance tax law that tax-exempt obligations are, in fact, taxable. They say that, if it is true, it will be the only phase of business where tax-exempt obligation would be taxed. They say, for instance, that if the individual, company, corporation, bank or any other business owns tax-exempt municipals they will not be taxed.

They contend that under this insurance bill, which we are asked to report to the Senate, that those obligations will be taxed. Now as I understand it you take the position they are not taxable.

Mr. LINDSAY. That is correct.

Senator TALMADGE. Why aren't they taxable under the operating gain, for instance?

Mr. LINDSAY. They are excluded from income.

Senator TALMADGE. In other words, no element of any tax-exempt obligation could be considered in any of these three phases.

Mr. LINDSAY. To the extent that there is a deduction, a reserve deduction which is based in part upon tax-exempt interest, that deduction is reduced, but the income side does not include the tax-exempt interest.

Senator TALMADGE. One of my constituents goes so far as to make this assertion: Under present market conditions, taxable utility bonds are currently offered to yield about 4.6. Under the proposed new tax bill in order to be comparatively attractive municipal bonds would have to yield approximately 4.10. This excludes the great bulk of municipal bonds currently being offered in the range of three, three and three-quarters. If full tax-free status is granted his company would be interested in this type of security, on yields as low as approximately 3½ percent.

If his contention is correct, that will vastly affect the market authority of the county bonds and others. You say he is totally in error on that.

Mr. LINDSAY. I suggest that as the revenue and tax burden increases through this bill over the situation as it existed before, for certain companies there is more of an advantage to having tax-exempt securities than there was before.

Senator TALMADGE. You think then he is totally wrong in his assertion with reference to this?

Mr. LINDSAY. I would not suggest that he is totally wrong. I think he is basing his argument on the manner in which we adjust certain deductions. It is our belief that we afford full exemption to tax-exempt interest and at the same time we avoid a double benefit.

Senator TALMADGE. What does he have reference to when he contends that these obligations would be taxable? This particular company has about 10 percent of their reserves in tax-exempt obligations which I believe is some 4 or 5 percent higher than the industry.

Mr. LINDSAY. I think he has reference to the fact that there is an adjustment downward of the reserve interest deduction.

Senator TALMADGE. Under what phase of the bill?

Mr. LINDSAY. Both phase 1 and phase 2.

There is no problem in phase 3. There is no adjustment downward there.

Senator TALMADGE. How would it differ with an insurance company and a bank, for instance?

Mr. LINDSAY. The bank does not have to allocate expenses to tax-exempt interest——

Senator TALMADGE. In other words if a bank bought a hundred thousand dollars worth of tax-exempt bonds and paid, we will say 3½ percent, they would automatically get a deduction of $3,500.

Mr. LINDSAY. Yes.

Senator TALMADGE. Is that correct?

Mr. LINDSAY. They get an exclusion. There is a provision in the tax law, section 265, which generally disallows expenses relating to tax-exempt income. But an exception is made for interest.

Senator TALMADGE. Was my statement about that correct? They would not pay taxes on any portion of that $3,500 interest-free money that they received from the hundred-thousand-dollar investment, would they?

Mr. LINDSAY. Yes; your statement is correct.

Senator TALMADGE. How would that work with reference to an insurance company?

Mr. LINDSAY. The insurance company would not——

Senator TALMADGE. Assuming they also had a hundred-thousand-dollar investment in 3½-percent tax-exempt bonds, and received an income from that of $3,500, how would their treatment differ from a bank's?

Mr. LINDSAY. Let's say all the insurance company had was tax-exempt interest, to take a very simple example. There would be no tax.

Senator TALMADGE. None whatever?

Mr. LINDSAY. None whatever.

Senator TALMADGE. Could it ever arise under any contingency whatever?

Mr. LINDSAY. Neither would there be a loss created by the deduction related to that tax.

Senator TALMADGE. In other words, you can't use interest-free money to set up your reserves, or how did you answer that?

Mr. LINDSAY. You can use interest-free money. That would be deducted in computing the reserves, but your deduction is adjusted downward to the extent that it relates to tax-exempt income.

Senator TALMADGE. Would that make that portion of the income ever taxable under any conditions?

Mr. LINDSAY. That is the heart of the argument. We would contend not. Others contend yes.

Senator TALMADGE. In other words, that is where the difference is.

Mr. LINDSAY. Yes.

Senator TALMADGE. Suppose that I have other investment income in addition to bonds.

Mr. LINDSAY. I gave the example of $50 of tax-exempt income and $50 of taxable income. Compare that with a situation in which you have $100 of taxable income. If you have $100 of taxable income, the deduction under the bill might be, say, 75 percent, so that only 25 might be taxed.

Under our bill, however, we would not subtract the $75 from the $50 in the first example to create a loss. We would deduct something in the order of $37 or $38 and still tax a lesser amount. The deduction is reduced proportionately to the extent that it relates to tax-exempt interest. Otherwise you are giving a double benefit by not taxing the income in the first place, and yet giving a deduction of expenses relating to that tax exemption.

Senator TALMADGE. How does he make the flatfooted assertion that it makes the tax-exempt municipal bonds under this proposed bill fully competitive to the utility bond that yields 4.6? The interest rate would have to be as high as 3.75 on the tax-exempt obligation, or even 4.10.

Mr. LINDSAY. I don't know how he makes that assertion.

Senator TALMADGE. He takes the position that if this bill is passed municipal tax-exempt obligations will have to bring on the order of 4.10 to be as attractive to an insurance company as a taxable utility bond that earns 4.6 at the present time.

Do you take the position that this gentleman is misinformed, or there is some bug in this bill? I still don't understand. [Laughter.]

Mr. LINDSAY. I think the same kind of an adjustment is made in the 1942 and 1955 stopgap law. We do it in a different way, but you achieve the same results. It is a little surprising to me that so much is made of this point.

Senator TALMADGE. It would be a very important thing not only to insurance companies but to counties, States, and municipalities that build hospitals, school buildings, and things of that type, if they suddenly found their interest rate raised to the degree of maybe three-quarters of 1 percent. This being true when trying to be competitive in the market when selling their obligations. This is important not only to the insurance companies and the taxpayer, but it is of vast importance also to those subdivisions of State governments in States at the present time which have tax-exempt status.

I think we ought to make it uniform if we are going to attempt it, and I don't think we can constitutionally, under the present law, tax obligations of States, counties and municipalities. I certainly think we ought to make it uniform and operate it in the same way with reference to an individual taxpayer, a bank, a casualty company, and others, as we would to an insurance company.

I don't think we ought to try to tax it in part on one hand and totally exempt it on the other hand. I would appreciate it if you would look into this matter.

Mr. LINDSAY. We will reexamine this whole subject.

Senator TALMADGE. Give me a detailed explanation of its ramifications.

The CHAIRMAN. I would suggest that that be made a part of the record at this time.

(The information referred to follows:)

TREATMENT OF TAX-EXEMPT INTEREST RECEIVED BY LIFE INSURANCE COMPANIES UNDER PRESENT LAW AND H.R. 4245

H.R. 4245 provides for the exclusion from taxable income of interest on wholly tax-exempt securities. This exclusion or deduction applies in all phases of the computation of the proposed tax base for life insurance companies. Like present law and previous formulas, H.R. 4245 provides adjustments in the deduction for required interest to prevent a double deduction. A similar adjustment is provided in the case of the 85 percent intercorporate dividend deduction and partially tax-exempt interest. In the absence of such an adjustment, the same item of income would be exempted twice, once when received and again when included in the interest needed to meet reserve and other policy obligations. With this adjustment, no tax is imposed at any step on tax-exempt interest but a double benefit is not allowed.

Section 265 of the Internal Revenue Code provides in general that no deduction shall be allowed for expenses and interest relating to tax-exempt income. In the case of expenses, a specific exception to the rule is made for amounts allocable to wholly tax-free interest. The provisions of H.R. 4245 are consistent with the general treatment to the fullest extent practicable within the framework of the special tax situation of life insurance companies. Thus, the bill provides no disallowance of expenses allocable to tax-free interest. It permits the full deduction of investment expenses in step 1 and of general operating expenses in step 2, without regard to whatever portion may be attributable to tax-free income.

In the case of interest on reserves invested in tax-exempt securities, H.R. 4245, like present law and other recent formulas, makes adjustments to prevent double deductions. The need for such adjustments has been recognized and provisions to prevent a double deduction have been a traditional part of the tax law applicable to life insurance companies, in view of their special circumstances and the special taxing formula applicable to the industry.

To make the adjustment, the bill provides a proportionate reduction in the policy and other contract liability deduction in step 1 and in the deduction for reserve interest and interest paid in step 2. This reduces these deductions to the extent they relate to tax-exempt interest which has already been deduced or excluded in arriving at taxable investment income and net gain from operations.

The treatment of tax-exempt interest and the adjustment to prevent a double deduction under the bill may be illustrated as follows. Assume, for example, that a life insurance company has net investment of income of $100 (including tax-exempt interest), tax-exempt interest of $10, and a reserve and other policy contract interest liability, computed prior to adjustment of $75 or 75 percent of the net investment earnings. The company's tax base for step 1 under H.R. 4245 would be computed as follows:[1]

| | |
|---|---|
| Net investment income | $100.00 |
| Deduct tax-exempt interest | 10.00 |
| Taxable net investment income | 90.00 |
| Reserve and other policy contract liability deduction: | |
| Deduction rate times adjusted reserves | $75.00 |
| Less proportionate adjustment for tax-exempt interest previously deducted (75 percent times 10) | 7.50 |
| Deduction | 67.50 |
| Step 1 base | 22.50 |

As shown in the example, the final deduction for reserve and other policy contract liability bears the same ratio ($67.50 divided by $90 or 75 percent) to the taxable net investment income, after deducting tax-exempt interest, as the unadjusted reserve and other policy contract liability bears to the entire net investment income including tax-exempt interest. If all of the investment earnings of the company illustrated here were from taxable investments, the deduction for reserve and other policy contract liability would have been $75 or 75 percent of the entire investment income, leaving $25 subject to the regular corporate tax rate. By having 10 percent of its investments in tax-exempt securities the company would have a tax base of 10 percent less than if its investments were all in taxable securities.

If half of the investment earnings in the above example were from tax-exempt bonds, the deduction would be 75 percent of the remaining $50 taxable investment income, or $37.50, leaving $12.50 in the step 1 tax base. Without the adjustment, the taxpayer in this situation would have deductions totaling $125 against $100 of income, leaving a deficit for tax purposes of $25.

In effect, the adjustment of the reserve and other policy contract liability under H.R. 4245 apportions the deduction for required interest between taxable and tax-exempt investment. It eliminates the portion allocable to tax-exempt interest which has already been deducted from the taxable investment income.

The adjustment to prevent double deductions under H.R. 4245 is virtually the same in effect as built-in adjustments for the same purpose under present law (the 1942 formula), the 1955 stopgap, the 1950 formula, and the flat rate tax of 6½ percent (equivalent to an 87½ percent deduction under the 1950 formula) applicable in the period 1951-54.

In connection with the adoption of the 1942 formula for the taxation of life insurance companies, the Ways and Means Committee "Report on the Revenue Bill of 1942" stated in part that it "substitutes for the existing reserve and other policy liability deductions a flat percentage of income. This percentage represents the average of the aggregate deductions of all companies for the preceding year, computed under a formula which has the effect of reducing the reserve earning deduction and eliminating the double deduction of tax-exempt interest."[2] The final legislation in 1942 retained the treatment described in the Ways and Means Committee report.

In 1958, for example, the 1942 formula permits each life insurance company a deduction of about 75.5 percent of its taxable net investment income. The 75.5 percent deduction figure represents the ratio (on the basis of industrywide data for 1957) of the interest needs of the industry, computed under the statutory formula, to the entire amount of its net investment income, including tax-exempt interest. As the 1942 formula applies to a particular company, if the company receives $100 of tax-exempt interest, it deducts that amount in arriving at its taxable investment earnings. In so doing, the company automatically reduces its reserve and other policy liability deduction by $75.50, since it does

[1] The adjustment illustrated here would be carried out in the same way in step 2. In step 2, the reserve interest deduction would be based entirely on the rate actually assumed by the company and the proportion used in making the adjustment would reflect the ratio of the actual interest increment on reserves to actual earnings.

[2] "The Revenue Bill of 1942, Rept. No. 2333, House of Representatives, 77th Cong., 2d sess., p. 27.

not receive the 75.5 percent deduction with respect to the $100 tax-exempt interest which it would have been allowed if the $100 had been obtained from ordinary taxable investments.

The 1950 formula used the same procedure as the 1942 formula. The 1951 law was in effect identical with the continued application of the 1950 formula in 1951–54 with an 87½ percent deduction based on 1950 conditions.

As indicated above, the adjustment to prevent a double deduction occurs automatically under the present law and previous formulas. Since the deduction for required interest under H.R. 4245 is based on reserves in accordance with the circumstances of the individual company rather than on a flat percentage of taxable investment income based on industry average conditions, the method of making the adjustment under the bill differs in superficial respects. However, if desired, the same mechanical procedure for eliminating a double deduction for tax-exempt interest used under the present law (the 1942 formula) could be adapted to the determination of the taxable investment income margin and the net gain from operations under steps 1 and 2, respectively, of H.R. 4245.

Under both present law and H.R. 4245, a life insurance company which invests its entire investment portfolio in tax-exempt securities would have no Federal income tax liability whatsoever with respect to its investment earnings. If a company derived 25 percent of its investment earnings from tax-exempt securities, its tax liability with respect to investment earnings would be 25 percent lower under either formula than that of an otherwise, similarly situated company whose entire portfolio consisted of taxable securities. Similarly, a company with half of its investment earnings from tax-exempt sources would pay one-half as much tax under either present law or H.R. 4245 with respect to its investment earnings as one similarly situated except that its investments were solely in the form of taxable securities.

Since the effective rate of tax under H.R. 4245 is generally higher than under present law (with exceptions and variations depending upon the circumstances of individual companies) the value of the tax-exempt feature of municipal securities in the hands of life insurance companies would generally be greater under the bill than under present law. The attractiveness of municipal securities to life insurance companies as a whole should accordingly be enhanced and the market for such securities to that extent should be greater.

Average prices for municipal securities have shown no significant variation since the introduction and consideration of H.R. 4245 by the Congress. For example, the yield basis of high-grade municipal bonds (Standard & Poors') was 3.86 percent as of the week ended January 3, 1959. The yield basis for such securities was 3.74 percent for the week ended March 7, 1959. There was no significant fluctuation in the yield basis or prices of municipal securities during the intervening period.

The proposal to eliminate the adjustment for double deductions under H.R. 4245 would provide an extraordinary benefit for tax-exempt interest in the hands of life insurance companies. For example, if the adjustment were eliminated, a life insurance company whose required interest was about 75 percent of its investment earnings would be in position to take an initial $100 deduction for each $100 received on tax-exempt securities and an additional deduction of $75 for the same interest added to policy reserves. The suggested removal of the adjustment would make it possible for a company in this situation to achieve complete exemption from Federal income tax with respect to its investment earnings by investing about 25 percent of its portfolio in municipal securities. Under these circumstances, the company would be enabled to deduct the entire 75 percent of its investment earnings arising from taxable investments in the form of required interest.

In brief, the proposal to eliminate the adjustment for double deductions would in effect apportion taxable investments to policy reserves and the tax-exempt investments to surplus funds. The deduction for required interest would thus be allocated to the maximum extent to taxable earnings while the deduction for tax-exempt interest would be allocated to the maximum extent to the taxable surplus margin of earnings above interest requirements. Such treatment would be unrealistic. It would result in an unusual tax advantage for life insurance companies by virtue of their unique taxing formula.

Certain constitutional arguments have been raised with respect to the adjustment, based in large part on a 1928 Supreme Court decision in *National Life Insurance Company* v. *United States* (277 U.S. 508). This case held (Justices Holmes, Brandeis, and Stone dissenting) that section 245(a) of the 1921 Life

Insurance Tax Act was unconstitutional in that it indirectly imposed a tax on income from tax-exempt securities by reducing the reserve interest deduction by the full amount of the tax-exempt income.

The net effect of the 1921 act, unlike the present H.R. 4245, was in many cases to impose exactly the same tax on a life insurance company whether or not it had tax-exempt interest. While the trend of more recent decisions in the Supreme Court casts considerable doubt on the constitutional aspects of the National Life case, it is important to note that the law there was different from the present proposal.

In any case, the constitutionality of the method used in the 1942 formula and other subsequent formulas to prevent a double deduction has not been challenged. The adjustment in the bill is in substance the same as that in the 1942 formula.

It is estimated that the removal of the adjustment to prevent a double deduction for tax-exempt interest under H.R. 4245 would reduce the revenue produced on the 1958 income of life insurance companies by about \$35–\$40 million. If the adjustment were similarly removed with respect to the intercorporate dividend deduction, it would reduce the revenue at 1958 levels by another \$55–\$60 million, or a total of about \$90–\$100 million. In future years, the resulting revenue decreases would be substantially greater as life insurance companies acquired additional tax-exempt or stock investments because of special tax considerations.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Thank you, Mr. Chairman.

Mr. Lindsay, you have given us a very well-prepared statement. I do have a question or two.

Would the Treasury be opposed to the company-by-company actual earned interest rate over a period of 5 years, as against the modification thereof in the bill, if it were not for the fact that it would produce less revenue?

Mr. LINDSAY. We support the provision in the bill. That is not to say that we would oppose the adoption of the 5-year average, even though it would produce less revenue.

Senator CURTIS. I am not asking whether you would support the less revenue. But if your reason for preferring the language that is in the bill because it produces more revenue, do you have objections to the company-by-company basis of 5 years?

Mr. LINDSAY. We thought that some consideration should be given to the company's own assumptions, which would be altogether ignored in the 5-year earned rate average system, and so there was some theoretical justification in our minds for the formula used in the bill, wholly aside from revenue.

Senator CURTIS. But it does produce more revenue?

Mr. LINDSAY. It does produce more revenue. I might say that the 5-year average produces more revenue than if you looked at just the individual years.

Senator CURTIS. I think perhaps that was the reason that the 5 year was mentioned, was because it would bring in more revenue.

Mr. LINDSAY. Yes.

Senator CURTIS. But do you have objection to a change other than its effect on the budget, the revenue?

Mr. LINDSAY. Well, one thing I think I mentioned before was the principle of assuming that the company needs what it actually earns. But we don't have strong objections to that formula.

Senator CURTIS. Pardon me, did you finish?

Mr. LINDSAY. Yes.

Senator CURTIS. In your statement you have, "or the industry assumed rate, if higher."

How do you determine the industry assumed rate? Do you take a list of all of the 1,300 companies and add up their assumed rate and divide it by 1,300, or do you weight according to the business done?

Mr. LINDSAY. We look at the year before.

Senator CURTIS. You take it the year before?

Mr. LINDSAY. Yes, and it is a weighted average.

Senator CURTIS. Weighted with what factors?

Mr. LINDSAY. By the reserves.

Senator CURTIS. Reserves, or volume of business?

Mr. LINDSAY. Reserves.

Senator CURTIS. I asked about this yesterday, but we were not on the record. You would be very helpful to me if you would state what you regard is a policy dividend.

Mr. LINDSAY. It is a payment to the policyholder of a participating contract. And it may be——

Senator CURTIS. Is it an actual, is it always an actual payment in cash by the transmission of a check?

Mr. LINDSAY. I don't think necessarily.

Senator CURTIS. What companies pay it?

Mr. LINDSAY. Mutual companies almost always do, and some stock companies have participating contracts also and pay dividends to policyholders.

Senator CURTIS. Stock companies pay participating dividends, and practically all mutuals?

Mr. LINDSAY. Right.

Senator CURTIS. Is it an adjustment of the premium, in your opinion?

Mr. LINDSAY. In my opinion it has two elements to it: Adjustment of the premium, return of capital, and also perhaps payout of part of the earnings on the investment of the premium.

Senator CURTIS. Do you care to express an opinion as to what portion might be an adjustment of cost, and what portion might be some form of earnings?

Mr. LINDSAY. I think that is a very difficult measure to——

Senator CURTIS. Would it be fair to assume that the greater part of it is an adjustment of premium?

Mr. LINDSAY. I think it is fair to assume that the greater part is adjustment to the cost.

Senator CURTIS. In part, that is an adjustment of premium costs. Is that based upon the long run or, say, a short term, on an annual basis? Do you know what the practice is in insurance circles on that?

Mr. LINDSAY. I think they take quite a long view of the situation. It is a longrun picture.

Senator CURTIS. In other words, the insurance has a certain price, and then they apply policy dividend that lowers that price, but in arriving at that dividend, they figure it over a long period of time, is that correct?

Mr. LINDSAY. I believe so.

Senator CURTIS. Yes.

So it ends up so that policyholders pays the lesser amount, does he not?

Mr. LINDSAY. Yes.

Senator CURTIS. Now, if it is determined in the long run the question of whether or not a policy dividend should be paid, then a policy dividend might be paid in a year when there is no profit under that, no profit to a company; is that not so?

Mr. LINDSAY. Whether there is a profit from underwriting or not depends on whether you are talking about net gains from operations including underwriting before dividend to policyholders, or after dividend to policyholders.

Senator CURTIS. I am assuming, and I agree with you that the greater portion of this policy dividend is a premium adjustment, and it is figured on the long-term basis, and that they might allow that policy dividend in a year that they didn't have a profit; isn't that true?

Mr. LINDSAY. Didn't have a net operating gain——

Senator CURTIS. Yes.

Mr. LINDSAY. At all?

Senator CURTIS. Yes.

Mr. LINDSAY. I wouldn't know whether a dividend would be paid under those circumstances or not. I would be willing to assume it for purposes of your example, but I just dont' know.

Senator CURTIS. If it were paid, and it were justified as good insurance practice over the long run, then you could have a situation where a company would pay a tax, even though they had no gain?

Mr. LINDSAY. Because the dividend does not reduce the investment income base.

Senator CURTIS. Yes. So you could have a situation in this bill as written where you would have a tax with no gain?

Mr. LINDSAY. I think you have to make some assumptions to reach that conclusion. And I don't know whether or not dividends would be paid to policyholders where there is no gain. I just don't know that.

Senator CURTIS. Well, I can conceive of a small company that would very conservatively work out what, over a long run, they can allow as a policy dividend or, in other words, arrive at the net cost of insurance, yet they want to get some new business, and it costs more money to get this new business than they take in during the first year. They may wish to advertise, they may wish to do other things where they would have legitimate expenses that would wipe out their gains, and if they would depend upon the treatment in this bill of a policy dividend as to whether or not they would pay a tax when they didn't have a gain; wouldn't they?

Mr. LINDSAY. Yes.

Let me say if the first step measure of investment income were very, very harsh, say it permitted only a 50-percent deduction, then in almost every case you would be taxing mutual companies on far more than their gains from operations even where they have a loss. If it is very light, it would be unlikely that that would occur, so we have to be careful in our judgment as to how we measure that first step.

But I am concerned about the possibility of, in effect, in part destroying this first step by permitting it to be reduced by dividends to policyholders.

Senator CURTIS. Well, maybe it should not be reduced by the entire amount, I don't know. But what is the tax effect where a stock company has a loss in their operating income? In what situations does that lessen their tax under phase 1?

Mr. LINDSAY. That would lessen the tax under phase 1 to the extent of 100 percent of the loss.

Senator CURTIS. And that you are speaking of situations where they charged in the first instance the real cost of the premium?

Mr. LINDSAY. Yes.

Senator CURTIS. But the company that goes through the operation of asking, that ends up by charging, say, the same amount would get a different tax treatment?

Mr. LINDSAY. If the company that charged the larger premium and then adjusts as it goes along, can do so to the extent of reducing its tax without limitation, it might find it is in a very strong position of competitive advantage as compared with a stock company.

Senator CURTIS. How could a company improve its position by selling insurance for less than cost?

Mr. LINDSAY. I have difficulty with the assumption that a dividend will be paid in a loss situation.

Senator CURTIS. But suppose by declaring a dividend what you do is you lower the cost of the insurance, and if you lower it below what it takes to provide it, how does that improve the insurance company's position?

Mr. LINDSAY. It wouldn't, but if the dividend— —

Senator CURTIS. Therefore, I could see no incentive to do it for tax purposes, because there would be no way by which they could gain.

Mr. LINDSAY. Well, if there was not a loss situation there might be an incentive, more of an incentive than there is today to increase the dividends to policyholders, if by so doing you could get a tax advantage.

Senator CURTIS. I can't see how there would be more of an incentive there than it would be an incentive for a company that charges the net cost of reducing that below what it would cost to provide the protection.

Mr. LINDSAY. The bulk of the dividends to policyholders operate now as a deduction under phase 2. There is only a very small margin left over.

Senator CURTIS. In other words, we are talking about a rather small situation; aren't we?

Mr. LINDSAY. I believe we are.

Senator CURTIS. Both in the practice and revenuewise; isn't that correct?

Mr. LINDSAY. Well, revenuewise we may be talking in the order of what, $70 million?

Senator CURTIS. $70 million.

Mr. LINDSAY. $70 million.

Senator CURTIS. Is that high?

Mr. LINDSAY. If you gave full deduction for dividends to policyholders, I think it would probably be that.

Senator CURTIS. For the most part unless they have an operating loss they are going to get that anyway. They are going to get to deduct their policy dividends for the tax in phase 1.

Mr. LINDSAY. I am talking about this small amount that is not now deducted, because you have eliminated phase 2 under the bill with your deductions. We are talking in the order of maybe $70 million.

But in the future perhaps the dividend payments would be stepped up, not by all companies but the few that might be in position to do so, because they have large surpluses.

Senator CURTIS. Is it your opinion that to give the same negative offset to the mutuals and the participating stock companies as is given to the other stock companies would cost $70 million?

Mr. LINDSAY. That is the figure I gave you.

Senator CURTIS. That is a little high.

That is all, Mr. Chairman.

The CHAIRMAN. Senator Frear.

Senator FREAR. Mr. Lindsay, I only have two or three questions, and they, I am sure, are basic to you. But I think it would be helpful, for myself and maybe others, if you would give us, please, very briefly the history of this bill from last April.

Mr. LINDSAY. Following the extension of the stopgap and the public hearings in March before the Senate Finance Committee, the Treasury in April submitted a letter to the chairman of this committee and the chairman of the Ways and Means Committee, outlining proposals for taxing life-insurance companies on a permanent basis.

The first proposal was a proposal that life-insurance companies be taxed on a net operating gain or total income approach.

That would be somewhat similar to this bill, if you didn't have the 50-percent deduction for the amount in excess of phase 1, and if you did not have a step 1.

At that time the Treasury, as it had before, consulted with representatives of the industry, discussed problems under the approach suggested, and finally came to the conclusion that a pure total income approach would work very harshly against the stock companies, and developed this combination formula. The basic structure of the bill, without its details, were discussed with industry representatives and with the joint committee staff, and suggested in public hearings by Mr. Scribner in November. It was based on that that the Ways and Means Committee went forward, and after discussing other alternatives, came to the conclusion that this combination formula, the structure of this bill, probably had the best chance of success as the fairest way of coping with a very difficult problem, not that it is perfect, but that it seemed to be the best available suggestion to date. There was left the problem of determining the details of the bill, how to measure the investment income in the first step, and so forth.

Senator FREAR. In this industry council, were small and large stock and mutual companies represented?

Mr. LINDSAY. We have seen individually, representatives of individual companies, including some small companies and specialty companies, but on the whole we have dealt with the representatives of the two large associations, which represent the bulk of all insurance companies.

Senator FREAR. Do I take it from what you have said that in general the group of insurance companies, both associations and their members, are in agreement with the legislation now before us?

Mr. LINDSAY. I think I would like to hear what they say in public hearing tomorrow and the rest of this week before I predict what I think they are going to say.

Senator FREAR. I did not mean to put you on a spot, Mr. Lindsay, but I am rather serious about the question.

What I am trying to find out is, in these conversations with the Treasury Department, the joint staff, and the members of the industry, in general, do I correctly understand that the members of the industry recognize that the insurance companies had a fairly easy affair, as far as taxes were concerned, and that they admit this even though they didn't want any more taxes extracted than were necessary, but this was at least a plane on which most of the industry was in agreement?

Mr. LINDSAY. I very definitely have that impression. There are some exceptions among people in the industry who think that the bill is too harsh, and that we should just go along with the stopgap. But, on the whole, I believe that many responsible elements in the industry, people with whom we have dealt, feel that this bill in its overall structure is a reasonable approach to the taxation of life insurance companies.

I don't think they like the first step as it now appears in the bill. They would much prefer to see the 5-year average device, and there may be some other detailed things that they are particularly interested in, but, on the whole, I think they think the bill is an acceptable, fair bill.

Senator FREAR. Well, from these conferences then, I gather that the insurance companies, through their associations, did give you the idea, that is you, the Treasury, and the joint committee staff, that this first step was not entirely to their liking, or they thought it might be improved upon.

Now, in what step between then and the bill as it came before the House did the Treasury enter this item, or make this change in phases 1, 2, and 3, or any others?

Mr. LINDSAY. From the point of time, I am not sure that I recall, but I think this provision was drafted in the subcommittee print; the subcommittee of the Ways and Means Committee prepared a report and the subcommittee print bill. It was then discussed by the Ways and Means Committee as a whole, and this particular measure of the investment income appeared in the final bill.

It was worked out in its details in the Treasury, but we were consulting with the joint committee staff and others as we went along.

Senator FREAR. Who are "others"? Was the industry invited in on this?

Mr. LINDSAY. At that time, no, because at that time our discussions were confidential.

Senator FREAR. Yes; I understand.

Then following today's session of the Finance Committee will be the first opportunity that the industry will have to give its expressions either privately or publicly.

Mr. LINDSAY. Publicly, the first opportunity. I think privately they have already expressed themselves on it. [Laughter.]

Senator FREAR. I am sure you are not referring to any members of the industry seeing any members of this committee. [Laughter.]

Mr. LINDSEY. I didn't have particular reference to that in mind.

Senator FREAR. What other, if any, gimmicks have been added to this bill or detached from the original suggestion when you, the Treasury that is, and the joint committee staff and the industry had their meetings? Are there any major changes in this legislation as it now appears, and if so have they been made in the last 60 days?

Mr. LINDSAY. Well, the third step was not in the subcommittee print and is entirely new. But such a step had been proposed by elements in the industry, itself, some time ago, not as a supplement to phase 2, but as a substitute for phase 2. In other words, just investment income, and then the third step and that would be the bill. That is where that idea was first suggested.

The subcommittee print, as I recall, did not include the 10 percent deduction for increases in nonparticipating reserves, but consideration of that was suggested in the Secretary's letter of April 1958, and that kind of a deduction had been discussed all along. It didn't appear in the first bill, but was finally adopted and accepted by the Ways and Means Committee.

Also, the deduction for 2 percent premiums on group policies was not in the subcommittee print. It was put in later, and it is something that the industry has been asking for all along.

I think that is about it.

Senator FREAR. I thank you, Mr. Lindsay, and I want to say that I think you gave us yesterday and again today in your report to this committee a fair and thorough analysis. At least as a layman, I have understood it. I know that the witnesses who are coming up in the next few days before this committee are going to have specific questions that they will want answered, and they will pose to this committee certain problems that they are going to ask for relief on.

It is my understanding that it will be the intention of the Treasury Department to have representatives here during that testimony, and I expect that I will be given the privilege of asking you and your associates in the Treasury how at least one member of this committee can best get information to solve whatever problems may arise, sir.

Mr. LINDSAY. Yes.

Senator FREAR. That is all, sir.

The CHAIRMAN. Mr. Lindsay, in connection with the questions asked by Senator Frear, in these conferences with the industry, was there any expression of approval of continuing the present law? the 1942 formula?

Mr. LINDSAY. By whom?

The CHAIRMAN. By any of the industry that you conferred with.

Mr. LINDSAY. I would say no. I am sure there are some insurance companies who would prefer to see the present law extended, but those would be companies that have very little investment income and therefore escape taxation.

The CHAIRMAN. There were no recommendations made to you to continue the present law?

Mr. LINDSAY. No.

The CHAIRMAN. Senator Hartke.

Senator HARTKE. In regard to section 815 of the act, which deals with distribution to the shareholder, does this section impose a penalty on the surplus which was accumulated prior to the effective date of this act?

Mr. LINDSAY. No, but before that prior accumulated surplus can be distributed without triggering the tax you have to pay the tax with respect to that 50 percent of net gains from operation that had been deducted since 1958.

In other words there is an order of priority on distribution: First, dividends paid out of tax-paid income could be paid without any additional tax effect on the company. Any excess dividends would be assumed to come out of untaxed amounts accumulated since 1958. Once those are exhausted, and prior accumulations are paid out, the payment of those prior accumulations would not actuate any further tax.

Senator HARTKE. They would not actually be further taxed then?

Mr. LINDSAY. No.

Senator HARTKE. And there is no penalty imposed then on surplus accumulated prior to that time?

Mr. LINDSAY. That's right.

Senator HARTKE. In regard to Senator Butler's question, and in which maybe I misunderstood your answer, I think that you said that that was a tailormade bill for the insurance companies, is that right?

Mr. LINDSAY. Yes, I probably stated it that way.

Senator HARTKE. And in regard to these tax exempt interest provisions, I thought you said that they did not apply to any other individual or corporate entity.

Mr. LINDSAY. That is correct.

Senator HARTKE. In other words, you are attempting to have two separate fields of imposition of tax in this tax-interest exemption field, is that right?

Mr. LINDSAY. Yes, but let me say this, in making an adjustment in the reserve deductions you are dealing with the kind of a deduction that most other taxpayers don't have anyway.

Senator HARTKE. Would there be any——

Mr. LINDSAY. That is what I had in mind.

Senator HARTKE. Could there be any reason why it could not be applied to other corporations and other individuals on an equal basis as applied to insurance companies?

Mr. LINDSAY. I think it would be entirely possible to require that expenses allocated to tax-exempt interest be disallowed.

Senator HARTKE. Does the Treasury contemplate such action?

Mr. LINDSAY. We have not contemplated such action. We have enough on hand with this bill. [Laughter.]

Senator HARTKE. Yet you would want to be fair with the insurance companies, as fair with them as you would with other taxpayers, would you not?

Mr. LINDSAY. We hope to be.

Senator HARTKE. And this leaves at least the implication that you are not being.

Mr. LINDSAY. The implication was suggested. [Laughter.]

Senator HARTKE. Now then, has there been any consideration given by the Treasury to the effect upon municipal bonds and their potential sale as a result of these particular provisions on tax-exempt interest?

Mr. LINDSAY. As we believed that the formula in the bill was correct and fair and gave full credence to the exemption, we did not make a study as to the effect on the municipal bond market.

Senator HARTKE. It is correct and fair as to whom?

Mr. LINDSAY. As to the taxpayer.

Senator HARTKE. But will it not have the effect of making less desirable municipal securities?

Mr. LINDSAY. They would be more desirable if we gave not only full exemption but also a double deduction or double benefit, and in that sense this is less desirable than what some companies are requesting that we do.

Senator HARTKE. I know you have done a fine job of educating me, I will say that for you, but one other question: The President, in his annual budget message, in order to present a balanced budget gives an anticipated increase of 30 percent of profits for corporate entities. Was that factor taken into consideration for insurance companies in your overall estimate, when you also had included in the President's budget the adjustment of the insurance company taxation. Do you follow what I am talking about?

Mr. LINDSAY. I don't think there was a double inclusion there. I do think that the budget did take into account about 500 million for the insurance companies based on what was considered to be prevailing law.

Senator HARTKE. As I understand the President's budget he anticipates approximately a 30-percent increase in corporate profits for 1959 over 1958, isn't that correct?

Mr. LINDSAY. I believe so.

Senator HARTKE. But was such a figure taken into consideration for insurance companies in this overall corporate increase or wasn't it considered?

Mr. LINDSAY. I really don't believe I can answer that question.

Senator HARTKE. Would you see if you could find out for me?

Mr. LINDSAY. Yes, I will.

(The following information was supplied by Mr. Lindsay:)

The approximately 30 percent increase which Senator Hartke mentioned is a composite figure which takes into account different rates of change in different industries. With respect to life insurance companies, the budget estimates assumed that net investment income would show a year-to-year increase of about 8½ percent.

Senator HARTKE. That is all, thank you.

The CHAIRMAN. Senator McCarthy.

Senator MCCARTHY. Mr. Chairman, I hesitate to raise this particular question again, but I have one insurance company in Minnesota which holds something like 36 percent of its investments in tax-exempt municipal securities, and the company is quite persuaded that it will be much worse off if this bill is passed than it would be under the 1942 act or under the 1950 act. Are they mistaken or not?

Mr. LINDSAY. We, I would like to, in connection with a memorandum that we stated we would submit for the record, reexamine that. We thought that we were giving substantially the same treatment as under the 1942 act, but doing it in a different way, and it would be very helpful for us if we could be given some of the material these gentlemen have to demonstrate the disadvantage of this act over the 1942 act.

Senator MCCARTHY. Let me ask you this, wasn't it your theory that you were applying a pro rata share of costs against the tax exempt income?

Mr. LINDSAY. Yes.

Senator MCCARTHY. This was the theory upon which you were proceeding.

Mr. LINDSAY. Yes.

Senator MCCARTHY. So the first question is whether or not you have done that or not. The second question is whether or not you should do it, or whether we want you to do it.

Mr. LINDSAY. Yes.

Senator McCARTHY. This is the point of our disagreement, the difference.

Mr. LINDSAY. That is right.

Senator McCARTHY. I have a second question that relates to the exemption with regard to the handling of pension funds: Could you tell me what insurance companies, principally, are handling these pension programs now?

Mr. LINDSAY. By and large the larger companies are handling them now.

Senator McCARTHY. What is the reason, is it the question of spreading the risk, the uncertainty of the business, the cost factor? Why is it that the large companies, as I understand do now conduct or carry on most of the pension business? They seem to be able to compete at least in some areas with the banks and trust companies, even though they are handling the pension programs of small businesses, what is the explanation for that, Mr. Lindsay?

Mr. LINDSAY. Well, I suppose that the explanation is in part the same as the explanation for the fact that these companies happen to be the largest and have many, many customers, are well-known to the corporations that want to set up pension plans and they tend to go to the large companies. I don't know that I can give you a fuller answer than that.

Senator McCARTHY. It might not be an economic justification.

Mr. LINDSAY. I believe there are group policies handled by some small insurance companies.

Senator McCARTHY. One other general question, and I assume this is involved in the theoretical approach to this legislation: Would it be impossible to have a situation arise under their bill comparable to what happened in 1947?

Mr. LINDSAY. I don't see how that could happen.

Senator McCARTHY. In terms of a balanced tax program what you propose here is much sounder than what we had in 1947.

Mr. LINDSAY. That is correct.

Senator McCARTHY. Thank you, Mr. Chairman.

The CHAIRMAN. Just one more question, Mr. Lindsay. What is included in the budget for this item from insurance taxation?

Mr. LINDSAY. 500 million.

The CHAIRMAN. Mr. Lindsay, on behalf of the committee, I want to thank you for the splendid presentation you have made of a most difficult taxation subject. It is one of the best presentations we have had before this committee in my 26 years' experience. We appreciate the frankness and your capacity to make the discussion you have.

Mr. LINDSAY. Thank you very much.

The CHAIRMAN. We will adjourn until 2:30 this afternoon.

(Whereupon, at 12:50 p.m., the hearing was recessed, to reconvene at 2:55 p.m. of the same day.)

## AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Deane C. Davis, the president of the National Life Insurance Co. of Vermont.

Mr. Davis, will you come forward? We are glad to have you, sir.

## STATEMENT OF DEANE C. DAVIS, PRESIDENT, NATIONAL LIFE INSURANCE CO. OF VERMONT, ACCOMPANIED BY W. JAMES PREBLE, ACTUARY

Mr. DAVIS. Mr. Chairman and members of the committee, my name is Deane C. Davis. I am president of National Life Insurance Co. of Vermont, a mutual company organized 109 years ago; a company with slightly over $2 billion of insurance in force, upon the lives of approximately 250,000 policyholders; a company which does no group, accident and health, or industrial business.

I have with me here today one of my company associates, Mr. W. James Preble, an actuary by profession, who will assist me on my actuarial questions involved.

I want to make it clear that I am testifying today solely on behalf of the company which I represent. I emphasize this because I am currently acting as chairman of the industry Joint Committee on Federal Income Taxation of Life Insurance Companies. That committee as such has no official position here today.

I am in favor of the basic pattern and structure of H.R. 4245. There are several provisions of the bill which I believe need amendment. The two most important amendments relate to the formula to be used for determining taxable investment income in phase 1, and the provision in phase 2 of the bill which limits deductions related to participating business.

Before speaking to the two points of proposed amendment, I would like to place on the record some facts and figures which I believe are indispensable to a proper perspective of the problem and which have convinced me that the combination approach represented by this bill is logically sound, equitable between companies, and in the public interest.

These facts point out some profound changes which have taken place in the life insurance industry, which require a new and different approach than has prevailed at any time since 1920. They point out the rapid growth of lines of business which in 1920 were more or less incidental to the main business of most life insurance companies then operating.

To illustrate the changes which have taken place in the constitution of the life insurance business since 1920, charts I and II analyze the business over the period from 1920 to 1957 according to the different types of business in force. This could be done in any number of ways, but I have attempted to classify the business according to those types which, on the one hand, represent contracts calling for the accumulation of reserves and depend upon investment earnings for their maintenance, and those types which, on the other hand, are of relatively short duration or present greater opportunity for underwriting gains than for investment gains.

Chart I shows the changes in the life insurance business in force over this 37-year period for each of the following five classes of business:

1. Ordinary life and endowment insurance.
2. Participating industrial insurance.
3. Nonparticipating industrial insurance.
4. Ordinary term insurance.
5. Group life insurance.

This chart shows that whereas all life insurance business in force has increased during this period, and has increased markedly since 1940, group insurance and ordinary term insurance have increased at a much more rapid rate. These classes of business develop small reserves and depend only slightly upon investment earnings for their maintenance.

(The charts referred to follow:)

CHART I

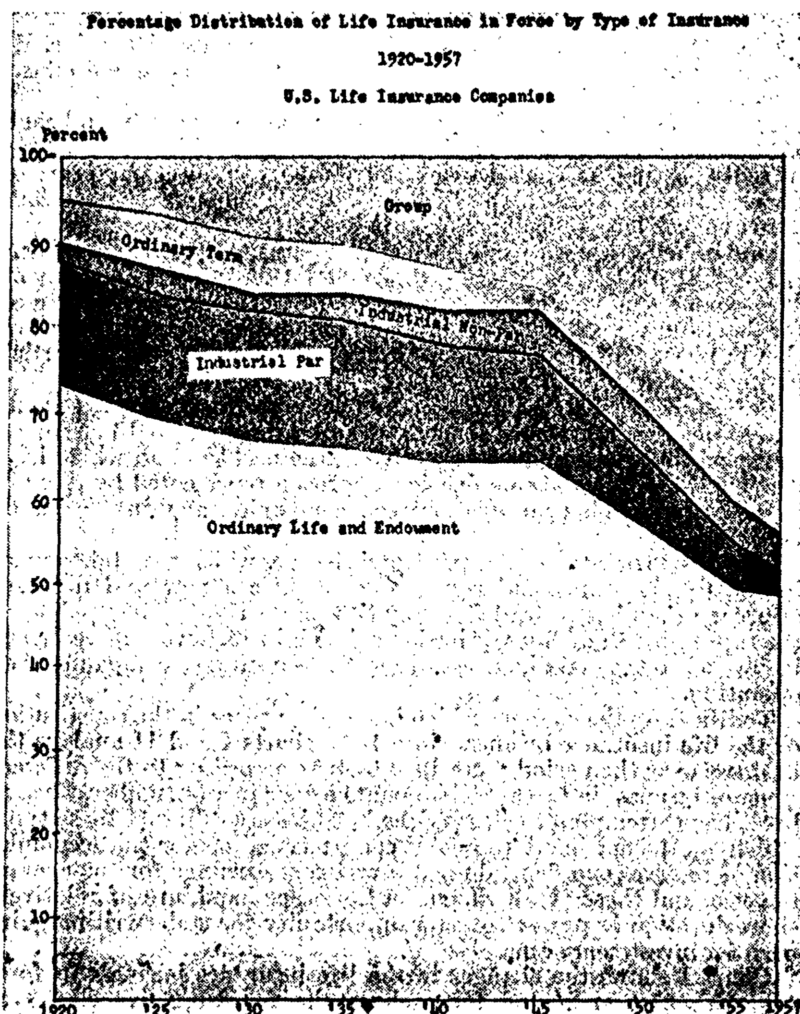


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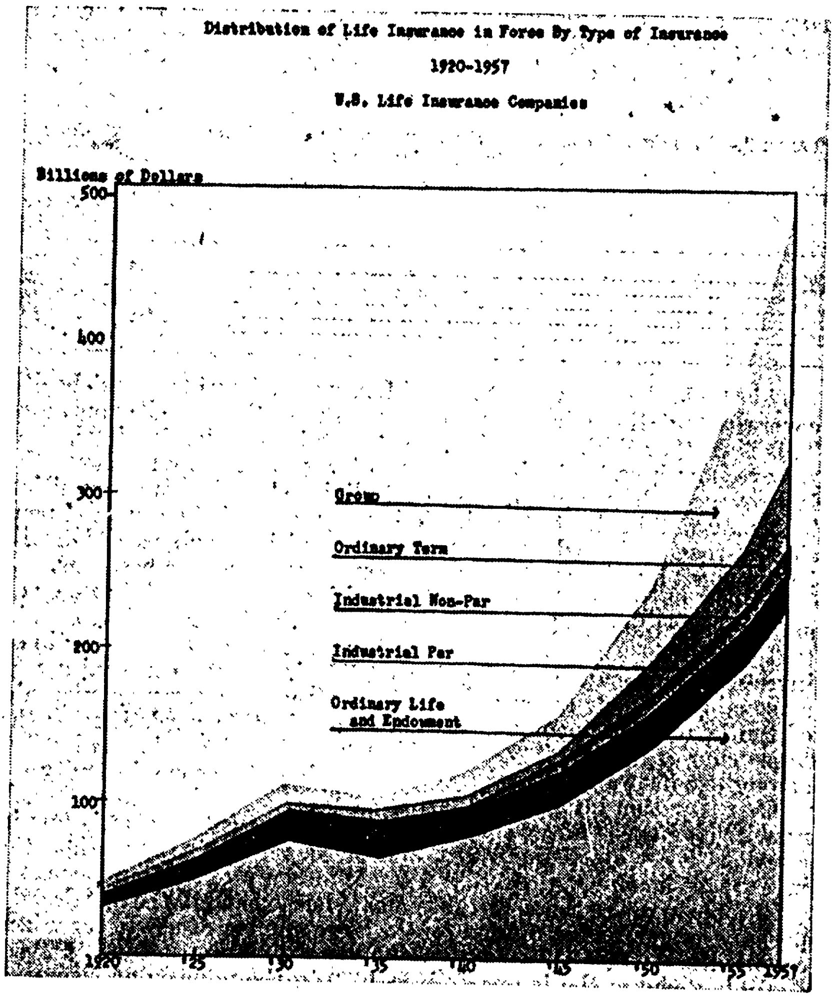
CHART II




Mr. DAVIS. This is seen in better perspective in chart II, where the percentages of these various types of business are shown rather than the absolute amounts. Again it is apparent that ordinary life and endowment insurance, which are those types of contracts calling for the accumulation of reserves which produce investment income, have decreased in relative importance over this period of time from approximately 73 percent of the total in 1920 to approximately 47 percent of the total in 1957. Group insurance, on the other hand, has increased from less than 4 percent of the total to over 33 percent during the same period.

The charts do not include accident and health insurance and annuities. The trend in these lines is shown in table 1, on page 5, where they are listed at 5-year periods ending with 1957, and you will note that the annuities have only increased in that period of time there shown, and we only had the figures for 1940, from 9.4 to 9.5 percent, whereas accident and health has increased from 5 to 21.2 percent.

Senator KERR. Does that mean of the total insurance in force?

Mr. DAVIS. Yes.

TABLE 1.—*Premium income, annuities and accident and health—Percentage of total premium income*

| Year | Annuities | Accident and health |
|---|---|---|
| 1940 | 9.4 | 5.0 |
| 1945 | 10.2 | 7.5 |
| 1950 | 11.5 | 12.2 |
| 1955 | 10.3 | 18.8 |
| 1957 | 9.5 | 21.2 |

This table demonstrates the rapid growth of accident and health coverage and the relatively slow growth of the annuity business. This is further evidence of the trend toward specialization in the low reserve, low investment income type of contract. It also shows the lack of growth percentagewise of individual and group annuities. This may well be due to the discriminatory tax levied on insured pension business and the double taxation of annuities, a subject which will be discussed by other witnesses, I am sure, during these hearings.

In 1921, Congress abandoned the total income approach in favor of an investment income base. In retrospect, I think it can fairly be said that there were sound reasons for doing so. At that time the ratio of investment income to total gains of life insurance companies was reasonably uniform among companies. Hence, whatever may be said of the investment income approach as a scientific yardstick for the measuring of income, in 1921 it did at least distribute the tax burden among life insurance companies with rough and reasonable equity.

That situation no longer prevails. All of these new kinds of business involve types of coverage in which investment income is low in relation to net operating gains, and hence render inappropriate the investment income approach as a single measure of taxable income.

In some measure the tax situation as it has existed in the last decade, perhaps longer, has accounted for the large number of newly organized companies.

Table 2 shows the increase since 1950 in the number of insurance companies in the United States. This table shows, as was testified to this morning by Mr. Lindsay, that the number of companies has doubled in 7½ years, from 621 to 1,314, and it may be a matter of interest to you to show the distribution of these companies and to see in what States that growth has been.

(The table referred to follows:)

TABLE 2.—*U.S. legal reserve life insurance companies—Number of companies domiciled in each State*

| State | Dec. 31, 1950 | June 30, 1958 | State | Dec. 31, 1950 | June 30, 1958 |
|---|---|---|---|---|---|
| Alabama | 14 | 43 | Nevada | 1 | 1 |
| Arizona | 3 | 81 | New Hampshire | 2 | 2 |
| Arkansas | 8 | 29 | New Jersey | 5 | 8 |
| California | 15 | 19 | New Mexico | 2 | 2 |
| Colorado | 10 | 24 | New York | 22 | 28 |
| Connecticut | 5 | 7 | North Carolina | 13 | 27 |
| Delaware | 7 | 31 | North Dakota | 5 | 8 |
| District of Columbia | 12 | 14 | Ohio | 12 | 13 |
| Florida | 17 | 28 | Oklahoma | 10 | 27 |
| Georgia | 17 | 32 | Oregon | 1 | 4 |
| Idaho | 2 | 6 | Pennsylvania | 26 | 43 |
| Illinois | 31 | 42 | Rhode Island | 2 | 2 |
| Indiana | 20 | 49 | South Carolina | 27 | 50 |
| Iowa | 15 | 13 | South Dakota | 7 | 7 |
| Kansas | 11 | 13 | Tennessee | 11 | 21 |
| Kentucky | 8 | 11 | Texas | 118 | 323 |
| Louisiana | 77 | 112 | Utah | 4 | 14 |
| Maine | 1 | 2 | Vermont | 1 | 1 |
| Maryland | 11 | 17 | Virginia | 13 | 19 |
| Massachusetts | 10 | 11 | Washington | 11 | 16 |
| Michigan | 5 | 11 | West Virginia | 2 | 3 |
| Minnesota | 9 | 15 | Wisconsin | 8 | 11 |
| Mississippi | 9 | 22 | Wyoming | 0 | 2 |
| Missouri | 13 | 26 | | | |
| Montana | 1 | 3 | Total, United States | 651 | 1,314 |
| Nebraska | 17 | 21 | | | |

Source: Individual State insurance departments. These companies are considered legal reserve by their respective State insurance departments and may not be so considered by all other State

Mr. DAVIS. I would call your attention particularly to the States of Texas and Arizona.

The very fact that life insurance companies have been taxed under an investment income approach has encouraged a high degree of specialization on the part of new companies formed and, to a substantial extent, in previously organized companies. It has influenced many of these new companies to emphasize coverages with relatively small investment income.

Under the tax formulas that have been in effect since 1921, all the tax burden has fallen on net investment income. No part of this tax burden has been related to underwriting gains. It is clear that under these circumstances the tax will fall with undue severity upon those companies whose net investment income is large in proportion to their underwriting gains. Conversely, companies with large underwriting gains and relatively little net investment income have received preferential tax treatment.

For purposes of illustration, table 3 shows an analysis of 1957 operations of a small group of specialty companies that write almost nothing but credit insurance:

TABLE 3.—*Total net gain and net investment income, 5 credit insurance companies*

[In thousands]

| Company | (1) Total operating gain | (2) Net investment income | (3) Ratio (1÷2) |
|---|---|---|---|
| 101 | $13,892 | $682 | 20.370 |
| 102 | 5,617 | 258 | 21.771 |
| 103 | 3,753 | 245 | 15.314 |
| 104 | 1,269 | 63 | 20.143 |
| 105 | 2,314 | 43 | 53.714 |
| Total | 26,744 | 1,290 | 20.732 |

The table shows that in these 5 companies, net gains from operations are over 20 times their net investment income. If, as under the 1955 stopgap law, we assume that 15 percent of their investment income is subject to tax, we find that only $194,000 out of $26,744,000 of total operating gains have been taxed. This is less than 1 percent of those gains which, in the case of this very short-term business, arise almost entirely from underwriting. Although the companies used in table 3 are "specialty" companies, and therefore serve to dramatize the inequities involved in taxing investment income only, there are hundreds of other companies which differ only in degree.

These facts demonstrate how completely inappropriate is the 1942 law under the conditions which now prevail. The 1942 law, if made effective—

(1) Would leave untaxed a substantial reservoir of underwriting gains;

(2) Would continue a tax preference to companies with large operating gains and little investment income, and penalize companies with relatively high investment income and relatively low operating gains;

(3) Would re-establish arbitrary and indefensible factors based on industry averaging;

(4) Would be grossly unfair to companies with reserve interest requirements higher than the industry average;

(5) Would provide no relief for new companies experiencing operating losses;

(6) Would provide no special provision for small companies.

I understand that some companies favor making the 1942 law applicable to 1958 operations, and making the new bill effective with respect to 1959 operations.

The argument advanced for this position is that it would give an additional year to study the new law and an opportunity to propose amendments before the law actually went into effect.

I recognize the complexity of this bill. No matter in what form the bill is passed, it is probable that future amendments will be required to cover situations not now foreseen. Certainly, a bill of this complexity and importance requires that reasonable opportunity be given for everyone to study it and make their views known.

On the other hand, if more time is needed for consideration of the form of this bill, certaintly provision can be made to accomplish that result without in the meantime applying the 1942 formula, which has been completely discredited.

If the 1942 formula should be made applicable, the result would be to continue the inequities inherent in the 1942 law.

It would be far better to adopt the procedure which this committee used in 1950, to extend the time of filing returns so long as is needed for such consideration. I feel strongly that our business needs to have this question settled.

In the published record of the House hearings, page 429, there is a significant example of the kind of inequities that would be preserved under the 1942 law. The record shows a company with over $1¼ million of net gains for 1957 that paid under the Mills stopgap law approximately $9,000 in Federal income taxes. If the 1942 law were applied, the tax would still be insignificant, not certainly more than double. This is an extreme example, but there are many others which differ only in degree.

National Life Insurance Co. would pay, under this bill, over $700,000 more than it would under the 1942 law, under this bill, which we are now considering, over $700,000 more than it would pay under the 1942 law, and under the amendments, in its present form, even with the two amendments which I shall propose, we would still pay under H.R. 4245, over $300,000 more than the 1942 law. Perhaps you will accept that fact as some evidence of how strongly I feel that application of the 1942 law even for 1 year is completely indefensible.

At this point I wold like to describe briefly the two proposals of amendment to which I previously referred. The first involves the method prescribed for computing taxable investment income (phase 1).

The broad outline of the combination approach embodied in this bill was first suggested by Treasury staff representatives who met with representatives of the life insurance industry on October 28, 1958. I should like to state it was my privilege to be a member of that group.

The method for calculating taxable investment income in the first phase, for which the Treasury staff expressed a preference at that time, was the adjusted reserve method, otherwise sometimes known as the Menge formula or sometimes the surplus interest formula.

The adjusted reserve method involves making a computation of the amount of reserve interest credit which would be needed to maintain the reserves of each particular company after revaluing these reserves on the basis of the company's interest rate actually earned in the taxable year. When this amount has been thus determined, it is deducted from the total net investment income and the balance is the taxable investment income in dollars.

The methods which have been used in previous investment income formulas have differed, but all have involved, in one way or another, the interest rate assumed by the company in computing reserves—either using an industry average or some arbitrary factor based on industry averaging. The major difficulties in applying these formulas over all these years have stemmed from the invalidity, both in theory and in practice, of using such assumed rates.

The method of using low, and therefore conservative, projections of assumed interest earnings for computing reserve liabilities, long used by companies, has stood the test of time for the purpose for which it was developed, namely, to assure the solvency of the companies. It is one thing, however, to use an actuarial projection for the purpose of computing adequate reserves to assure solvency over a long period of years; it is quite another to use an actuarial projection as one end of the measuring rod to determine an investment income tax base for each separate year.

In order to avoid the artificialities and inequities inherent in using, for tax purposes, assumed rates of interest earnings, the adjusted reserve method was developed, which uses the actual earned rate of interest of the individual company. It furnishes a practical method whereby the basic invalidity of using the assumed rate of interest is avoided and, in addition, it eliminates the inequities of industry averaging.

In the bill before you the basic principle of reserve adjustment has been adopted. Now, that is something that is brand new in this whole investment income formula. We have never had anything like it before, and the thing I want to point out is that the drafters of the bill now have taken the first part of this adjusted reserve method and have repudiated the second part.

Unfortunately, during the considerations by the Ways and Means Committee the original adjusted reserve method was modified. Instead of using the individual company's actual earned rate of interest to make the revaluation, the bill specifies a different rate for reserve revaluation. This rate is the mean between the individual company's earned rate and its assumed rate, or the industry average assumed rate if higher. The introduction of this modification, unfortunately, reintroduces many of the artificialities and inequities which were avoided in the original form of the adjusted reserve method. It reintroduces the use of both the assumed rate of interest and industry averaging, in certain cases.

Now, I have understood that one reason, at least, why the adjusted reserve method was modified was that the method used in the present bill would raise more revenue.

I should like to be on record that I believe that is a poor reason to adopt an unsound and arbitrary formula. I would much prefer to see the adjusted reserve method in its original form adopted as the measure of taxable investment income in phase 1, and set to rest forever this controversy over how to construct an investment income base for the taxation of mutual or stock alike companies. We can do it by adopting the original Mende formula in which it was first submitted to the Treasury, and for which preference was first expressed.

If, on the other hand, it is felt that revenue considerations are such that more revenue must be obtained than would be provided under the original adjusted reserve method, a much more satisfactory modification exists. This modification would retain all of the advantages of the original adjusted reserve method and, in addition, would avoid possible fluctuations that might concievably occur if only the earned rate for the tax year were employed.

The modification to which I refer would substitute a 5-year average of the individual company's actual interest rate earned on investments for the rate experienced in the particular tax year.

The other important amendment which I believe should be adopted involves the treatment in phase 2 of operating gains which they are less than taxable investment income. It has come to my attention that other witnesses intend to testify in some detail on this point. In order to save time, therefore, I shall limit myself to a few general observations.

The committee report accompanying H.R. 4245 contains the following statement:

"Moreover, the bill provides that although, generally, underwriting losses can offset investment income otherwise subject to tax, this is not to be the case to the extent that the underwriting loss is attributable to policyholder dividends."

The term "underwriting loss" as used in the committee report means the amount by which taxable investment income exceeds gain from operations.

This treatment of policyholder dividends represents an adoption of the argument sometimes made, that mutual companies would otherwise be able to unreasonably reduce tax liability by paying out excessive dividends. This argument ignores the basic fact that policyholder dividends are merely price adjustments and, therefore, in computing taxable income, should be allowed as a deduction without any limitation whatsoever.

Logically, this issue should be settled on the basis of a determination of the essential character of a policyholder dividend rather than on the basis of some fear that mutual companies will elect to minimize their tax liability by unsound management decisions.

The life insurance business, I would like to interpolate, is well regulated throughout this country by State regulations for solvency, and so on, and it is completely unthinkable in my opinion that a company in any State that is properly regulated throughout the country would permit a mutual company to engage in any such enterprise as has been assumed as the basis of that argument.

So I want to come to the point that what is paid back by a mutual company is nothing but a price adjustment, pure and simple. The Treasury this morning said that nine-tenths of the profit was price adjustment. I say that ten-tenths are price adjustments, because all that there can be in the mutual company's dividend is savings of expenses, savings of mortality, both of which are related to the process of underwriting, or some investment earnings that may be left over after the reserves have been properly added to under the actuary's business.

But what I say to you, if anybody believes that any element of the interest that is embedded in that policyholder dividend, small as it may be, is anything other than a price adjustment, I merely want to call your attention to the fact that exactly the same thing takes place in the stock company in the computation of premium, itself.

So there is no difference, in my opinion, whatsoever, between the treatment of any element of interest embedded in the dividend as being different in setting the price.

Now if, as I contend, a policyholder dividend is only a price adjustment, failure to recognize full deductibility of such dividends creates a tax discrimination against participating business. For example, if a nonparticipating policy costs $50 per year, and a corresponding participating policy costs $60 per year, the dividend paid to the participating policyholder will probably be about $10 per year on the average. To the extent that the bill limits the allowable deduction for policyholder dividends, discrimination is created between these classes of business.

In support further of that principle, there will be testimony, because I have had the privilege of reading it within the last half hour, either this afternoon or tomorrow, by a witness, which compares the actual costs, the net cost in the participating of a mutual company and the whole list of stock companies on the other hand. You find price, when you get all through, is so close that failure to permit the participating business to use the dividend route in order to adjust the price to mutual policyholder will throw a greater burden on the mutual policyholder than the man who buys from a stock company.

Maybe there is some public policy that makes sense to that; it doesn't to me.

However, in order to avoid any controversy—and believe me we have tried for the last year to settle this controversy among ourselves in the many different companies, and I want to say to you there is building up a real solid support for the pattern and structure of this bill.

If this committee at this time will turn its real earnest attention, as it is, to the point of ironing out those differences and amending this bill, we will have this controversy settled for the first time for a period of time that can be called permanent. I don't know how long that is, but that is a lot longer than in the past.

In order to avoid any controversy with respect to the exact nature of policyholder dividends, I do not recommend that so-called underwriting losses be fully allowed as offsets to taxable investment income in mutual companies, in spite of the fact that this full offset is allowed in stock companies. Instead, I recommend that 50 percent of such losses be allowed. This 50-percent allowance would go part way toward eliminating the discrimination now found in phase 2 of the bill and would give some recognition to the argument, sometimes made, that policyholder dividends are not entirely price adjustments. Moreover, it offers practical protection against any fears that may prevail that mutual companies would attempt to reduce their tax liability by unwise management decisions.

On that point I should like to say this morning I heard the testimony concerning what it would cost to make this allowance, and I believe Mr. Lindsay, the representative of the Treasury Department, used the figure of $70 million, and I think that is the cost of it. If you gave 100 percent, that is what he was talking about this morning. Fifty percent would be one-half of that, or approximately $35 million.

It is the earnest hope of the great majority of life insurance companies in this country that this problem, when settled, will be settled on a basis of permanent legislation. I strongly urge that you adopt this bill with the two amendments which I have suggested, and with others that will be suggested.

Without expressing a personal opinion upon the merits of other modifications which will be proposed, it is my personal opinion that the two most important modifications required to give this legislation the necessary degree of permanence are the two which I have suggested.

The CHAIRMAN. Thank you very much, Mr. Davis, for a very able statement.

The Chair has just been informed that the Treasury has issued a regulation extending the time of filing of returns on insurance income from March 15 to June 15.

Senator KERR. Which year? [Laughter.]

The CHAIRMAN. Do you have any questions, Senator Kerr?

Senator KERR. Mr. Davis, how long have you been with the National Life Insurance Co.?

Mr. DAVIS. Well, I came there in 1940; that would be 19 years ago.

Senator KERR. Mr. Chairman, I hope the committee will indulge me a personal reference.

The first life insurance I ever owned my mother bought for me that she paid a nickel a week for to a fellow who came around every week, representing the Prudential Life Insurance Co. Did you ever hear of it?

Mr. DAVIS. Yes, I have heard of them. [Laughter.]

Senator KERR. The second insurance I ever owned was, when I was 18 years old, my father bought me $1,000 ordinary life policy in the National Life of Montpelier, Vt., and he told me to add to it whenever I could.

I remember that he quoted a statement on your advertisement, and I wondered if you still used it and, as I recall it, it was something like this—you correct me if I am in error, "All death claims paid out of interest and rent income."

Mr. DAVIS. No, sir; we do not use that on our advertising any more. [Laughter.] It certainly would not be true if we did.

Senator KERR. Do you remember what you did?

Mr. DAVIS. I have seen some of that old literature, sir.

Senator KERR. I must say it made a very profound impression on me, and I referred to it not at all as critical, but as something which I regarded as very complimentary.

So I have been with the National Life Insurance Co. of Vermont, Mr. Chairman, a good deal more than twice as long as this witness has [laughter] and I hope that in the opinions that I might express, or votes I may cast, will not cause anyone to feel that there has been any conflict of interest. [Laughter.]

Mr. Davis, I was quite interested in your remarks about the 1942 formula.

I gather from your statement that the present bill would cost your company, for 1958, $700,000 more than the 1942 law would, if your liability is determined and paid under it?

Mr. DAVIS. That is correct, sir, in the form that the bill is now drawn; yes.

Senator KERR. Well, in the event the committee decides to pass this bill now before us, or even with the amendments that you have suggested, would you still recommend that it would be made applicable to 1958 instead of the 1942 act?

Mr. DAVIS. I certainly would, sir.

I believe that the 1942 law has so many, so many inequities in it that would be created and enhanced by the fact of the changes that have taken place while it has been in suspended animation, that it would be a tremendous mistake.

Senator KERR. You are aware of the fact that the 1942 law is the one which has already determined the tax liability for 1958?

Mr. DAVIS. Yes, indeed, sir; I am aware of that.

Senator KERR. And that if it were changed it would result, as did the action last year, in the Congress changing the tax liability of a great industry for a specified year subsequent to the termination of that year?

Mr. DAVIS. Yes, sir.

Senator KERR. And whether the change produced more revenue or less, on the one hand, it would be a retroactive increase in taxation and, on the other hand, a retroactive relief from tax liability, as was the effect of the congressional action last year?

Mr. DAVIS. I think it would be retroactive in the sense that you would not know the exact dollar of your liability until after the end of the taxable year.

Senator KERR. Well, that is already in here.

Mr. DAVIS. Yes. But I do not believe that it is legally retroactive, considered retroactive to do so.

Neither do I think that anybody is in the slightest bit hurt by the whole situation, other than the fact that they are going to pay more taxes. [Laughter.] But that—what I am trying to say here is where are you going to draw these inequities? That is the whole point.

Everybody in this industry since the middle of the summer has known the basic outlines of what we have been working along with here on this tax bill.

Senator KERR. But they also know that the year ended, and the law, no new law, was passed.

Mr. DAVIS. Yes, indeed; they did, sir.

Senator KERR. You said to make it legally retroactive. If we make it retroactive at all we had better do it legally, hadn't we?

Mr. DAVIS. I would think we had better; yes, sir. [Laughter.]

Senator KERR. But you still urge this committee to make whatever bill we pass, whatever bill we bring out, and which may eventually pass, as amended in the Senate or in conference, retroactive to 1958?

Mr. DAVIS. Yes, sir.

Senator KERR. In your statement, Mr. Davis, you say:

> The very fact that life insurance companies have been taxed under an investment income approach has encouraged the high degree of specialization on the part of new companies formed, and to a substantial extent in previously organized companies. It has influenced many of these new companies to emphasize coverages with relatively small investment income.

I want to ask you a question about the words "to a substantial extent in previously organized companies."

What part of this tremendous increase percentagewise of industrial nonparticipating and group insurance has been written by the mutual companies, and what percent by the stock companies?

Mr. DAVIS. I could not give you the exact division between mutual and stock. I would say the overwhelming majority of the group is written by the larger companies. How it would break down, I guess the majority of it would be with the mutual companies.

Senator KERR. Now, in which one of these designated kind of insurance, if either, would that type of business that has been referred to here as credit insurance be included?

Mr. DAVIS. That would be called term.

Senator KERR. It would not be included then in either of these designated classifications appearing on your charts 1 and 2?

Mr. DAVIS. Oh, yes indeed, sir. It would be in the second one titled "Ordinary Term." I am looking at chart 2.

Senator KERR. Yes, in ordinary term.

Now, that is the——

Mr. DAVIS. Incidentally, group credit, my associate calls to my attention—I mean that group credit is in the group part of it, and the individual credit is in the individual term.

Senator KERR. Is in the ordinary term?

Mr. DAVIS. Yes, that is right.

Senator KERR. Now, couldn't your associate tell you and me what part of that group is group credit, approximately?

Mr. PREBLE. I would say a very small percentage of it.

Senator KERR. A very small percentage?

Mr. PREBLE. Yes.

Senator KERR. But of the so-called credit insurance, would you give us an opinion as to what percent of the total of that in force is written by the mutual companies, and what percent by the stock companies?

Mr. DAVIS. I would say practically all of it by the stock companies, if I understood the question correctly.

Senator KERR. Does not your company write credit insurance?

Mr. DAVIS. No, sir.

Senator KERR. It does not?

Mr. DAVIS. No, sir.

Senator KERR. Well, would you estimate that—you do write term insurance?

Mr. DAVIS. Yes, individual, not group term.

Senator KERR. Individual.

Well now, the individual term, that is what you call ordinary term——

Mr. DAVIS. Yes.

Senator KERR (continuing). On this chart would be what, a third or 40 percent as large an amount as the group insurance that is here? One of these tables, does it give the amounts?

Mr. DAVIS. It gives the amounts of each of the segregations as shown on the chart, you can see that, of course, by taking the dollar sign on the left of chart 1, and the percentage sign for the various years covered from 1920 to 1957 in chart 2.

Now, I think your question relates to the breakdown between credit insurance, individual credit insurance, and group credit insurance.

Senator KERR. Here is what I am trying to find out: In your statement here that I referred to you say there has been a high degree of specialization on the part of new companies formed, and to a substantial extent in previously organized companies, and I gather that this high degree of specialization refers primarily to this term or credit insurance?

Mr. DAVIS. That is the most glaring. I do not think it covers the greatest volume, however.

I think in other fields like health and accident, that is a very important one. But any of those coverages that are predominantly on the term basis would be in that category.

Senator KERR. Here is what I am trying to determine for my own benefit and for this record. No. 1, under the provisions of this bill, in your judgment, are the stock companies which write credit insurance discriminated against so far as their relative position under this bill is concerned, with that of mutual companies?

Mr. DAVIS. No, sir; I think not.

Senator KERR. Here is what prompts that question, and I would like for you to help me find the answer.

Under phase 3, or whatever the third section of this bill might be called, tax liability accrues either when bringing income amounts to 60 percent of something—what is it——

Mr. R. M. ORAM (technical advisor, Joint Committee on Internal Revenue Taxation). Sixty percent of annual premiums; 60 percent of 1 year's premiums.

Senator KERR. Equals the 50 percent.

Senator BUTLER. Twenty-five percent of the reserve.

Mr. ORAM. Sixty percent of one year's premiums.

Senator KERR. Does what?

Mr. ORAM. When the accumulated untaxed income reaches that figure——

When that 50 percent not taxed equals an amount or equals 60 percent of the annual premium, anything above that is taxed, or if any untaxed part is declared out as a dividend, then the company owes that tax, but there is an alternate ceiling here, and that is when—that lets it be free from taxation so long as the accumulated amount does not equal 25 percent of the reserve.

Now, a stock company has, generally speaking, no reserve ceiling available to it; does it?

A stock company writing credit insurance does not accumulate reserve?

Mr. DAVIS. That is right. It does not have very high reserves.

Senator KERR. It does not accumulate?

Mr. DAVIS. That is right.

Senator KERR. So that ceiling is of no benefit to it?

Mr. DAVIS. That is correct.

Senator KERR. Let us say that the National Life Insurance Co., generally speaking—and I am sure this is not correct, but for purposes of illustration—had 75 percent of its income from policies that did require and that permit a reserve to be accumulated; and 25 percent of its income from this term insurance, let us say.

If the 25-percent reserve is as elastic as I think it is that ceiling would be adequate to make it possible so that your company probably never would have any tax liability for that additional 50 percent because if it were regarded alone it might get to where 60 percent of the annual income would get you out of that reserve. This other would fix it so it would not happen to you; is that possible?

Mr. DAVIS. If it were a stock company; but National Life is a mutual, and phase 3 does not apply to mutuals, and is not intended to, as I understand it.

Senator KERR. Well, would it be if a mutual owned a wholly owned subsidiary that was a stock company writing term insurance and filed a consolidated return? [Laughter.] I am not saying that you do; I do not know whether you do or not.

Mr. DAVIS. Well, we cannot. The law prevents us from doing it.

Senator KERR. What law?

Mr. DAVIS. The law of New York and the law of Vermont.

Senator KERR. So that you could not do that anyway?

Mr. DAVIS. Yes.

Senator KERR. But you can write this term insurance then as the National Life?

Mr. DAVIS. We can write individual term insurance, and we could write group, too. We do not. We could. I mean we are chartered to do it; I mean authorized under the law to do it.

Senator KERR. Yes. Whatever your income might be there, let us say, of a highly profitable nature, could be added to your assets, the sum total of which would still not exceed 25 percent of the reserves and, therefore, it would not be taxable to you in your overall picture while, if you were engaged only in the writing of term insurance, it would; is that possible?

Mr. DAVIS. I think that is possible; yes.

Senator KERR. Then, if that is possible, is this phase 3 of the bill, which as I understand it would apply to a stock company writing credit insurance, could it be logically or appropriately or accurately said that that provision constitutes discrimination against the stock companies as compared to mutual companies?

Mr. DAVIS. I don't think so, Senator. I think you are dealing with a situation where you have got a measuring stick or a definition to try to separate these companies that are doing this credit business. There is nothing wrong with those companies.

Senator KERR. Not at all. I am just trying to evaluate this bill from the standpoint of whether or not—you see, we are in this situation. The mutual companies have told us this discrimination in favor of stock companies. The stock companies tell us it discriminates in favor of mutual companies. And while ordinarily that would be a pretty good recommendation for it as written [laughter], I am just wondering if either or maybe both are right; see?

Mr. DAVIS. I think one of them is right. [Laughter.]

Senator KERR. We didn't suffer a total miss, then, did we?

Mr. DAVIS. No, sir.

Mr. KERR. I asked the representative of the Treasury this morning how long mutual companies had been following the practice of returning or making adjustments in the form of policy dividends and we got a little bit—we found that that has been going on since about 1759. I said quite frankly that as far as I am concerned, I am not in favor of the tax bill as a means of equalizing competition between two groups of free private enterprise, both of which are worthy and both of which are in accordance with law, and it seems to me, and I have so stated, rather a drastic action to take to arbitrarily limit the amount of adjustment that can be made if it is made accurately and on the basis of experience in the record in the cost of the policy to a policyholder in a mutual company. But Mr. Lindsay, if I understood him this morning, told us that this bill as written would not touch the dividend on the policy that was made possible by a cost adjustment, and you referred to that in your testimony.

Mr. DAVIS. Yes.

Senator KERR. The $140 million of the total $1,400 million approximately now being returned in the form of policy dividends actually represented earnings on investment by the mutual companies on resources already owned and disassociated from the current cost of carrying the insurance as would be reflected in your bookkeeping if you didn't have these investments in which your reserves were already invested.

Will you address yourself to that specifically as to your opinion on that matter?

Mr. DAVIS. Well, I regret to say that that figure that was used by Mr. Lindsay this morning I am unfamiliar with and naturally I am not going to take issue with him as far as the amount that he is using.

What I do take issue with Mr. Lindsay and the Treasury Department on is that the whole thing of the return of a policyholder dividend is a price adjustment and I think the statistics of the comparative net cost among mutuals and stocks generally throughout the country will support that. And one of the witnesses this afternoon will have testimony on that point.

Senator KERR. Understand, I am going to listen to it, but it doesn't seem to me that that comparative cost would be a determinative factor there. It would seem to me that if this $1,400 million that the mutual companies pay out in policy dividends is savings on insurance cost, that is one thing. If it is a sum made up by these two component parts, No. 1, savings in the cost of insurance, and No. 2, the return from investment of reserves, that would be another thing.

Mr. DAVIS. Well, I take it from your question that you treat the component parts so far as there is any interest element involved in the dividends, that that stands differently than savings from expenses or mortality.

Senator KERR. Well, I am not taking the position yet that they should be treated differently. I am of the opinion that the origin of the money for distribution purposes is different.

Mr. DAVIS. Well, I think, of course, the actuaries differ on this thing, but I believe the fairest approach to this whole proposition of what is in the policyholder dividend is some element of all three of those savings.

Now, how much it will vary from year to year even the actuaries can't tell you. The composition of the price structure in a life insurance contract so far as it relates to the premium, the reserve, the cash surrender value, dividends, and all those things, they are so inextricably tied together.

Senator KERR. Let us not get them tied together so closely that we can't reserve the right to return the excess from the cost of the policy of the insurance.

Mr. DAVIS. I should like to do at least that much, sir.

Senator KERR. I would, too. But it seems to me, and I want your reaction to this, that the money that your company or any other mutual company earns on its investments already made on reserves already accumulated, aside from the degree to which you are able to carry a policy at a figure less than the annual premium, it would seem to me first that there are different items of income to you, and second, that that policyholder under that mutual policy would be in a different posture with reference to the right he has got to participate in the savings you can make out of his premium on the cost of insurance and his participation that he is entitled to in your earnings on your investments.

Doesn't it seem to you that there would be a difference there? Not in the fact that as a policyholder he is entitled to participate in both. But in the first place, it is a return of excess cost that you charged him; isn't it?

Mr. DAVIS. Yes. I think you can more easily say that in the premium itself—that that you can identify of the policyholder dividend is a part of the overcharge in the premium.

Senator KERR. There can't be any question about that.

Mr. DAVIS. That is capital. I think everybody ought to agree with that.

Senator KERR. Under our system of taxation where there is a basis and a reasonable effort to take investment return, in the hands of whoever it may be, aside from, you know, churches or charitable institutions, the right of a policyholder or a stockholder to participate in that earning is subject to the right of the Government to tax that earning before either the policyholder or the stockholder can identify the part that he is entitled to participate in in the form of a dividend.

Mr. DAVIS. I think the Government has a legal right to; yes, sir.

Senator KERR. Well, now, wouldn't you say if they have the principle of taxing earnings that they would have to make an exception if they didn't tax them even in the hands of an insurance company?

Mr. DAVIS. I wouldn't call it an exception because it is an entirely different situation. The use of those reserves which have to be set aside in level term insurance just must involve the assumption in the construction of the premium of this amount of money that can be earned because it would not be good for anybody—the insured, the company, the country, or anybody else—if these reserves were not earned.

Senator KERR. You mean if these reserves were not used to earn.

Mr. DAVIS. Used to earn. I'm sorry.

Senator KERR. Sure.

Mr. DAVIS. Now, having used them to earn, it is true that you can argue that there has been newly created wealth come into the picture by the process of using those reserves. But that is something which temporarily is used for the support of the life insurance contract, and if it is to be taxed, certainly in a mutual company I would think the only point where it would reach taxation or should reach taxation is when it finally comes into the hands of the individual policyholder, if it is to be public policy to tax death claims. That would be the point.

Senator KERR. You know a return of capital from a corporation, even though it is in the form of kind of a dividend, is not taxable in the hands of the stockholder, while a dividend from earnings is. But that return of capital is treated differently even in the hands of a corporation than an earning in the hands of a corporation because on the one hand it is a capital gains tax and on the other hand it is an ordinary income tax. And it would seem to me that there would be a basis for the position of the Treasury that the earnings of even a mutual company on its investments are entitled to be taxed before the balance of it is available to the company to pay it out to its policyholders. It has to be, it seems to me, in the form of a dividend rather than in the form of a cost adjustment on the policy he owns.

Now, I take it that you can't see your way to agree with that.

Mr. DAVIS. I can't see it because it strikes, it seems to me, at the very foundation upon which the mutual life or mutual organization is based when we apply it to life insurance.

The CHAIRMAN. Senator Butler?

Senator BUTLER. No, sir.

The CHAIRMAN. Senator Frear?

Senator FREAR. Nothing more.

The CHAIRMAN. Senator Cotton?

Senator COTTON. I have a couple of simple questions.

I just wanted to ask you this. You have suggested two, as you characterize them, important amendments to this bill. If the first amendment based on the actual earnings of an individual company and without the added provision of the 5-year average should be written into this bill, can you tell us how that would affect the revenue in this bill?

Mr. DAVIS. I shall have to turn to my associate for his figures. I think I can give them but I don't dare.

He tells me that he feels that it would be about $35 million more. That is, $35 million more than it would be to adopt a 5-year average.

Senator COTTON. No; I beg your pardon. I didn't make my question clear. My question is, If you wrote into the bill an amendment based on 1 year's earnings without the 5-year provision, how would it affect the revenue as it is in the bill in its present form?

Mr. DAVIS. Well, I think it would reduce it by about $85 million.

Senator COTTON. $85 million. Now, if that first amendment that you suggested should be written into the bill with the 5-year provision, how would that affect the revenue? How would that compare with the revenue in the bill as presently written?

Mr. DAVIS. Well, between $45 and $50 million.

Senator COTTON. Less?

Mr. DAVIS. Yes.

Senator COTTON. Incidentally, could you very briefly tell me why, based on a 5-year average of the actual earnings, the figure would be higher than if based on 1 year?

Mr. DAVIS. Well, I think the principal reason is that we are in a high period of earnings, for one thing, and have been, and I think the relation—what happens there is if you take the average between, say, 1958 and the 4 years immediately preceding, you throw up a little larger amount in the revaluation of reserves that would be considered surplus, and therefore be in the tax base.

Senator COTTON. Well, now, proceeding on the basis of trying to write an insurance tax bill, disregarding the revenue but trying to get a just and equitable working bill, would it in your opinion, forgetting the revenue entirely, be more just to have it based on each year's actual earnings or on a 5-year period?

Mr. DAVIS. It would be more just because it would eliminate every single bit of artificial factor in the formula, which is not the case now. You have two artificial factors in there. You have this mean between an actuary's guess on the one hand and an interest rate earned on the other, and then in certain cases you would make applicable a company average. Now, those are artificial in my judgment.

Senator COTTON. Would basing it on each year's income be less artificial and more realistic than taking your suggested possible 5-year average?

Mr. DAVIS. Yes, sir.

Senator COTTON. If you were writing the bill strictly to get down to brass tacks and have it on a fair, just, and equitable basis.

Mr. DAVIS. It certainly would. If that sole consideration, leaving the revenue out of consideration and the construction of the basic form. You should not even consider the 5-year average.

Senator COTTON. Now, if this bill contains your first amendment plus the 5 years, the revenue would be, you said, about $50 million less than as presently written?

Mr. DAVIS. Yes.

Senator COTTON. Now, referring to your second proposed amendment, namely, giving credit for the negatives in phase 2 of the bill how much would that amendment cost using as a yardstick the income derived by this bill if it should be enacted as written?

Mr. DAVIS. You mean comparing the negative alone against the bill?

Senator COTTON. Yes.

Mr. DAVIS. As it presently is?

Senator COTTON. Yes. Suppose your first amendment is not adopted, but the second is. How would it affect the revenue?

Mr. DAVIS. With your permission I am going to ask Mr. Preble to answer that question because he has worked on this aspect of the thing a lot more than I have.

Mr. PREBLE. Insofar as I know, Senator, that figure is not available. I don't know what it would be. If the first amendment were adopted, the additional loss in revenue as a result of the second amendment would be approximately $35 million.

Senator COTTON. So that if both amendments were adopted, including the 5-year average, the sacrifice in revenue for 1958 would be roughly $85 million for both?

Mr. PREBLE. That is correct.

Senator COTTON. If only the first were adopted, the sacrifice would be about $50 million.

Mr. PREBLE. $45 million or $50 million.

Senator COTTON. If only the first part of it—that is, just getting down to 1 year's actual earnings—were written into the bill, how much would the sacrifice be?

Mr. PREBLE. About $85 million; $85 million to $100 million. Something in that range. I am not sure.

Senator COTTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Smathers?

Senator SMATHERS. I didn't hear his direct testimony, Mr. Chairman, so I will pass.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Mr. Davis, I appreciate your statement.

In reference to the second amendment that you discussed, involving the negatives, considering the bill as written is it your opinion that a company could be liable for a tax and still have no net gain because of the failure of the bill as written to permit that negative offset?

Mr. DAVIS. I think so; yes. A mutual company; yes.

Senator CURTIS. A mutual or a stock that has considerable participating business.

Mr. DAVIS. Yes. Enough participating business.

Senator CURTIS. Is that assumption fantastic?

Mr. DAVIS. Is what?

Senator CURTIS. Is that assumption that it might be liable for a tax even though it had no gain fantastic or theoretical?

Mr. DAVIS. No.

Senator CURTIS. It could happen.

Mr. DAVIS. Yes, sir.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. I was interested in your reply to Senator Kerr about that advertising slogan. Was that, "All death benefits paid"——

Mr. DAVIS. I'm sorry. I can't remember the exact words but I remember it because it has been a matter of discussion at our company many, many times.

Senator ANDERSON. Would it be untrue as to the year 1957?

Mr. DAVIS. Oh, yes.

Senator ANDERSON. In 1957 you had $400 million loaned out. You received 3 percent or 4 percent on that?

Mr. DAVIS. I think our earnings this year—well, for the money, all the money, old and new, it is around 4.7. Something like that.

Senator ANDERSON. You have got at least $14 million or $15 million from that; haven't you?

Mr. DAVIS. Yes.

Senator ANDERSON. And you had $50 million worth of real estate. You had to get some gross of around $4 million or $5 million out of that. Your death benefits were $12 million. So your slogan still would have been all right; wouldn't it?

Mr. DAVIS. Well——

Senator ANDERSON. Why did you abandon it?

Mr. DAVIS. I didn't abandon it. It was abandoned a long time before I got there.

Senator ANDERSON. It is possible by assigning expenses——

Mr. DAVIS. It is possible.

Senator ANDERSON. To other things that you can pay death benefits from interest or rents. At least the last investment report would indicate that you are in fairly good shape that way. [Laughter.] I didn't want you to be too modest about the fine growth of the company.

You listed in the statement on page 6 about the formation of new companies that the increase is from 651 to 1,314 from 1950 to date. You called attention to two States in that. Arizona on December 31, 1950, had 8 companies and now has 81. New Mexico, which lies close to it and has somewhat similar conditions, had two companies in

1950 and now has two. Have you any explanation of the enormous expansion of companies in Arizona?

Mr. DAVIS. I don't think the people in New Mexico have quite as much imagination when it comes to speculation. [Laughter.]

Senator ANDERSON. It is the way life goes. Just a year ago I thought I had too much imagination. [Laughter.]

Now we go to Texas, from 118 to 323. You can see they have got imagination. Would it be perhaps that New Mexico got its epidemic of burning on life insurance companies earlier in the 1930's when a great many companies closed up? Arizona went to 81. Now, the reason I am asking that question is that I have a telegram that came in today. It says:

> The First National Life Insurance Co., of Phoenix, Ariz., of which I am a director, has completed a study of H.R. 4245 as passed by the House last week. We feel three parts of the bill unfair.
>
> Part 1, there is a provision for a deduction and the formula permits the large companies, who are now reserving at a rate below the industry average, to use the industry average. This is an advantage to them of tremendous importance, and in effect, a tax windfall to these companies. Almost all stock companies reserve on a 3-percent basis, while the large mutuals are reserving on a 2¼- or 2½-percent basis.

Would you comment on that?

Mr. DAVIS. Well, it is difficult for me to comment on the First National Life Insurance Co., of Arizona.

Senator ANDERSON. No; I am not referring to that. I am referring to the claim that the formula permits the large companies—he is referring particularly to the large mutuals—to get a tax windfall by using the industry average whereas you have just said you would rather not use the industry average and you have a fair-sized company, and I understand that certain other companies, particularly large mutuals, are also in favor of using their individual averages on a 5-year basis—either the 1 year or the 5-year basis. Do you feel that that is a fair way to do it for the industry generally?

Mr. DAVIS. You mean use the actual earnings? Yes, sir; I do. And I would like to comment on the telegram.

Senator ANDERSON. Yes; that is what I want you to do.

Mr. DAVIS. To this extent. If I gathered what they are saying, it is that there is a windfall involved in some companies that have a very low interest assumption basis. Therefore, a high reserve basis.

Senator ANDERSON. Yes.

Mr. DAVIS. I don't think that is true at all. The minute you get away from a figure that nobody can jockey or a figure using assumptions, you run into this question of what are you going to use, the average of this or the average of something else? All the trouble, the whole history of investment income trouble as a base all these years for life insurance companies, the reason—and this is a good example—when they moved away from the actual earnings interest rate, then they discovered doing that, here are companies that now are going to use the mean between an assumed rate and an actual rate; then the assumed rate begins to have weight in the picture and a company that has been very, very conservative under those circumstances would be hurt under this kind of an approach, and so the company average is put in to offset the hurt.

Why try to do that? Why not take something that is absolutely not to be tinkered with at all and represents simply the company's earned rate every single year? The only way you can affect that rate is not earn it.

Senator ANDERSON. Well, I am glad to hear you say that because I have thought that the proposal for a 5-year average tended to help, if it didn't amend, a conservative policy. It might be that life insurance business was one field where a conservative policy was greatly to be desired.

Mr. DAVIS. Correct.

Senator ANDERSON. Therefore, I am asking this because we are asked questions: "Why do you do certain things?" Other members of this committee know what I mean. Therefore, you don't think that using the industry average is an advantage of tremendous importance to the big companies, and particularly the big mutual companies?

Mr. DAVIS. No. I think the minute you get away from the fixed rate that they actually earned, then you have to start tinkering it up in order not to do harm to certain companies, and that is why the company average is put in there.

Senator ANDERSON [reading]:

> Part 2, a taxation is placed on gains from operations. We feel the unfairness to this is apparent and could have disastrous long-range effects on the stock life insurance companies of the United States. We are not referring to the capital gains aspect, but to the deductibility of policyholders' dividends before taxes are determined. This enables the mutual companies to have a tremendous competitive advantage over all stock companies.

I listened to your answers to Senator Kerr and I assume that you don't agree with that either, do you?

Mr. DAVIS. That is an outworn philosophy that has been played for so long that it ought to be forgotten.

Senator ANDERSON. Well, I agree with you, but I wanted an expert to testify on that.

The third part says [reading]:

> Part 3 provides for additional taxation on gains from operations, and has the same unfair aspect as in part 2 of the bill, but goes further and places a limit on the amount of surplus that can be accumulated. This is a barrier to the growth of stock companies—especially small stock companies.

Do you think that is true?

Mr. DAVIS. No; I do not.

Senator ANDERSON. I was just looking at some figures of stock companies. I am looking at stock prices 10 years ago and stock prices today. I read a newspaper advertisement yesterday saying that $1,000 put in a certain Washington company 10 years ago would be $100,000 today, and those of us who are living here and had that happen under our noses have an unpleasant feeling about it.

To take Connecticut General, the price per share was $90. The stock had been split 4 to 1. I don't guarantee the figures but I believe them to be right. The bid price on December 31 was $358, making a $1,432 value as against $90 10 years ago.

Would that indicate that the stock companies had been badly handled in the last few years?

Mr. DAVIS. No. I don't think so. I think also in fairness you should say on all these stock shares, I haven't seen one that is not way too high over its actual value.

Senator ANDERSON. I will see you outside. I have got stock in one that isn't.

Mr. DAVIS. I would advise you to sell it right now. [Laughter.]

Senator ANDERSON. I can hardly get my seed back.

The Travelers—Senator Douglas asked you about Travelers a minute ago—is a very large, well-organized company, a very strong company. There the price ranges from $668 to where it is now worth about $4,750. I only use those figures to show that good, well-managed stock companies were getting along very well. If you do hit these places where people complain that the bill is very severe, it may be that they are just getting in the way and may need some special treatment, but the insurance industry is in pretty good shape, would you say?

Mr. DAVIS. Yes. I would think so.

Senator ANDERSON. I have a letter from a Texas company—I am not going to read it—saying the stock companies would arbitrarily be placed at a competitive disadvantage with mutual companies. You testified, but merely because I want it again, you don't believe the purpose of this bill is primarily to discriminate against them?

Mr. DAVIS. Oh, indeed not.

Senator ANDERSON. And on the point that was raised by Mr. Lindsay where he said he would rather have a good bill—I am probably misquoting him, but he wanted a good bill with good principles in it and wasn't so concerned about what the yield was. I feel the same way. I would like to see a very good bill even if the return dropped $450 million or $475 million, or $500 million from the $560 million.

Do you believe that the switch to the 5-year actual rate on investment return, even though it cost $40 million, might be a desirable thing to put into the bill?

Mr. DAVIS. Oh, I certainly think so.

Senator ANDERSON. How about the pension program?

Mr. DAVIS. The pension program I personally happen to believe—and it doesn't happen to mean very much in my company—I think that it should have been corrected a long time ago.

Senator ANDERSON. You therefore feel it would be all right to put the pension change in immediately and not jump it in three steps?

Mr. DAVIS. Yes, sir.

Senator ANDERSON. It might cost $60 million but is that as important as getting a good insurance bill?

Mr. DAVIS. I think that is one of the elements of getting an insurance bill, but I think if it is graded in, the principle having been established, it isn't so important as these other things.

Senator ANDERSON. I used to quote from an editorial writer who said that no great problem is settled until it is settled right. That is why Senator Gore and I got so much out of this last year because we knew it wasn't settled right. This time we would like to settle it right. If the step ought to be taken at once—I understand it nearly was taken the other time.

Mr. DAVIS. Oh, yes. The Ways and Means in 1955 enunciated that principle, passed it unanimously, as I remember it.

Senator ANDERSON. Then you subscribe to the belief that this is a good bill.

Mr. DAVIS. This is a tremendous bill, Senator. I am so pleased after all these years. This really is a bill. Now, my company will pay taxes—last year we paid $2 million. This year we will pay, if the bill is left alone, something like $4,280,000. If you amend it the way I ask you to, we will pay $3,815,000, which is still more than we would pay under the 1942 law. But this industry has reached a point—I am not assigning the blame anywhere, within the industry or without the industry—it has reached a point where for the benefit of industry and the public at large, this question must be settled and we never were so close to a good sound bill as we have in the basic framework, and I want to pay a tremendous tribute to the staffs of the Treasury Department, of the Joint Committee on Internal Revenue Taxation—I think that is what you call them—Mr. Stam's group, and the Ways and Means technicians. They have been so patient. We worked a whole year trying to iron this thing out. We got down to the basic form. Now let us finish it off right.

Senator ANDERSON. Now after some trimming that might be made along the amendments you suggested, if this bill provides $500 million, and if the 1942 act which is going to be in effect probably if this doesn't pass provides $500 million, which is the best way to raise $500 million? As this bill is amended even if you took out some of these things?

Mr. DAVIS. Yes.

Senator ANDERSON. Or the 1942 act?

Mr. DAVIS. This bill beyond any question. I don't think you will find a student of this question anywhere that would say the 1942 law.

Senator ANDERSON. Of course, I don't understand how we passed it. I was in the House at that time and Senator Gore was.

Mr. DAVIS. There has been a lot of changing. What did we say? A lot of water over the dam, water under the bridge, since the 1942 law was passed.

Senator ANDERSON. That is all, Mr. Chairman.

The CHAIRMAN. Senator Gore?

Senator GORE. You have given a general, and in some respects a moving endorsement of this bill which you describe as being a tremendous bill.

Mr. DAVIS. Yes, sir.

Senator GORE. Although you do suggest two amendments.

Would you turn to page 2 of the bill. On page 2 of the bill you will find the definition of a life insurance company. Is that definition broad enough to classify as life insurance automobile insurance?

Mr. DAVIS. To classify as life insurance an automobile insurance company?

Senator GORE. Classify as a life insurance company a company which writes automobile insurance.

Mr. DAVIS. Well, I think it would.

Senator GORE. You think it would. Is it broad enough to cover the writing of workmen's compensation insurance?

Mr. DAVIS. Yes. As affected by this bill, yes.

Senator GORE. Is it broad enough to cover accident and health insurance policies?

Mr. DAVIS. If the 50-percent factor is there, yes.

Senator GORE. Is it broad enough to cover so-called credit insurance?

Mr. DAVIS. Yes.

Senator GORE. Is it broad enough to cover business by these specialty companies to which reference has been made?

Mr. DAVIS. I think so.

Senator GORE. None of which is primarily life insurance.

Mr. DAVIS. I wouldn't say that.

Senator GORE. You think automobile insurance is life insurance?

Mr. DAVIS. No. But I think an automobile company that sells life insurance ought to be treated as a life insurance company so far as its life insurance business is concerned. That is all this definition, with the rest of the bill, does.

Senator GORE. Then you agree with this definition.

Mr. DAVIS. Yes, sir.

Senator GORE. Well, I don't.

Isn't this bill, which you endorse, based on the principle that the entire free investment income of both mutual and stock companies should be subject to taxation?

Mr. DAVIS. Well, yes. I think the fair answer to that is yes, although it is different.

Senator GORE. But you don't endorse that principle?

Mr. DAVIS. I don't endorse the principle that all free investment—I don't endorse the free investment theory of interest as a tax base; no.

Senator GORE. Just how do you endorse this bill, then, Mr. Davis?

Mr. DAVIS. I endorse this bill on the basis that a revaluation of the reserves of the life insurance company so that you set up a lower amount of reserves and a higher amount of surplus and apply against the reserves the amount of your actual earnings rate and against your surplus the amount of your actual earnings that you earned on that, and that is your base.

Senator GORE. Well, now, you have just answered affirmatively when I asked you if the basic policy of this bill is not a taxation of the free investment income, after deductions, of both mutual and stock companies. And yet the second amendment which you propose would violate that very principle, would it not?

Mr. DAVIS. I think not.

Senator GORE. Just what would your second amendment do?

Mr. DAVIS. My second amendment would do the same thing for mutual companies with respect to offsetting the difference between total gains and investment gains that it does in the bill for stock companies.

Senator GORE. Would any part of the loss, if a loss resulted, be subtracted from liability under phase 1?

Mr. DAVIS. Yes, sir.

Senator GORE. Then it would violate the principle.

Mr. DAVIS. I wouldn't think so.

Senator GORE. Thank you, Mr. Chairman.

May I ask one other?

I believe you made a statement earlier today in reply to a question from Senator Kerr that most of the so-called speciality, credit or credit life insurance, however you want to describe it, was written by stock companies. I don't know the percentage but I gather from life insurance reports, the "Best's Life Insurance Reports," that Prudential engages to a rather large extent in term insurance. Isn't Prudential a mutual?

Mr. DAVIS. Yes. It is a mutual. We are speaking about credit insurance. Term can be credit insurance or noncredit insurance.

Senator GORE. Well, it is entirely possible for me to be confused on terminology as well as on anything else. And I guess I am in this case.

To what extent do mutual companies engage in automobile insurance, credit insurance, health insurance, accident insurance, short-term insurance?

Mr. DAVIS. They engage in all those forms.

Senator GORE. I know they do. I am trying to find out to what extent they do.

Mr. DAVIS. Some companies to a large extent.

Senator GORE. Well, I know you didn't intend to mislead me and I guess that I was misled, if misled, by my own misunderstanding of terminology; but I did misunderstand, I guess, your meaning in answering Senator Kerr.

Now, can you give me the extent to which mutual companies engage in these categories of insurance which I have named?

Mr. DAVIS. I think if you would take all the stock companies in one group and all the mutual companies in another, you would find the proportion of this nonreserved business much larger in stock companies than you will find in mutuals.

Senator GORE. A much larger percentage or——

Mr. DAVIS. What I mean is the percentage of their total business. If you set the stocks over here and the mutuals over here [demonstrating] and then compare the percentage of business that doesn't have investment reserves, reserves from which investment income is earned, you will find on the whole the percentage within each stock company and the whole stock companies in a group would be larger, I believe, in relation to the whole of the stock companies.

Senator GORE. But how do the totals compare? Do you know?

Mr. DAVIS. My guess would be if you took the totals, because of the tremendous volume that the mutuals have, there might be more in the mutuals.

Senator GORE. Is there anyone here who can answer that question?

(No response.)

Senator GORE. Mr. Chairman. Could we ask the committee staff to obtain information on this point?

The CHAIRMAN. The staff will obtain it and it will be inserted in the record.

(The information subsequently obtained by the staff follows:)

*Premium income of U.S. life insurance companies, 1957*

[In millions]

| Type of business | Stock companies | Mutual companies | Total |
|---|---|---|---|
| Credit life (individual and group) | $175 | $75 | $250 |
| Group life | 525 | 750 | 1,275 |
| Ordinary regular and decreasing term | 75 | 175 | 250 |
| Accident and health (individual and group) | 1,575 | 1,325 | 2,900 |
| Workmen's compensation, auto and other liability | 225 | ........... | [1] 225 |
| Subtotal | 2,575 | 2,325 | 4,900 |
| All other ordinary life | 2,200 | 4,725 | 6,925 |
| Industrial life | 675 | 875 | 1,550 |
| Annuities (individual and group) | 325 | 1,075 | 1,400 |
| Total | 5,775 | 9,000 | 14,775 |

[1] Includes workmen's compensation $85,000,000, auto liability $105,000,000 and other liability $35,000,000.

Source: Life Insurance Fact Book, Spectator Year Book and special tabulations of life company reports. Some breakdowns estimated.

Senator GORE. Now, Mr. Davis, is it true that to the extent to which a mutual or a stock company may engage in these categories of short-term insurance, without the establishment of reserves, the company's net earnings from this type of business are completely untaxed by the present law?

Mr. DAVIS. Yes, sir.

Mr. GORE. Both mutual and stock.

Mr. DAVIS. Yes.

Senator GORE. You think it should be taxed for both?

Mr. DAVIS. Yes, sir.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Mr. Davis, I would like to ask one or two qualifying questions, some of which you have already touched on.

There has been some argument, as you know, that stock companies allege that this bill aids mutuals, and vice versa. As I understand the present ratio of payments it is about 75 percent on the mutual companies and 25 percent on stock companies. Is that true of both the 1942 act and also the stopgap act?

Mr. DAVIS. Yes, I think so.

Senator TALMADGE. In other words, the same ratio would hold under both provisions.

Mr. DAVIS. Yes.

Senator TALMADGE. Now, turn to your statement. You state:

> I do not recommend that so-called underwriting losses be fully allowed as offsets to taxable investment income in mutual companies, in spite of the fact that this full offset is allowed in stock companies. Instead, I recommend that 50 percent of such losses be allowed. This 50-percent allowance would go part way toward eliminating the discrimination now found in phase 2 of the bill and would give some recognition to the argument, sometimes made, that policyholder dividends are not entirely price adjustments.

I believe you testified that if the amendment you recommended were adopted, the net effect of it would be to reduce the revenue approximately $35 million under the terms of this act.

Mr. DAVIS. Yes, sir.

Senator TALMADGE. All of that reduction would be in favor of the mutual companies, would it not?

Mr. DAVIS. Well, there would be some stocks, you see, that would get benefits from it, too, on their participating business.

Senator TALMADGE. Providing the stock companies wrote participating policies.

Mr. DAVIS. Yes.

Senator TALMADGE. That is normally heavier in the mutuals, is it not?

Mr. DAVIS. Yes. It is much heavier, of course.

Senator TALMADGE. Now, if that amendment of your were adopted, then this bill—if no further change be made in it—would bring in slightly over $500 million in revenue, would it not?

Mr. DAVIS. Yes.

Senator TALMADGE. Now, what would be the burden of taxation under that apportionment between mutual companies and stock companies? Approximately, if you have the figures at hand, or if you could give a good guess.

Mr. DAVIS. Well, Mr. Preble says it would probably be about 67–33.

Senator TALMADGE. About 67–33.

Thank you very much.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. Judge Davis, as I understood your answer to Senator Kerr, there is some question as to whether or not the 1942 law would be the operative law this year for 1958. Isn't that right?

Mr. DAVIS. Well, I think it is technically operative already. It has been ever since the end of the year.

Senator HARTKE. And some companies evidently have anticipated that the law would be as the law was written rather than anticipating the law which the Treasury was going to possibly adopt, is that right?

Mr. DAVIS. Well, it is true that some companies so hoped.

Senator HARTKE. Well, as a member of the bar—you are, are you not?

Mr. DAVIS. Yes, sir.

Senator HARTKE. Is it customary or proper for any individual or firm to assume that the law would be changed and come before the court with the idea that you misunderstood what the law was going to be and guessed wrong?

Mr. DAVIS. Well, I think in the application, you are giving it a general application, of course, that would be improper.

Senator HARTKE. So the company which anticipated that the 1942 law was going to be in effect and set up his tax reserve accordingly is legally in a stronger position than those companies which participated in the formation of this law to the exclusion of those small companies which had no call upon them individually to express their opinion until the law comes before either the House or Senate for consideration, isn't that right?

Mr. DAVIS. I think legally there is no difference whatsoever in the position between a company such as my own, which has set up its tax liability on the basis of the 1942 law. Why? Because that is, it seems to me, the only logical thing to do until there is action by Congress one way or the other. But I certainly never foresaw or ever thought and have told my directors from time to time the 1942 law in my opinion would probably never be applied again. Believe me, I hope it never will be.

Senator HARTKE. Do you have assurance from any individual, any part of the Government, any committee or any organization that the law would change?

Mr. DAVIS. Well, yes. I had assurance from listening to the long discussions with technicians in the Treasury Department, with the Under Secretary of the Treasury, with the Secretary of the Treasury, with the technical staff of the Ways and Means Committee, several members of the Ways and Means Committee, and putting them all together I used by own judgment and believed that it would never again be applied.

Senator HARTKE. Did you at any time have any idea that the composition of those authorities might change?

Mr. DAVIS. Oh, indeed, yes. That is a risk that is almost like life insurance. [Laughter.]

Senator HARTKE. And in effect did change last November, did it not?

Mr. DAVIS. Yes, indeed, sir.

Senator HARTKE. Well, what I am getting at, I have heard here several times, and I hear the Treasury Department in answer to Senator Byrd, has said that no one had suggested that the 1942 law should be used. I may be wrong on that but it is what I thought the Treasury Department answered.

The CHAIRMAN. No one recommended to the Treasury Department.

Mr. DAVIS. I don't know that I understand.

Senator HARTKE. As I understood it, the Treasury Department said that no one had suggested that the 1942 law be used.

Mr. DAVIS. I think that was the testimony; yes, sir.

Senator HARTKE. And I understood you to say that this was formed with all of the insurance people. This particular bill was formed by consulting all of the insurance people as to the type of law they wanted.

Mr. DAVIS. You mean House 4245?

Sentor HARTKE. Yes.

Mr. DAVIS. If I gave any such impression as that, I hope it will be corrected. That is not the fact.

Senator HARTKE. The reason I said that, I have a large file here of people who tell me they want the 1942 law to be effective for an insurance company. I just wondered where their representation was when this law was born.

Mr. DAVIS. Well, most of them are members of various organizations which knew of all of the steps from time to time during the formulation. Whether each one knew individually I cannot say, of course.

Senator HARTKE. Let me ask you, Did you at any time when the formation of this law was being made hear anyone recommend that the 1942 law be carried into full force and effect at the expiration of the stopgap law?

Mr. DAVIS. Not until just recently.

Senator HARTKE. Not until just recently?

How recently?

Mr. DAVIS. Within 2 weeks.

Senator HARTKE. All right. Let me ask you, in your statement you refer to the Menge formula which you say should be followed, is that right?

Mr. DAVIS. Yes, sir.

Senator HARTKE. All right. And then you are talking about the assumed rate and the adjusted reserve method which you say partly has been used in this final bill, is that right?

Mr. DAVIS. I say that the principle of adjusting the reserves is used in the bill. That portion of it has been adopted.

Senator HARTKE. Was this a result of compromise between the people who were forming this bill, as you were adopting the policy?

Mr. DAVIS. Oh, no. Definitely not. We had no part. The industry had no part whatsoever in discussing with the Ways and Means Committee after the hearings in November, I believe—the November hearings.

Senator HARTKE. In other words, this formula was adopted as far as you are concerned, completely separate and apart from consultation with the industry.

Mr. DAVIS. Oh, yes, indeed.

Senator HARTKE. Well——

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Mr. DAVIS. I won't say the consultations that were had before that didn't have some bearing on it, but the change was not a matter of industry discussion or compromise or anything like that. In fact, there has been no compromise in this whole picture anywhere to my knowledge. It has been—if the compromises have been made, they have been made in principle or in spite of principle by the drafters of the law, and what went on in the Ways and Means Committee. There has been no trade, is what I am trying to say.

Senator HARTKE. But the Menge formula is the one you want adopted, is that right?

Mr. DAVIS. The one I say should be adopted; yes, sir.

Senator HARTKE. In one of your proposed amendments. Let me get one other thing clear here, and then I will be through. You make the statement: "This argument ignores the basic fact that policyholder dividends are merely price adjustments." Then when you come back, as I understand it, and recognize that it may be more than mere price adjustments. Isn't that right? And in answer to Senator Kerr you said that the so-called policy dividend is in fact a combination of items.

Mr. DAVIS. Yes. I do not recognize that they are anything but price adjustments, but that argument as to what the content or essential nature of policyholder dividends is has been made for quite a number of years. Many stock companies take the position that it is not entirely a price adjustment, and we are looking for practical results and progress here. And so I personally feel that in a situation like that, you have to face up to the realities of life and try to meet these arguments that are made on an honest basis. That is the reason I am for the 50–50 deal.

Senator HARTKE. But as I understand your argument on page 14, you say it ignores the fact that the policy dividends are merely price adjustments and therefore should be allowed as a deduction without any limitation.

Mr. DAVIS. That I think is the basic principle. That is my belief, that they should be allowed as a price adjustment in full in a matter of principle. But I have heard so much, and I heard it in the Ways and Means Committee, the very announcement when we started—I was a little bit shocked actually—that the position should be taken at that point that because there had been carried into some penciled calculations that ultimately found their way into the budget at $500 million as being the amount that the 1942 law might have, that that was a measuring stick by which you took a look and had to come out and get at least that much. I think that is poor legislation.

Senator HARTKE. You say as a matter of principle your statement on page 14 is correct, but you are willing to agree you have heard so much about it, it should be changed.

Mr. DAVIS. That is correct. I say if mutual companies are given at least half of the same treatment with respect to policyholder dividends that the stock companies are given with reference to their difference between the tax base under step 2 and under step 1, that I personally believe that that would be a practical way to take care of everybody's position on this thing.

Senator HARTKE. Let me ask you one other question. It doesn't have relation to this, but it is something that bothers me in another related field with insurance companies and this tax field.

Do you anticipate in your company a 30-percent increase in profits in 1959 over 1958?

Mr. DAVIS. No. Practically none.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. This isn't a final question but you suggested some amendments. Would you supply languege so we can put it in the record and thereby not only have a chance to study it but allow other people to take a look? Language that carries out the amendments you propose or such other modifications you have in mind.

Mr. DAVIS. Would you like it in the form of bill language?

Senator ANDERSON. Yes. Amendments to the bill, and then we can send that to the Treasury and ask them what they think it does, and other people who may wish to comment on it.

Mr. DAVIS. I would be very happy to.

The CHAIRMAN. And we would like to insert the language in the record as a part of your remarks.

(The material referred to is as follows:)

PROPOSED AMENDMENT TO H.R. 4245 RE REVALUATION RATE IN FIRST PHASE

Strike out section 805 (b) (2), page 13, and substitute following:

"(2) DEDUCTION RATE.—For purposes of this part, the deduction rate for any taxable year is the amount ascertained by dividing by five the sum of the investment yield rates (as defined in subsection (c) (1)) for the taxable year and each of the four preceding taxable years."

PROPOSED AMENDMENT TO H. R. 4245 WITH RESPECT TO DEDUCTION FOR DIVIDENDS TO POLICYHOLDERS, ETC.

Strike section 809 (g) and substitute the following:

"(g) LIMITATION ON CERTAIN DEDUCTIONS.—

"(1) RESERVES FOR CERTAIN NONPARTICIPATING CONTRACTS.—The amount of the deduction under paragraph (6) of subsection (d) shall not (after the application of subsection (f)) exceed the amount by which—

"(A) the gain from operations for the taxable year, computed without regard to such deduction and the deductions under paragraphs (3) and (7) of subsection (d), exceeds

"(B) the taxable investment income for the taxable year.

"(2) DIVIDENDS TO POLICYHOLDERS AND GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE.—If the gain from operations for the taxable year, computed without regard to the deductions under paragraphs (3) and (7) of subsection (d) but after the deduction under paragraph (6) of subsection (d), exceeds the taxable investment income for the taxable year, the amount of the deductions under paragraphs (3) and (7) of subsection (d) shall not (after the application of subsection (f)) exceed—

"(A) the amount by which—

"(i) the gain from operations for the taxable year, computed without regard to such deductions but after the deduction under paragraph (6) of subsection (d) as limited by paragraph (1), exceeds

"(ii) the taxable investment income for the taxable year, plus

"(B) 50 per centum of the amount by which—

"(i) the taxable investment income for the taxable year exceeds

"(ii) the gain from operations for the taxable year, computed after the deductions under paragraphs (3) and (7) of subsection (d) and the deduction under paragraph (6) of subsection (d) as limited by paragraph (1);

otherwise the deductions under paragraphs (3) and (7) of subsection (d) shall be reduced by 50 per centum.

"(3) APPLICATION OF LIMITATION.—The limitation provided by paragraph (2) shall apply first to the amount of the deduction under paragraph (7) of subsection (d) and then to the amount of the deduction under paragraph (3) of subsection (d)."

The CHAIRMAN. Any further questions?

Senator FREAR. Only one parting shot, Mr. Davis.

I suppose if you ever gave consideration to reviving your old slogan, you would have to change it and say, "Taxes and death benefits are paid from interest and rents." [Laughter.]

Mr. DAVIS. That is right. We have got a better slogan now, Senator.

Senator FREAR. Good.

Mr. DAVIS. "Solid as the granite hills of Vermont."

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

The next witness is Mr. Carrol M. Shanks, the president of the Prudential Insurance Co. of America.

Mr. Shanks, will you come forward. You may proceed.

## STATEMENT OF CARROL M. SHANKS, PRESIDENT, PRUDENTIAL INSURANCE CO. OF AMERICA, ACCOMPANIED BY WILLIAM CHODORCOFF, VICE PRESIDENT AND COMPTROLLER, AND LOUIS R. MENAGH, EXECUTIVE VICE PRESIDENT

Mr. SHANKS. Mr. Chairman, my name is Carrol M. Shanks. I am president and chief executive officer of the Prudential Insurance Co. of America, which is a mutual company. We insure the lives of 35 million people in the United States and Canada, and I am concerned primarily with the effect of the present tax bill on these people.

I want to say I have with me Mr. William Chodorcoff, comptroller and vice president, and Mr. Louis Menagh, executive vice president of Prudential.

I will limit my discussion to four situations created by the present bill which, in my estimation, should be remedied not only to make the bill more equitable and reasonable, but in the public interest.

The first situation has to do with the highly unsound basis for the computation of taxable investment income called for in the bill. In the present bill, this is computed on an entirely artificial basis. Any method which relates the policy reserve deduction to the rate of interest assumed by a company in calculating its policy reserves, or even the industry average, is unsound. All such methods penalize the conservative company. Greater equity could be secured if the deduction rate as specified in the bill is replaced with the individual company average earned interest rate for the most recent 5 years, and by using this same rate for adjusting the reserves. Doing this would put all companies on a sounder basis for the tax computation in step 1, and it would eliminate any incentive for any company to weaken its reserve structure in the future.

If this amendment were made to the bill, the total tax yield for the industry would be reduced by approximately $43 million.

The second situation that I want to discuss is of great importance because, in many ways, it threatens the very foundation of the mutual life insurance companies. Certainly, it will bring about significant changes in the nature of our business.

Under the present bill, virtually all mutual companies will, in effect, pay a tax of 52 percent on a substantial portion of their "dividends to policyholders."

Mutual companies include in policyholders' premiums a margin which is, by contract, required to be returned to the policyholder if it isn't needed. Dividends to policyholders, therefore, are actually price adjustments, as has been said here many times, and should be considered as such. This was so held by an appellate court, and the Supreme Court refused to reconsider.

A large portion of the dividends to policyholders of mutual companies, sometimes a very large portion, are being taxed in this bill because the tax formula disallows any price adjustments paid to policyholders which would reduce the computation in step 2 below the amount computed in step 1. In the case of the Prudential, our taxable investment income in 1958 under step 1 of this new bill was $130,700,000. Our gain from operations in step 2 before Federal income tax and policyholder-price-adjustments, was $388 million. In 1958, our dividends to policyholders, that is, adjustment of the price of insurance to policyholders, were $305,700,000. This made our actual gain from operations $82,300,000.

However, the present bill says that we cannot take full credit for the $305,700,000 in price adjustments distributed, but can take credit only for that amount which will make the final result of the computation in step 2 equal to the final result of the computation in step 1. This computation is set up in the appendix to show what steps are taken. This produces a remarkable situation: The Prudential's actual operating gain after adjustments in 1958 was $82,300,000, but we must report that our operating gain was $130,700,000 in order to make the figures come out right; and we must writeoff and forget the disallowed $48,400,000. This means that the Prudential, along with most other mutual companies, is right back paying an excise tax on income from investments. Under the new bill, the Prudential in 1958 will pay over 90 percent of its actual gains from operations in Federal income tax. That is far in excess of the 52 percent being paid by all other corporations—including all stock life insurance companies which never will have to pay more than 52 percent.

The reason we are paying 90 percent, rather than 52 percent, is because we are paying the full tax on the disallowed $48,400,000 which we are, by contract required to return to policyholders. In effect, the present bill acknowledged that some of the adjustments are proper adjustments, but that the rest are something else, and that this something else, whatever it is, is taxable.

This situation should be corrected, we believe, It is suggested that the bill be amended to give at least 50 percent credit to any negative in step 2. Such an amendment would reduce the revenue by $35 million.

The third situation has to do with pension funds.

No taxes are paid on pension funds trusteed with banks and trust companies, and I mean no taxes, with the result that most business currently written, with the exception of that contracted by smaller employers, is being trusteed. The intention of the House committee was clear but, possibly through oversight, the 1959 bill makes no provision for the elimination of capital gains taxes on insured pension funds, which will now be taxed and weren't taxed before (and aren't taxed in trusteed plans); and also the application of the step 2 formula will automatically reinstate 50 percent of the pension fund taxes which were eliminated in step 1.

I think I should say there could be a number of results under that step 2 depending on the various situations involved.

There is now no provision in step 2 for eliminating from gains from operations and gains attributable to pension funds. Any company with a positive gain in step 2 pays taxes on 50 percent of this gain. This means that pension fund gains included in step 2 will be taxed to the extent of 50 percent. Moreover, in the fourth step of the present bill, all capital gains will be taxed to the extent of 25 percent.

The end result of this is to again impose a substantial tax on insured funds which is not imposed at all on trusteed funds—and which the House committee indicated in its report, primarily in the interests of small business, should not be done.

Even if these corrections are made, insured pension plans will still pay some taxes.

They will pay taxes, for instance, on the interest earned on whatever surplus is held for pension plans. If the corrections are not made, it is almost certain that very few insured pension plans will be written, and many already written will go off the books, with a consequent loss of revenue to the Government.

May I say within the last 3 months the Prudential has lost approximately $5 million per year of income in connection with pension plans, and with respect to about $6 million more, we have been notified that they are intending to take it off in the near future, and that situation is quite common with the pension companies.

The fourth situation involves group insurance, for which the present bill allows a special deduction. This special deduction is designed to compensate for the fact that in group insurance there is less than the usual diversification of risk.

However, this deduction in more cases than not, becomes inoperative as a result of the tax formula. It is unlikely that any of the mutual companies will get this deduction under the present bill, since it will be disallowed as a result of the way step 2 will generally work out. In many cases, the stock companies also will not get this credit. The need for this deduction still exists even if step 2 is negative, and therefore it should be permitted without limitation.

If the present bill is not altered to make it more reasonable, I am certain that there will be several undesirable repercussions of far-reaching social and economic significance.

The first result will be an acceleration in the trend away from those life insurance services that involve savings features. This will happen because the end result of excessive taxation of savings held by life insurance companies, as contrasted with other institutions who hold savings, is to eliminate one important incentive for individuals to save, but will greatly curtail the usefulness of life insurance organizations as important sources of investment capital. It may be that other equally efficient sources of capital investment would develop but there is no assurance of it. And if other sources developed would they have the efficiency and the social responsibility that today characterizes the major insurance companies? The Prudential, for example, follows an established policy of giving preferential treatment to the smaller- and medium-sized borrowers in industry, who need help, in the form of borrowed funds. The Prudential holds more farm and home mortgages than any other institution in the world and this has a demonstrated importance because during the depression, the long-range nature of the life insurance business, not only with Prudential but with all the other life insurance companies, made it possible to arrange practical ways to avoid, and minimize the effects of, foreclosure. In the end, policyholder funds were not lost on this, but it was possible only because of the nature of the life insurance business.

In a mutual company, any increase in taxes must be paid by the policyholders. The latest estimate of the revenue produced by this bill if unamended is $563 million. If such a tax in addition to the State premium taxes of over $300 million be assessed, the result will, in my opinion, be a substantial curtailment in the growth and usefulness of life insurance. I doubt that this would be a desirable consequence either from the standpoint of the Government or the people.

The CHAIRMAN. Mr. Shanks, I see you have an appendix. I assume you want that inserted the record?

Mr. SHANKS. Yes, if I may, sir.

The CHAIRMAN. Without objection, that will be inserted.

(The document referred to is as follows:)

APPENDIX

In essence, the new plan is a four-step formula that produces widely differing results in its application to stock and mutual companies.

Stated in the simplest possible terms, these are the four steps:

The first step is a tax computed on investment income. Taxable investment income in this step is arbitrarily measured and is subject to a 52-percent tax. As a result of step 1, the mutual companies will provide 69.5 percent of the expected total yield of $545 million. The stock companies from this step will produce 23.1 percent of the total yield of the tax plan.

The second step is a tax on gains from operations in excess of the taxable investment income from step 1. Fifty percent of such gains will be taxed currently, making the taxable income of the company, under steps 1 and 2, the sum of taxable investment income plus one-half (gains from operations minus taxable investment income).

If a stock company has a gain from operations that is less than the taxable investment income, it will pay a tax on this lesser amount.

Under this second step, the stock companies are expected to produce 5.1 percent of the total tax, and the mutuals 2.2 percent. Most mutual companies, after deductions of dividends to policyholders (which are actually price adjustments), will have a negative figure rather than a positive one. For this reason, only enough dividends are allowed as a deduction—regardless of the amount due policyholders as a legitimate price adjustment—to make the gain from operations equal to the taxable investment income. As a result the mutual company's tax will remain an excise tax on arbitrarily measured investment income except that it will be at a higher rate than before. What this means is that—in spite of the intention to tax both investment income and gains from other operations—the tax base on investment income is arbitrarily set so high that the application of the formula leaves little room for a taxable measure of gains from other operations.

The third step, which applies to stock companies only, results from a provision in the bill which permits stock companies to allocate certain untaxed funds to a policyholder's surplus account, and to allocate certain other taxed funds to a stockholder's surplus account. The purpose of the third step is to provide for taxation of the untaxed fund in the policyholder's surplus account if and when any of this fund is distributed to stockholders. This step will apply subsequent to the tax year 1958.

The fourth step provides for taxing the net long-term capital gains of both mutual and stock companies. Previously, capital gains have not been taxed. After the year 1958, they will be taxed separately at 25 percent.

### CALCULATING TAXABLE INVESTMENT INCOME—STEP 1

In this new 1959 formula, all life insurance companies will compute the taxable portion of their net investment income by applying a deduction rate multiplied by their adjusted life insurance reserves. The deduction rate will be the average of their actual rate earned on assets and a special interest rate. The special interest rate will be the higher of the assumed reserve interest rate on the company's own books, or the industry average assumed interest rate. The adjusted reserves will be the reserves shown on the company's books reduced by 10 percent for each 1 percent by which the deduction rate exceeds the company's own required interest rate.

This method provided by the bill for determining the policy and contract liability deduction is unsound. Any method which relates this deduction to the rate of interest assumed by a company in calculating its reserves is unsound. All such methods penalize the conservative company, as can be seen from the following illustration, based upon the formula in the bill, which shows the effect on the taxable income of different assumed reserve interest rates by two otherwise identical companies. Each company earns 4 percent on assets of $100 million, but company A assumes a 3-percent reserve interest rate, and company B a 2.8-percent rate—each of these rates being in excess of the industry average.

| | Company A (3-percent reserves) | Company B (2.8 percent reserves) |
|---|---|---|
| (1) Assets | $100,000,000 | $100,000,000 |
| (2) Reserves | $98,000,000 | $100,000,000 |
| (3) Deduction rate (½ of earned rate and reserve rate) ... percent | 3.5 | 3.4 |
| (4) Reserve adjustment rate ... do | 5.0 | 6.0 |
| (5) Adjusted reserves | $93,100,000 | $94,000,000 |
| (6) Investment income | $4,000,000 | $4,000,000 |
| (7) Reserve interest deduction (line 3×line 5) | 3,258,500 | 3,196,000 |
| (8) Taxable income (line 6 − line (7)) | 741,500 | 804,000 |

While the formula used in the bill attempts to minimize the defect it does not go far enough.

This defect can be completely avoided by substituting for the so-called deduction rate used in the bill, the individual company average earned interest rate for the most recent 5 years and by using this same rate for adjusting the reserves.

This substitution would eliminate the incentive for any company to weaken its reserve structure in the future.

### CALCULATION OF THE TAX UNDER STEPS 1 AND 2

The 1959 formula, in effect, levies a tax of 52 percent against some portion of the policyholder dividends as a result of disallowing varying proportions of them as a deduction in the tax computation in the second step.

This can be best explained by applying the new formula to Prudential's figures for 1958.

| | |
|---|---|
| Step 1: Under the new formula the company's taxable investment income was | $130,700,000 |
| Step 2: | |
| (a) The gain from operations (including investment income) before Federal income tax and policyholder price adjustments was | 388,000,000 |
| (b) Following established formulas, price adjustments were returned to policyholders | 305,700,000 |
| (c) Actual gain from operations (a) − (b) | 82,300,000 |

Step 1 plus step 2 formula:

$130,700,000 plus ½ ($82,300,000−$130,700,000)

or

$130,700,000 plus ½ (−$48,400,000)

As can be seen, the $48,400,000 is a negative figure, and if the formula is completed, the $130,700,000 taxable investment income figure from step 1 would be reduced by one-half of the $48,400,000. But the mutual company is not permitted a negative in this computation, so enough of the distributed dividends must be disallowed to make the computation in step 2 equal to zero—in this case by crediting only $257,300,000 of the $305,700,000 in dividends distributed. On this basis the step 2 computation would have to be:

| | |
|---|---|
| (a) Gain from operations before Federal income tax and adjustments | $388,000,000 |
| (b) Maximum allowable dividends | 257,300,000 |
| (c) Formula-computed gain from operations (a)−(b) | 130,700,000 |

In short, under this bill the operating results of a mutual company (in virtually every case) must be arbitrarily adjusted so the tax formula can be written to make the gain from operations match the income from investments, viz, $130,700,000 plus one-half ($130,700,000−$130,700,000). When this is done with the company illustrated, the tax will amount to more than 90 percent of actual gains from operations.

There are at least two glaring incongruities in this situation. The first is that the company's actual operating gain in 1958 was $82,300,000 and not the $130,700,000 which the tax formula stipulates that it must be; so the company must write off and forget the disallowed $48,400,000. In the case of a stock company, any negative figure in step 2 is simply subtracted from the tax in step 1.

Another glaring incongruity lies in the fact that this tax formula arbitrarily determines that a certain proportion of the dividends to policyholders—however much the formula may allow—constitutes a nontaxable price adjustment, and however much may be left is assumed to be something else, which by indirection is taxable.

Actually, of course, it is all price adjustment, and gains from operations should not be figured on any basis but on the net income.

It is interesting to note that in the case of these 1958 figures, the crediting of the $48,400,000 negative in step 2 against the income in step 1 would produce a tax of 52 percent. This would put the company exactly in line with other corporations.

Actually, crediting the whole of the negative figure will always produce a tax for mutual companies of 52 percent, since the computation in step 1, which regularly exceeds the computation in step 2, is taxed at 52 percent.

The CHAIRMAN. Now, Mr. Shanks, I would like to ask your position as between the 1942 formula and the bill that is now before the committee.

Mr. SHANKS. I would choose the legislation now before the committee. I think it is much sounder all the way through. I think we could get into nothing except trouble with the 1942 law.

The CHAIRMAN. Will you elaborate why you favor the pending bill.

Mr. SHANKS. I favor the present bill as against the 1942.

The CHAIRMAN. I know you do. I want to know what your objections are to the 1942 law.

Mr. SHANKS. Well, the 1942 law is, first, purely upon investment income and then it is upon an industry average basis which is so set up that during the low interest rate periods we paid nothing, did pay nothing in 1947 and 1948, I believe, and at other times it swings 'way high, and as a consequence, it is very unstable and also takes no account of new developments in business, and it would be in my estimation very unsatisfactory.

The CHAIRMAN. And you prefer the bill now before the committee.

Mr. SHANKS. That is right.

The CHAIRMAN. As it is.

Mr. SHANKS. That is right.

The CHAIRMAN. Without amendment.

Mr. SHANKS. Of course, it should be amended.

The CHAIRMAN. I understand that, but between the two, you would choose this bill as against the 1942 formula.

Mr. SHANKS. Definitely.

The CHAIRMAN. Senator Kerr?

Senator KERR. Would there be a difference in the amount of tax that your company would have to pay for the year 1958 under the 1942 law and this year?

Mr. SHANKS. Yes, Senator; we would pay $9 million less under the 1942 law.

Senator KERR. Under the 1942 law.

Mr. SHANKS. Under the 1942 law.

Senator KERR. Than you would under this law. Is your observation with reference to the law based on your contemplation of one of the two laws as a permanent measure or does it go to the extent that if the committee were confronted with the alternative of making this current bill either as it is written or as amended effective January 1, 1959, or January 1, 1958, but was going to do what it could to get it adopted either January 1, 1959, or January 1, 1958, at which time would you feel it would be wise to make it effective?

Mr. SHANKS. I should say it should be made effective for 1958, January 1, 1958, to cover the year 1958.

Senator KERR. Now with reference to the illustration you gave us here on page 2, you said that the adjustment of the price of insurance to policyholders was $305,700,000. What part, if any, of that represents earnings on investments which in turn were paid in the form of dividends to policyholders?

Mr. SHANKS. Almost none, if any.

Senator KERR. Well, now, you heard Mr. Davis' testimony.

Mr. SHANKS. Yes.

Senator KERR. I believe his position was that adjustment in price, if paid to the policyholder, should even include the amount the company has earned on investments disassociated from the premium paid by the policyholder. I wonder what your position is in that respect.

Mr. SHANKS. My position is that these returns, even if there were some investment income in there, that they should be still considered as price adjustment because in computing the premium on those policies, we took account, of course, of the mortality, of the expense, and we took account of interest, and so this all would apply back in lowering of that premium.

Senator KERR. Don't you think there should be a difference in treatment of adjustments in price made possible by returning to the policyholder all of his premium except the amount required to carry his insurance on the one hand, and then the amount to which it might be augmented by return from investment with reference to which the policyholder may or may not have made a contribution?

Mr. SHANKS. Well, I think the policyholder in all events has made a contribution to it. But I don't see how you could draw a distinction between them.

Senator KERR. I would like for you to go into a little more detail in the explanation of the matter you referred to, Mr. Shanks.

The application of the step 2 formula will automatically reinstate 50 percent of the pension fund taxes which were eliminated in step 1.

Mr. SHANKS. Well, because they are taken into account in computing the gains of operations.

Of course, in the case of stock companies, it is different there.

Senator KERR. Well, so far as I am personally concerned—and I am not—what I feel about this is not binding either on the Senate or the committee, you understand that. I think that if it is right to eliminate the tax on these trusteed pension accounts, that it is right to do so when we write the bill and make it effective then instead of phasing it out a little at a time or substantial portions of it at a time.

Mr. SHANKS. Yes.

Senator KERR. But in contemplation of the possibility that that might be done, this would create some concern in me that even though we did what we thought amounted to taking action, that unless we did something else, the step 2 formula in the bill would automatically reinstate the 50 percent of the taxes which we thought we had eliminated.

Mr. SHANKS. Yes. I think in order to make certain that we don't get somehow snarled up, it should be eliminated for both steps 1 and 2 and we would be assured it would not be a tax. That is all we want. That it not be taxed.

Senator KERR. In other words, in addition to making a provision that the tax be repealed on it immediatley, we would have to have a provision in here that any income arising from that source would not be included in the gain from operations contemplated by step 2 of the bill.

Mr. SHANKS. That is right, and that would make it clear that it was out.

Senator KERR. Now you discussed a matter that I have been trying very hard to become familiar with and get acquainted with, and I am having trouble, and I realize in asking these questions I am exposing a good deal of ignorance, but I have found the only way to get rid of it is to expose it.

I would like for you to give us a little better detailed explanation of the situation to which that part of the bill is addressed and also of the effect of the language in the bill.

Mr. SHANKS. Well, that involves, of course, a deduction for group insurance. Group insurance, of course, builds up practically no reserves, and there should be some provision for building up slowly; 2 percent a year with the idea of it going to not more than 50 percent of the premiums for a year to take care of the special situations which arise because you do not have such a diversification of the risk. For instance, you have a good share of the people under the policy all concentrated in a few plants. For instance, if you have an explosion, such as was had in Texas City a few years ago, you would have a tremendous loss because of the concentration of the risk there. The necessity for the deduction is such that it should be built up and it should not be eliminated just because of the operations between step 1 and step 2.

Senator KERR. You say it should not be eliminated. Explain that.

Mr. SHANKS. Well, it is eliminated because you cannot take that 2 percent if it has the effect of creating the negative under step 2. It is the same problem involved with us as with dividends. We can't use the dividends if it creates a negative, and also a company can't take this 2 percent if it creates a negative, whether it is a stock company or a mutual company.

Senator KERR. In other words, what you are saying is that if you have allowed a credit—and now I wish you would explain, assuming that I even know less than I do—which would be a violent assumption—just what is meant by the statement, the taking of the 2 percent credit?

Mr. SHANKS. Well, being able to set aside out of your earnings 2 percent to slowly build up the reserve for catastrophic loss in connection with group insurance.

Senator KERR. For that class of liability?

Mr. SHANKS. For that class of liability.

Senator KERR. Does that mean 2 percent of the premium?

Mr. SHANKS. Two percent of the premium for the year, yes.

Senator KERR. And that be treated as a reserve not primarily for a specified risk but for that class of risk either written or to be written?

Mr. SHANKS. That class of risk of the group.

Senator KERR. By the company.

Mr. SHANKS. That is right.

Senator KERR. Now, to what extent is that permitted under the bill before us?

Mr. SHANKS. Well, it is permitted except that if in any year that we set aside that 2 percent, it would have the effect of creating a negative, and that is step 2 again, then we couldn't use it.

Senator KERR. Well, aside from that factor, what is permitted under the bill?

Mr. SHANKS. Pardon me.

Senator KERR. Aside from its indirect effect by the application of step 2, what is provided in the bill, in simple terms?

Mr. SHANKS. Well, it is provided that you may set up the 2 percent a year until you have arrived at, I believe it is, 50 percent of 1 year's premium.

Senator KERR. Now, you think that if that provision were made effective, and the effectiveness of it not nullified in whole or in part by step 2, that it would be an adequate provision?

Mr. SHANKS. Yes. We think it would be adequate.

Senator KERR. But in order for it to be effective in accordance with the spirit as you interpret it and believe it should be, having built up that reserve or a part of it, then it is your position that the earnings from it should not be affected by the negative provisions of step 2?

Mr. SHANKS. The earnings from the amount built up?

Senator KERR. Yes. What I am trying to do is get a clear picture of your recommendation here.

Mr. SHANKS. Well, I think that——

Senator KERR. And you have given it here and you have given it so that you understand it, and it may be that every other member of the committee does, but I am just frank to confess to you I don't quite understand it yet, and I am trying to get you to help me understand.

Mr. SHANKS. I think we should be able to deduct 2 percent each year until it gets to 50 percent, and then it stops.

Senator KERR. In other words, while it is building up to the 50 percent, it should not be counted as operating income under step 2 of the bill?

Mr. SHANKS. Yes. That is right.

Senator KERR. Now, after it gets to 50 percent, what is your position on it?

Mr. SHANKS. It would be held there as a reserve.

Senator KERR. But the earnings above that, then, would no longer be exempt from the application of phase 2?

Mr. SHANKS. I wouldn't think so, no.

Senator KERR. In other words, then, your suggestion with reference to that part of the bill is with reference to keeping those earnings exempt until that 50 percent of premium is reached, and then after that, feeling that an adequate reserve has been reached, then the income from it would no longer be exempt from step 2 of the bill?

Mr. SHANKS. I think that is right. If the 50 percent is an adequate reserve, which I believe it is, then it should not grow any more. It should be just held there.

Senator KERR. Yes. Now, in the next part I was quite impressed by what you had to say.

The first result will be an acceleration in the trend away from those life insurance services that involve savings features.

This will happen because the end result of excessive taxation of savings held by life insurance companies as contrasted with other institutions who hold savings is to eliminate those life insurance savings.

I wonder if that statement is provoked in part by the fact that, for instance, mutual savings banks pay no taxes?

Mr. SHANKS. Yes. In part.

Senator KERR. And that building and loan associations for all practical purposes pay little, if any?

Mr. SHANKS. That is right.

Senator KERR. You are taking the position that as of now, although your industry paid $200 some million taxes for 1957 and under either this bill or the 1942 act it would pay in the neighborhood of $500 million in taxes for 1958, these other groups of great financial institutions that we all are very friendly to and are respectful of pay no taxes or little taxes. You contemplate the situation where your relative position would be worsened with reference to them, would cause what would be a very great shift in the saving habits of the people in that the incentives would be in favor of the other financial institutions and adverse to the life insurance companies. Is that it?

Mr. SHANKS. I feel that very strongly.

Senator KERR. Is that what you mean?

Mr. SHANKS. That is right. I feel that very strongly. We are already getting the swing away from policies with the saving feature because of fear of inflation, and that sort of thing, and this large tax increase added on top of it I am sure will accelerate it. You know it is tough when it comes to competition with those other savings institutions. They say, why buy insurance because of the taxes? I mean it certainly will be snowballing.

Senator KERR. Thank you very much, Mr. Shanks.

The CHAIRMAN. Mr. Shanks, I would like to ask that you put your suggestions into amendment form.

Mr. SHANKS. Suggestions for the bill itself?

The CHAIRMAN. Yes.

Senator KERR. The suggested amendments that you had made, to put them in written form and submit them to the committee.

Mr. SHANKS. We will.

The CHAIRMAN. And give them to the clerk so they can be included in the record.

(The material referred to is as follows:)

PROPOSED AMENDMENTS TO H.R. 4245 WITH RESPECT TO PENSION PLANS

Page 6, line 19, strike the period, and insert: ", exclusive of any portion thereof attributable to contracts described in section 805(c)(2)."

Page 21, line 9, strike the period, and insert: ", such items and deductions to be exclusive of any portions thereof attributable to contracts described in section 805(c)(2)."

Page 21, line 14, strike the period, and insert: ", such items and deductions to be exclusive of any portions thereof attributable to contracts described in section 805(c)(2)."

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PROPOSED AMENDMENTS TO H.R. 4245 WITH RESPECT TO DEDUCTION FOR DIVIDENDS TO POLICYHOLDERS, ETC.

Strike section 809(g) and substitute the following:

"(g) LIMITATION ON CERTAIN DEDUCTIONS.—

"(1) RESERVES FOR CERTAIN NONPARTICIPATING CONTRACTS.—The amount of the deduction under paragraph (6) of subsection (d) shall not (after the application of subsection (f)) exceed the amount by which—

"(A) the gain from operations for the taxable year, computed without regard to such deduction and the deductions under paragraphs (3) and (7) of subsection (d), exceeds

"(B) the taxable investment income for the taxable year.

"(2) DIVIDENDS TO POLICYHOLDERS AND GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE.—If the gain from operations for the taxable year, computed without regard to the deductions under paragraphs (3) and (7) of subsection (d) but after the deduction under pararaph (6) of subsection (d), exceeds the taxable investment income for the taxable year, the amount of the deductions under paragraphs (3) and (7) of subsection (d) shall not (after the application of subsection (f)) exceed—

"(A) the amount by which—

"(i) the gain from operations for the taxable year, computed without regard to such deductions but after the deduction under paragraph (6) of subsection (d) as limited by paragraph (1), exceeds

"(ii) the taxable investment income for the taxable year, plus

"(B) fifty per centum of the amount by which—

"(i) the taxable investment income for the taxable year exceeds

"(ii) the gain from operations for the taxable year, computed after the deductions under paragraphs (3) and (7) of subsection (d) and the deduction under paragraph (6) of subsection (d) as limited by paragraph (1):

otherwise the deductions under paragraphs (3) and (7) of subsection (d) shall be reduced by 50 per centum.

"(3) APPLICATION OF LIMITATION.—The limitation provided by paragraph (2) shall apply first to the amount of the deduction under paragraph (7) and then to the amount of the deduction under paragraph (3)."

PROPOSED AMENDMENT TO H.R. 4245 RE REVALUATION RATE IN FIRST PHASE

Strike out section 805(b) (2), page 13, and substitute following:

"(2) DEDUCTION RATE.—For purposes of this part, the deduction rate for any taxable year is the amount ascertained by dividing by five the sum of the investment yield rates (as defined in subsec. (c) (1)) for the taxable year and each of the four preceding taxable years."

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PROPOSED AMENDMENT TO H.R. 4245 WITH RESPECT TO DEDUCTION FOR INVESTMENT YIELD ON PENSION PLAN RESERVES

Change section 805(C) (3), page 18, to read as follows:

(3) SPECIAL TRANSITIONAL RULE.—For purposes of this part, the amount taken into account as pension plan reserves shall be—

"(A) in the case of a taxable year beginning after December 31, 1957, and before January 1, 1959, zero;

"(B) in the case of a taxable year beginning after December 31, 1958, 100 per centum of the amount thereof (determined without regard to this paragraph)."

Senator WILLIAMS. Mr. Shanks, if the two amendments which you are proposing are adopted by the committee, how would that change your tax liability for 1958?

Mr. SHANKS. I think it adds to—43 and 35, that would be 78.

Senator WILLIAMS. In your particular case, if I understood you correctly, you said that the present law, H.R. 4245, would cost you about $9 million more than the 1942 act.

Mr. SHANKS. In the case of Prudential.

Senator WILLIAMS. Yes. How would that affect your particular stocks?

Mr. SHANKS. If we got credit for half of those negatives, it would bring us down to approximately 56 percent of our gains from operations—the two items.

Senator WILLIAMS. Well, if I understood you correctly, you said that H.R. 4245 would cost $9 million more than it would under the 1942 formula?

Mr. SHANKS. I think that was right.

Senator WILLIAMS. What would the dollar figure be if those amendments are adopted?

Mr. SHANKS. The dollar figure would be about $62 million that we would have to pay with those amendments made.

Senator WILLIAMS. How much less than the 1942 formula would that be?

Mr. SHANKS. That would be about $7 million less, I would think.

Senator WILLIAMS. That would bring your tax liability under the bill if it is amended as you recommend to $7 million less than the 1942 formula; is that right?

Mr. SHANKS. About $7 million.

Senator WILLIAMS. How does your tax liability compare with the stopgap formula and the 1942 formula?

Mr. SHANKS. Well, under the stopgap formula—it would be about $41 or $42 million, and it would be about $62 million under the proposed bill after the amendments.

Senator WILLIAMS. Is that after your suggested amendments?

Mr. SHANKS. After the suggested amendments.

Senator KERR. I thought the question was without the suggested amendments.

Senator WILLIAMS. I was trying to get it in the record both ways. I think you had it in the record before.

Mr. SHANKS. Yes. It would be about $42 million under the stopgap law and about $62 million under the proposed law with the suggested amendments. Without the proposed amendments, it would go from about $42 million to about $78 million.

Senator WILLIAMS. Thank you.

The CHAIRMAN. Senator Frear?

Senator FREAR. No questions.

The CHAIRMAN. Senator Smathers?

Senator SMATHERS. No questions.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. I want to try again. I think probably Senator Kerr got it down perfectly from his standpoint, but I am not sure he got it down for mine.

You believe that the 2 percent ought to be allowed to accumulate until you get your 50 percent?

Mr. SHANKS. Of a year's premium, yes.

Senator ANDERSON. You believe a full 2 percent should be allowed every year even if that should result in a negative in your step 2?

Mr. SHANKS. I think that is right; for all companies, it should be.

Senator ANDERSON. You wanted to go on——

Mr. SHANKS. Up to 50 percent.

Senator ANDERSON. Yes. I notice that you have the individual company average earnings interest rate for the most recent 5 years. Can I read you a question that was sent to me to ask you?

In your first suggestion you propose that the reserve deduction be based solely on the actual earnings rate and to no extent on the assumed rate of the individual company or the industry average. You suggest that because of arbitrary elements in the assumed rate.

On the other hand, isn't it also arbitrary to depend only on earnings rate which gives the company of high investment rate of return a larger deduction than a company with a low investment rate of return, even though their contractual obligations are the same?

Will you comment on that, please?

Mr. SHANKS. Well, I think in the first place we have made a big step forward because it is the individual company, and in the second place, if they have a higher interest rate, they have actually earned it, so that they have the money. It is a more direct means of computing what you should pay taxes upon because you have earned that money.

Senator ANDERSON. By the payment of dividends you might get to the point where you have a negative in step 2?

Mr. SHANKS. Yes; that is right.

Senator ANDERSON. And you believe that half of that ought to be credited when negative in case you get that rule?

Mr. SHANKS. I think in theory we are entitled to it all, but I think we have to be practical. As Mr. Davis says, I think half certainly takes account of all arguments that can be made against it.

Senator ANDERSON. I think I have no more questions.

Senator KERR. May I ask one more question here?

If the amendment you just referred to were adopted, would that then meet the criticism you have offered with reference to this 2 percent premium accumulation?

Mr. SHANKS. Well, yes, it would, but bear in mind, as I understand the present bill, it says the 2 percent cannot be used if it causes a deficit in phase 2. So it would specifically have to be handled on its own to take care of it.

Senator KERR. Yes.

The CHAIRMAN. Senator Gore?

Senator GORE. Mr. Chairman, I was called away and didn't get to hear the statement of the distinguished gentleman. Therefore, I don't feel I quite qualify to interrogate him.

I would like some clarification on the answers you gave to Senator Williams. Did you mean that the tax liability of your own company would be $78 million under this bill if only this latter amendment to which Senator Anderson and Senator Kerr referred were adopted, or did you have other amendments the effects of which are included in that estimate?

Mr. SHANKS. There were the two other amendments. That is the 5-year average and the negative deduction at one-half.

Senator GORE. Would you give me the estimate under the provisions of the present bill, both without your suggested amendments and with them of your own company's tax liability for 1958.

Mr. SHANKS. You mean with respect to the 2 percent you are speaking of?

Senator GORE. No. I am——

Mr. SHANKS. The whole thing?

Senator GORE. I am talking about the deduction for possible losses under phase 2 from your tax liability under phase 1——

Mr. SHANKS. Well——

Senator GORE. If your amendments were adopted.

Mr. SHANKS. If our amendment were adopted—you mean without the 5-year or with the 5-year adjustment on phase 1?

Senator GORE. How did you suggest them?

Mr. SHANKS. I will give them. I suggested both of them and it would bring it down from $78 million to about $62 million.

Senator GORE. In other words, it would reduce your own tax liability by $16 million.

Mr. SHANKS. Approximately $16 million.

Senator GORE. Now, what would be, in your opinion, if you have an estimate, the effect on the revenue to the Government of the adoption of the amendments?

Mr. SHANKS. I think it would bring it down about $78 million all told for the industry.

Senator GORE. $78 million for the entire industry, of which your company would perhaps have $16 million.

Mr. SHANKS. About $16 million.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Mr. Shanks, I would like to ask you about one matter you didn't testify about. It is one that has been brought up by others, and that is the provision for taxation of tax-exempt bonds.

Is it your opinion under the terms of the act which we are asking to report to the Senate, tax-exempt obligations would be taxable?

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Mr. SHANKS. It is my opinion that we would get only a proportionate amount of the tax exemption. Therefore, to that extent I suppose you might say they are taxable.

Senator TALMADGE. One constituent of mine makes the assumption that they would be less desirable with reference to bonds issued by utilities, for instance, unless the income ratio went up about three-quarters of 1 percent. Can you comment on that?

Mr. SHANKS. I don't know the rate exactly, but it would make a substantial differences in that rate, and I imagine three-quarters of 1 percent might be about it. But I don't know.

Senator TALMADGE. Do you think that would render an obligation to the States, counties, and municipalities less desirable on the bond market than they are at the present time?

Mr. SHANKS. There is no question but what, if you take away part of the tax exemption, it makes them less desirable because probably their main appeal is their tax exemption.

Senator TALMADGE. You think, then, that that might result in increased interest rates for tax-exempt obligations in municipalities, counties, and States?

Mr. SHANKS. Well, I don't know how much of an impact the insurance buying would have, but to the extent that it had an impact, it would make the bonds harder to sell, and you would have to pay a higher interest rate.

Senator TALMADGE. It is your testimony you think the bill ought to be amended to clarify the exempt status?

Mr. SHANKS. Well, I haven't prepared myself to testify on it. I don't think it would affect our company very much, but I understand that a number of people are going to testify on it, but certainly if they are tax exempt with other industries and other companies, they ought to be tax exempt with the insurance companies.

Senator TALMADGE. Thank you, sir.

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

The committee will now adjourn until 10 o'clock tomorrow morning. Mr. Guest will be the first witness.

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

STATEMENT OF ROBERT L. HOGG, VICE CHAIRMAN OF THE BOARD, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

SUMMARY

(1) Life insurance companies are subject to Federal income taxes on their pension fund business while investment income from such business conducted by trustees, such as banks and trust companies, is tax exempt.

(2) Aside from creating a disadvantage in a competitive business, the present law increases the pension costs for small business.

(3) H.R. 4245 recognizes the inequities in (1) and (2) and embodies a large measure of correction.

(4) H.R. 4245, however, requires further amendments to establish Federal income tax equality between insured pension operations of life insurance companies and the trusteed pension operations of banks and trust companies.

My name is Robert L. Hogg. I am vice chairman of the board of the Equitable Life Assurance Society of the United States, 393 Seventh Avenue, New York City.

Our company as well as many other life insurance companies—large and small—has long been engaged in furnishing pension services. (See list of companies attached as appendix I.) In the preparation of this statement I have had the assistance of several of my associates, particularly Mr. Walter Klem, our senior vice president and chief actuary, and Mr. Ray M. Peterson, our vice president and associate actuary, who now accompany me. In the event further information is sought as to certain aspects of my statement, I shall ask your permission to counsel with them.

Previous witnesses have indicated their support of the general form of the bill under consideration and their concern as to its heavy taxation of the business. We share their views on these two points but I shall not elaborate upon them.

The basic purpose of my appearance is to register our support of an underlying principle of the bill which seeks to correct the discriminatory tax upon the pension business[1] of life insurance companies in the face of complete exemption for the same operations of banks and trust companies. The bill goes a long way in the direction of correcting this discrimination. It falls short, however, of establishing adequate tax equality. It is reasonable to assume that to some extent this failure to give equality is an unforeseen result of the complexities of the bill itself.

It is a common occurrence for this committee to hear complaints about discriminatory tax treatment. In many cases the existence of discrimination may rest upon conclusions of the witness himself. The conclusions may be ones upon which reasonable people may differ. This is not true as to the discrimination which H.R. 4245 would correct. A life insurance company pays a tax on the income from funds which it holds for pension plans. Trustees, banks, and trust companies holding pension funds pay no such tax. Discrimination is clear. No one seeks to deny it.

Not only do banks and trust companies not deny it, they boast about it. For years our competitors have advertised their tax advantage. An example of the publicity given to this tax discrimination is an item which appeared in the Wall Street Journal as recently as October 14, 1958, under a San Francisco dateline:

"A pension fund for all practical purposes is a 'cost-plus' operation which favors use of bank trusteed plans over those offered by insurance companies due principally to tax advantages," Paul A. Warner, president of Warner-Watson, Inc., asserted here. * * * "The primary expense advantage of a trust over all types of insured plans is that the insurance company must pay a Federal income tax from which the trust is practically exempt," he said. "The amount of this cost will vary with the yield of the insurance company but will doubtless average 0.33 percent of yield which, in turn, will average about 8 percent of total premium cost," Mr. Warner asserted.

The significant thing is that the unfortunate situation has not arisen as part of congressional policy. In fact, it has arisen in the face of a congressional policy to the contrary. Many years ago Congress encouraged the establishment of employee pension plans by employers through the device of permitting as a business deduction the employer's contributions to such a plan. Certainly it was not intended partially to neutralize this encouragement by creation of a discriminatory tax burden upon these plans when administered by life insurance companies. The present situation, however, far from being from design is really an evolution from the tax treatment of life insurance companies and the tax treatment of trusts. Pension business became important long after Congress established net investment income as a basis for the taxation of life insurance companies.

GROWTH OF TRUSTEED PENSION PLANS[2]

In 1950 insured and trusteed plans shared the field on roughly a 50–50 basis in terms of total funds held. At the end of 1958, just 8 years later, the ratio stood at about 40–60 against the pension plans of life insurance companies.

[1] In all references to pension business as well as pension plans, I mean pension plans meeting the standards of sec. 401 of the Internal Revenue Code and, for convenience, called qualified plans.

[2] Pension plans where funds are invested by a trustee.

*Insured reserves and trust funds of private pension plans*

[Dollar amounts in millions]

| End of year | Insured reserves | Trust funds | Total (1)+(2) | Proportion (percent) | |
|---|---|---|---|---|---|
| | | | | Insured | Trusteed |
| | (1) | (2) | (3) | (4) | (5) |
| 1950 | $5,575 | $5,750 | $11,325 | 49.23 | 50.77 |
| 1951 | 6,550 | 7,300 | 13,850 | 47.29 | 52.71 |
| 1952 | 7,675 | 9,000 | 16,675 | 46.03 | 53.97 |
| 1953 | 8,775 | 10,675 | 19,450 | 45.12 | 54.88 |
| 1954 | 9,950 | 12,900 | 22,850 | 43.54 | 56.46 |
| 1955 | 11,250 | 15,125 | 26,375 | 42.65 | 57.35 |
| 1956 | 12,450 | 17,625 | 30,075 | 41.40 | 58.60 |
| 1957 | 14,025 | 20,800 | 34,825 | 40.27 | 59.73 |

Sources: Insured reserves, Institute of Life Insurance (includes both group annuity and individual policy); trust funds, Securities and Exchange Commission and Social Security Administration (includes multiemployer plans and plans of exempt organizations).

In terms of current annual contributions only 35 percent is going to insured plans and the proportion is decreasing rapidly. Mr. Vito Natrella of the Securities and Exchange Commission in 1957 estimated this proportion will be down to 20 percent by 1965. This spectacular shift to trusteed pension plans does not arise solely because of the establishment of new pension plans. The life insurance companies are losing a substantial part of their existing business to trusteed operations of banks and trust companies. Unless a fair competitive position is established, the losses may be expected to continue more rapidly.

Losses of pension business take two forms: plans which change fully to a trusteed basis and plans which change partially to such a basis. Not counting these partial changes, 6 life insurance companies accounting for 76 percent of total group annuity premiums reported 199 cases of complete change to trusteed plans from January 1954 to July 1958. Thes cases represented an annual premium loss of $110 million. This figure does not include the substantial losses arising from contracts discontinued in part, business lost by life insurance companies other than these six, and business lost by all companies prior to 1954.

The following tabulation graphically shows the experience of the Equitable since 1951. Note particularly the accelerated rate of termination since 1954 when, instead of relief, greater discrimination arose under the Mills-Curtis bill as passed by the Senate. In its original form as passed by the House, substantial relief was provided.

*Equitable business completely lost to trusteed plans*

| Year of termination | Number of contracts | Annual premiums | Number of employees at date of termination (including retired) |
|---|---|---|---|
| 1951 | 7 | $2,795,000 | 4,816 |
| 1952 | 11 | 4,354,000 | 11,339 |
| 1953 | 10 | 1,826,000 | 10,962 |
| 1954 | 17 | 9,036,000 | 19,537 |
| 1955 | 25 | 30,707,000 | 124,180 |
| 1956 | 21 | 9,624,000 | 29,065 |
| 1957 | 15 | 3,677,000 | 15,426 |
| 1958 (6 months) | 11 | 6,977,000 | 15,594 |
| Total | 117 | 68,996,000 | 230,919 |

An employer, particularly a large employer, has a choice of methods for pension funding. He may select a life insurance company or he may use the trust services of a bank or trust company. While there are other reasons to use insurance company facilities, it is quite clear that cost is the predominant factor in choosing trust facilities of a bank or trust company.

FEDERAL INCOME TAXES AS A COST FACTOR IN INSURED PLANS

It is generally recognized that, for a typical pension plan, a variation of one-fourth of 1 percent in the rate of interest (i.e., 0.25 percent) will produce a differential of 6 or 7 percent in the long-run cost of the plan. Based on an average investment period of 25 years involving the accumulation of contributions and distribution of pensison benefits, the additional contributions required to offset the reduction in earnings due to taxes at the rate in the last stopgap act are as follows:

| *Net earnings before tax (percent)* | *Additional contributions, as percentage required to offset tax under 1957 stopgap act* |
|---|---|
| 3.25 | 6.2 |
| 3.50 | 6.7 |
| 3.75 | 7.2 |
| 4.00 | 7.7 |

The current rate of earnings before tax of most insurance companies is 3.75 percent to 4 percent. Hence, the effect of the last stopgap act, compared with a tax-exempt trust enjoying the same rate of earnings before tax, was to increase the cost of insured plans by 7.2 percent to 7.7 percent. Again the situation becomes infinitely worse under H.R. 4245 without provision for tax equality. At this stage with 1958 figures not available for the business as a whole, a reasonable estimate is that the present bill without the tax equality would mean that the cost of insured pension plans would be about 12 percent more than the cost of trusteed tax-exempt plans.

The greatest single item of expense in an insured plan is the Federal income tax, a cost not borne by a trusteed plan. Let's look at the situation as it would be if insurance companies were given the same tax treatment as banks and trust companies with respect to pension funds.

The following table shows that in recent years the difference in earnings between insured pension funds and trusteed pension funds is almost entirely accounted for by the Federal income tax.

*Percentage rate of investment income*

| Year | Tax-exempt corporate pension funds | Life insurance companies | | |
|---|---|---|---|---|
| | | Before Federal income tax | Reduction by reason of tax | After Federal income tax |
| 1951 | 3.09 | 3.18 | 0.20 | 2.98 |
| 1952 | 3.26 | 3.28 | .21 | 3.07 |
| 1953 | 3.40 | 3.36 | .21 | 3.15 |
| 1954 | 3.72 | 3.46 | .22 | 3.24 |
| 1955 | 3.58 | 3.51 | .28 | 3.23 |
| 1956 | 3.68 | 3.63 | .30 | 3.33 |
| 1957 | 3.84 | 3.75 | .31 | 3.44 |

Source: Corporate funds; Securities and Exchange Commission Life Insurance Companies; Institute of Life Insurance Fact Book.

From the foregoing tabulations it is obvious a life insurance company in its pension operations cannot compete on a cost basis with the tax-exempt operations of a bank or trust company. Life insurance companies have lost ground to their tax-exempt competitors.

This shift of business to trusts has created a maladjustment for smaller employers. This shift of business to tax-exempt trusts has been more extensively used by a large employer with a decrease in pension cost, leaving his smaller competitor with a higher cost for his pension service.

In its Survey of Corporate Pension Funds, 1951–54, the Securities and Exchange Commission found from sample data that "smaller-sized businesses have proportionately more plans of the insured type than do the larger companies."

As to existing plans, the average number of employees covered by group annuity contracts was 707 in 1955 (645 in 1957) (according to the 1958 Life Insurance Fact Book) which contrasts with an average number of 4,075 for 643 plans handled by corporate trustees (as reported in 1955 by the New York State Banking Department). As to new plans, the average number of employees under group annuity contracts issued in the 3-year period 1955-57 was 231, (according to the reports of the Life Insurance Association of America). In a study made by the Bankers Trust Co. of new plans adopted in the period 1953-55 covering 68 plans with at least 200 lives, the average size of the group annuity cases was 660 employees and for the trusteed plans was 3,400. Finally, here is a striking comparison: During the period from January 1, 1954, to July 1, 1958, the average number of employees covered by Equitable discontinued pension plans which changed completely to trusteed funding was 2,055 and the average number of employees for newly issued contracts during the same period was 204.

The foregoing facts demonstrate clearly that the small- or moderate-sized employer finds it desirable to use the services which an insurance company provides.

Small business needs the services of the life insurance company. Under a trusteed plan, the employer is solely responsible for the successful operation of the plan. Although he engages the specialized services of the consulting actuary, the bank as trustee, and the tax lawyer, none of these specialists is or can be responsible for the adequacy of funds to support the benefits promised by the plan. The successful operation of a trusteed plan generally depends upon the continued existence of the employer. An inadequacy of contributions may not be properly recognized for many, many years. Even though contributions may be soundly determined by actuarial principles, a sufficient number of lives and a sufficiently long period of operation are necessary to permit the law of averages to operate—a law on which the actuarial determinations depend. The officers of a small business are least likely to have the time and talent required to fulfill the employer's responsibilities of a trusteed plan. A small pension fund handled separately as a trust will entail relatively high investment expenses and may not provide adequate attitude for proper diversification of investments.

Life insurance companies provide a unique and necessary service by which the small employer can secure—

(a) guarantees of the adequacy of funding with no risk as to failure of the law of averages to operate;

(b) the benefit of an investment activity with opportunities for wide diversification and low investment expense;

(c) an assurance that benefits accrued to date are adequately funded even though the employer should go out of business; and

(d) an assurance that paid-up pensions vested in ex-employees (portable pensions) will be secure and will not depend upon the employer always being in existence in order to administer and provide such benefits.

In view of the virtual necessity of the small employer using the services of the life insurance company, the Federal income tax discrimination as to "qualified" pension plans falls with special force upon the small employer. His only alternative is a risky venture for which he is unqualified. This situation cannot be said to be consistent with sound public policy.

It is also important to recognize that the burden of the tax can ultimately fall on the employee by his receiving a lesser pension from the funds which the employer has available for a pension plan. This is particularly true where the employer contributes under a "cents-per-hour" type of negotiated plan.

The tax equality now sought affects only a class of business of a life insurance company. While it would correct the inequities and discrimination cast upon the pension operation of life insurance companies, it would not create any advantage for one life insurance company over another. The suggested tax equality would benefit only the pension contract holders, no one else. Each pension contract, whether with a stock or a mutual company, is under constant scrutiny by the contract holder. Taxes are charged to each pension contract, without any connection whatever with any other line of business. Pension fund equality now sought would have no effect whatever upon competition with other companies operating solely in the ordinary life field, but it would equalize the position of insurance companies and banks in the pension field and treat pension business the same without regard to the entity furnishing the service.

The report of the Ways and Means Committee (p. 8) commenting on the treatment of pension income says: "The more favorable treatment of qualified pension and profit sharing business is believed necessary in view of the fact that the net investment earnings of a qualified pension or profit sharing trust are completely exempt from tax while they are accumulated in the trust." It seems clear that it was intended to try to bring about tax equality for the two methods of operation. However, to attain such objective the following amendments of the bill now under consideartion are required.

1. The bill provides for exemption of income arising in connection with pension reserves. In income from pension surplus is to be taxed at the regular corporate rate. While relief based on reserves is substantial, it falls short of complete tax equality. In the case of trust operations, the whole fund is exempt. In insured operations the fund is the total of pension reserves including other pension fund liabilities and pension surplus. Consequently, to ignore earnings on surplus and other pension fund liabilities falls short of establishing tax equality.

2. Along the same line, the same tax exempt treatment of capital gains and losses should be given to insured funds as is accorded trusted funds.

3. The bill clearly provides in step I exemption for income attributable to pension reserves. However, a part of this may be taken away in step II, relating to the tax on net gain from operations in which no account is taken of pension operations. Total tax [8] is based on net investment income in step I, plus 50 percent of the excess of net gain from operations in step II over net investment income. Reduction of net investment income in step I to the extent that pension income is deducted increases the probability of creating tax liability under step II in which pension operations are included.

This is evidently unintended and easily corrected. It could be provided that the inclusion of pension operations in step II will not create a tax liability under step II which would not otherwise exist.

(NOTE.—The following technical amendment would revise the definition of "pension plan reserves" now in the bill to include contracts issued to tax exempt organizations and to employers with qualified plans in Canada.)

Section 805(c)(2) to be replaced with following:

"For purposes of this part, the term "pension plan reserves" means that portion of the life insurance reserves which is allocable to contracts—

"(A) entered into with trusts which (as of the time the contracts were entered into) were deemed to be (i) trusts described in section 401(a) and exempt from tax under section 501(a) or (ii) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 of the corresponding provisions of prior revenue laws.

"(B) entered into with employers under plans which (as of the time the contracts were entered into) (i) were deemed to be plans meeting the requirements of section 401(a) (3), (4), (5), and (6), or the requirements of section 165(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1939; or (ii) were plans for which under the provisions of prior revenue laws the employer contributions were deductible;

"(C) entered into with employers exempt from tax under section 501(c) or (d) or section 115(a) or exempt from tax under the corresponding provisions of prior revenue laws.

"(D) providing benefits for employees or agents of the life insurance company under a plan which for the taxable year meets the requirements of section 401(a), (3), (4), (5), and (6).

"(E) entered into under approved superannuation funds or plans as defined by section 127, subsection (1), paragraph (c) of the Income Tax Act of Canada.

## APPENDIX I

### INSURANCE COMPANIES WHICH ISSUE GROUP ANNUITY CONTRACTS

Aetna Life
American Life, Delaware
American United Life
Bankers Life, Iowa
Canada Life
Confederation Life
Connecticut General Life
Continental Assurance
Crown Life
Dominion Life
Equitable Life, New York
Fidelity Mutual Life
General American Life
Great American Reserve
Great-West Life, Canada
John Hancock Mutual Life
Life and Casualty
Life Insurance Co. of Virginia
Lincoln National Life
Manufacturers Life
Massachusetts Mutual Life
Metropolitan Life

[8] In case of a stock company step III is also involved.

INSURANCE COMPANIES WHICH ISSUE GROUP ANNUITY CONTRACTS—Continued

Minnesota Mutual Life
Monumental Life, Maryland
Mutual Benefit Life
Mutual Life, Canada
Mutual Life, New York
Nationwide Life
New England Mutual Life
New York Life
North American Life, Canada
Northwestern National Life
Occidental Life, California
Pacific Mutual Life
Pacific National Life
Paul Revere Life
Piedmont Life
Protective Life of Alabama
Provident Life and Accident
Provident Mutual Life
Prudential Insurance Co.
Republic National Life
Security Benefit Life
Southwestern Life
Standard Life of Indiana
State Mutual Life
Sun Life, Canada
Travelers Insurance Co.
Union Central Life
Union Mutual Life
United States Life

INSURANCE COMPANIES WHICH ISSUE INDIVIDUAL PENSION TRUST POLICIES

Acacia Mutual Life
Aetna Life
American Life, Delaware
American National
American United Life
Bankers Life, Iowa
Bankers Life, Nebraska
Bankers National Life
Berkshire Life
Business Men's Assurance
California-Western States Life
Canada Life
Capitol Life, Colorado
Central Life, Iowa
Central Standard Life
Colonial Life
Columbian National Life
Columbus Mutual Life
Commonwealth Life, Kentucky
Companion Life
Connecticut General Life
Connecticut Mutual Life
Continental American
Continental Assurance
Crown Life
Dominion Life, Canada
Eastern Life
Equitable Life, New York
Equitable Life, Iowa
Farmers & Traders Life
Fidelity Mutual Life
Franklin Life
General American Life
Great American Reserve
Great Southern Life
Great-West Life, Canada
Guarantee Mutual Life
Guardian Life, New York
Gulf Life, Florida
Home Life, New York
Indianapolis Life
Jefferson Standard Life
John Hancock Mutual Life
Life Insurance Co. of Georgia
Life of North America
Life Insurance Co. of Virginia
Lincoln National Life
The Maccabees
Manhattan Life
Manufacturers Life
Massachusetts Mutual Life
Metropolitan Life
Midland Mutual Life
Midland National Life
Minnesota Mutual Life
Monumental Life
Mutual Benefit Life
Mutual Life, New York
National Life, Vermont
Nationwide Life
New England Mutual Life
New York Life
North American Life, Canada
North American Life, Illinois
North American Life & Casualty
Northeastern Life, New York
Northern Life, Washington
Northwestern Mutual Life
Northwestern National Life
Occidental Life, California
Ohio National Life
Ohio State Life
Pacific Mutual Life
Pan-American Life
Paul Revere Life
Penn Mutual Life
Philadelphia Life
Phoenix Mutual Life
Piedmont Life
Pilot Life, North Carolina
Postal Life, New York
Protective Life of Alabama
Provident Life & Accident
Provident Mutual Life
Prudential
Republic National Life
Reserve Life
Security-Connecticut Life
Security Benefit Life
Security Mutual Life, New York
Southwestern Life
Standard Life, Indiana
State Mutual Life
Sun Life, Canada

INSURANCE COMPANIES WHICH ISSUE INDIVIDUAL PENSION TRUST POLICIES—Con.

| | |
|---|---|
| Sun Life of America, Maryland | United States Life |
| Travelers Insurance | Volunteer State Life |
| Union Central Life | Washington National |
| Union Labor Life | West Coast Life |
| Union Mutual Life | Western Life |
| United Benefit Life | |

SAN ANTONIO, TEX., *February 25, 1959.*

Senator HARRY F. BYRD,
*U.S. Senate, Washington, D.C.:*

More than 85 percent of U.S. families have life insurance coverage. Most life insurance companies are mutuals or are owned by policyholders. Even a casual examination of the life insurance company tax bill pending before Senate Finance Committee shows it will increase taxes on life companies and on policyholders thereof by about 85 percent, and that mutual companies will be paying in such taxes about $7.50 out of every $100 of premiums received. This will affect annuities of elderly people already payable in a deflated dollar. Life insurance values represent life savings of millions of Americans but under this bill such savings will be taxed at least three times as heavily as other forms of savings in mutual savings banks, saving and loan associations, etc. This tax bill will drastically impair effectiveness of life insurance as a force for economic stability and will deplete the amounts available for investment by life insurance companies in American industry business and home loans. It is hoped you will use every effort to oppose the passage of this proposed bill.

A. H. CADWALLADER, Jr.

VARIABLE ANNUITY LIFE INSURANCE CO. OF AMERICA,
*Washington, D.C., February 26, 1959.*

Senator HARRY F. BYRD,
*Chairman, Finance Committee,*
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: H.R. 4245, relating to the taxation of the income of life insurance companies, which is before your committee, contains certain provisions which, by an apparent oversight, impose an unfair tax burden on companies such as ours, which issue variable annuity policies. The effect of these provisions is to impose upon our company a tax on certain portions of policyholders' reserves, a result which was not intended by the draftsmen of the legislation.

Variable annuity policies provide that policyholders' reserves are created by net premiums accumulated at a rate which reflects the actual investment experience of the company. The rate is determined on the basis of investment income plus capital gains and losses, realized or unrealized, less an amount representing an expense factor. These reserves are based not upon a predetermined or assumed rate of interest, but upon the actual investment experience of the company.

H.R. 4245 in the whole imposes no unfair burden upon our company, but under the bill, the company would be liable for a capital gains tax on all of its capital gains, even though a portion of all capital gains is allocated to policyholders' reserves. Thus, it would be a tax on a liability created by terms of the policy contract, an effect not intended.

The matter has been discussed with the technicians of the Treasury, Internal Revenue Service, and of the Senate. They are aware that this effect is an oversight and should be corrected if the Senate Finance Committee so directs.

It is respectfully requested, therefore, that H.R. 4245 be amended so as to remove this deficiency.

Without suggesting specific language, but for the purpose of defining the specific problem, the following language should be considered:

"That portion of capital gains credited by contract to the reserves of a policy will be deemed to be additions to life insurance reserves and will be part of investment income."

Your earnest consideration of this request will be greatly appreciated. I request that this letter be made a part of the official record of the hearings on this bill, and am taking the liberty of sending a copy of this letter to Mrs. Elizabeth B. Springer, clerk of the committee, for that purpose.

Very truly yours,

ROBERT A. CRICHTON.

LIFE INSURANCE CO. OF NORTH AMERICA,
*Philadelphia, Pa., February 24, 1959.*

Hon. HARRY FLOOD BYRD,
*Senate Office Building, Washington, D.C.*

DEAR SENATOR BYRD: H.R. 4245, an outrageous and punitive bill which will increase the taxes paid by life insurance companies by more than 90 percent and do irreparable harm to a vital industry and millions of policyholders has already passed the House. It will pass the Senate, too, unless stern and forceful action is taken immediately prior to hearings before the Senate Finance Committee which begin on March 3.

Estimated tax revenue from life insurance companies for 1958 to the Federal Government would be about 545 millions under H.R. 4245; about 500 millions under the 1942 law; and about 319 millions under the Mills-Curtis stopgap formula. All this revenue would be in addition to the 300 millions life insurance companies pay in State premium taxes.

The 545 million figure, a 90-percent increase, was arrived at in a manner in the words of Representative Curtis as "devoid of proper morals and ethics." Because the 1942 formula, which everyone agrees is unsound happens to take 500 millions from the industry in 1958, the Treasury, the sponsor of H.R. 4245, told the House to get 500 millions out of the industry without any attempt to evaluate the effects of this tax upon the industry.

We believe H.R. 4245 will raise the cost of life insurance to tens of millions of policyholders; discourage its purchase; grossly favor mutual funds, savings banks, and other forms of investment; and will seriously impair the effectiveness of life insurance companies as a vehicle for capital formation.

We respectfully request that the Mills-Curtis formula be continued for another year, perhaps amended to include a provision which can be taken from the present bill to tax creditors life insurance and other forms of short-term life insurance. This would produce 385 millions in revenue, or an increase of 66 millions.

It is positively immoral and completely contrary to every principle for which this Nation and its people have always stood to pass H.R. 4245. Life insurance is a vital bulwark in inducing people to provide for the security of their families and for their own retirement. H.R. 4245 discourages this form of thrift.

That in itself is bad enough but, in addition, the Federal Government is already providing stiff competition for life insurance through tax-exempt social security benefits, which seem fated for continual broadening in the future as they have been greatly broadened in the past.

The so-called free interest, already taxed, exists for a sound business reason. The reason is simple: it would be unwise and unsound for life insurance companies to set their reserves on other than a conservation basis. Reserves must be maintained over a great number of years during which interest rates are known to fluctuate widely.

In the name of everything that is fair and decent, and because it is just good hardheaded American commonsense, please defeat this monstrous proposal and help to preserve life insurance as a healthy and important factor in the growth of our Nation. Encourage life insurance companies to buy Government bonds if you must—tax them fairly because the cost of Government must be borne by all—but don't make life insurance bear an unfair competitive disadvantage through confiscatory taxation. Inflation, which attacks the very heart of fixed-dollar investments, has already made life insurance less attractive and will make it even more so in the future.

Respectively submitted.

EDMUND L. ZALINSKI.

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FEBRUARY 19, 1959.

MEMORANDUM FROM T. A. BRADSHAW, PRESIDENT, PROVIDENT MUTUAL LIFE INSURANCE CO. OF PHILADELPHIA

*To Our Directors, Officers, and Field Representatives:*

FEDERAL INCOME TAXATAON OF LIFE INSURANCE COMPANIES

A new proposal for Federal income taxation of life insurance companies (H.R. 4245) was passed by the House of Representatives on February 18, and will shortly be brought to the Senate Finance Committee for consideration.

Briefly, H.R. 4245 provides for a determination of the company's net taxable investment income (phase I) and its net gain from insurance operations after policyholders' dividends (phase II), and for combining phase I and 50 percent of any excess of phase II over phase I to arrive at the tax base. However, where the payment of policyholders' dividends causes phase II to be less than phase I, the net taxable investment income constitutes the tax base. Thus the tax on mutual companies will in most instances be based entirely on phase I.

There are additional provisions for a tax on profits when distributed to stockholders, and for a tax on capital gains.

We believe it advisable to give you this statement about the tax situation and the company's position with respect to it.

*1. The bill will severely increase the tax burden on policyholders*

H.R. 4245 is designed to replace a law enacted in 1942, which was never repealed but which has been suspended in its operation since 1950 by a series of stopgap laws, the last of which was enacted in the spring of 1958 to apply to 1957 operations. If not now repealed or suspended, the 1942 law will automatically apply to operations for 1958 and subsequent years.

While the 1942 law itself would impose a severely increased tax over that imposed by the stopgap laws, the new proposal (H.R. 4245) would impose increases almost as severe, as shown by the following tabulation (figures for Provident Mutual):

| Tax year | Actual tax under stopgap law | Tax if 1942 law applied | Tax under H.R. 4245 as introduced in House |
|---|---|---|---|
| 1955 | $1,994,000 | $2,358,000 | |
| 1956 | 2,082,000 | 2,796,000 | |
| 1957 | 2,183,000 | 3,270,000 | |
| 1958 | 2,279,000 | 3,736,000 | [1] $3,529,000 |

[1] Estimated.

We are told that in many mutual companies the tax under H.R. 4245, as now drafted, would result in increases ranging between 60 and 105 percent over the tax based on the 1957 law.

*2. The 1942 law should be repealed*

This law has long been regarded as unstable, discriminatory, and unsound. As recently as the spring of 1958 it was condemned by the House Ways and Means Committee, when it said: "It would be unreasonable to return to a fundamentally unsound tax formula simply because under the changed conditions of 1957 it would produce a larger amount of revenue."

It is highly important, therefore, that the 1942 law be repealed. But it is equally important that the new bill, H.R. 4245, be modified, because, as originally introduced, it, too, will produce an unduly severe increase in taxes, resulting in an unfairly high burden on life insurance policyholders.

*3. Magnitude of tax under H.R. 4245*

When H.R. 4245 was being formulated, we were told that the law should be so designed as to produce some $500 million of revenue from the life insurance industry on 1958 operations. Apparently the rationale was that the long-discredited 1942 law would have produced about $500 million if allowed to operate, and thus it should be the criterion for establishing the fair amount of tax.

As actually introduced in the House, it is now estimated that H.R. 4245 will produce more than $545 million of revenue for 1958 operations.

In order to accomplish this result, various provisions were included in the bill which we sincerely believe will produce inequities, no matter what the aggregate tax take from the industry may be.

Moreover, it is a demonstrable fact that even under the stopgap laws in effect in recent years the total tax burden on life insurance savings has been heavier than that imposed on any other form of thrift. We recognize that under present circumstances Congress may feel obliged to insist on some appreciable increase in tax over the levels produced under the recent stopgap laws. But the $500 million criterion is unduly high.

While it is of paramount importance that the 1942 law be repealed and H.R. 4245 seems to be the only present means to accomplish this, H.R. 4245 needs modification in order to produce equitable results.

*4. Effect of State premium taxes*

State premium taxes are actually taxes on capital deposits, a form of tax unknown to any other form of thrift. (In the Provident Mutual the State premium taxes for 1958 amount to $775,000; for the entire industry they are more than $270 million.)

A very large portion of these premium taxes presumably would be unconstitutional were it not for the fact that Congress, through the McCarran Act, specifically reserved to the States the power to impose them. In so doing Congress implicitly gave priority to the States in taxing the insurance business.

In the interests of fairness to life insurance policyholders, H.R. 4245 should recognize the burden of these State taxes by allowing a reduction in the Federal tax equivalent to all or part of the State premium taxes.

*5. Individual annuities and settlement options*

The income from individual annuities and settlement options is taxed directly to the recipients. Therefore, the income from reserves held for these purposes should be eliminated from the corporate tax base so as to eliminate double taxation. If deemed necessary, this deduction could be graded over a 3-year period in a manner similar to that provided in H.R. 4245 for reserves held on account of qualified pension plans.

*6. Adjusted life insurance reserves*

The method of determining adjusted life insurance reserves employed in section 805(b) (2) of H.R. 4245 produces a descriminatory result against conservatively managed companies by introducing into the calculation the company's average rate of interest assumed in its premium calculations instead of basing the calculation solely on its actual earned interest rate. In a mutual company the interest rate assumed should have no bearing on its tax liability. If you take two mutual companies, identical in all respects except that one assumes a lower interest requirement than the other, it simply means that the one with the lower assumpion will have a higher gross premium rate than the other, but will return a higher dividend, the dividend being a return of the unneeded premium. If a higher tax is assessed because of the lower assumption (as is the case in this bill), then a competitive disadvantage is created.

Section 805(b)(2) should be changed so as to base this calculation on the individual company's actual earned interest rate—or alternatively, on the average of its actual earned rate over, say, the preceding 3 or 5 years.

*7. Discrimination against participating insurance—Effect of "Dividends"*

As applied to companies issuing participating policies, H.R. 4245 provides in effect, that if the net investment income taxable under so-called phase I is larger than the net gain from operations (i.e., net gain from insurance operations after dividends to policy holders) under so-called phase II, then the tax will be based entirely on phase I. This means that many mutual companies—and also many stock companies issuing participating policies—would be deprived of credit for a large portion of their policyholders' dividends, which actually are a return of premium overcharges and are not corporate earnings. The result is that a substantial portion of the dividends is in effect added to the tax base. Obviously this adds to the net cost of participating insurance.

The return of premium overcharges (dividends) is what keeps participating policies in both stock and mutual companies in a competitive net-cost position with nonparticipating policies, because the gross premium for nonparticipating life insurance is lower. If, as is now provided in H.R. 4245, a substantial part of the ability to return premium overcharges is taxed away, then participating policies suffer a competitive disadvantage.

To correct this inequity, the law should allow as a deduction from the tax base in phase I some portion—say 50 percent—of the amount whereby the net investment income in phase I exceeds the net gain from operations in phase II.

If such an allowance is not made, then consider the dilemma of a mutual company in considering, for instance, whether or not it should make a charitable contribution. Any such contribution by a typical mutual company would be made in 100 percent dollars with no tax credit whatsoever. In contrast, such a contribution by a stock company issuing only nonparticipating policies would constitute a deduction in phase II and the net cost of the contribution, after tax deduction, would be reduced by about 26 percent.

*8. Other features*

There are other features of H.R. 4245 which seem to indicate the need for careful consideration and possible modification. They are of such technical nature that they cannot feasibly be discussed in this memorandum. Among other things, (*a*) the bill seems to remove partially the tax exemption normally granted to income from tax-exempt securities; (*b*) the imposition of a flat tax of 25 percent on long-term capital gain differs from the treatment accorded other types of taxpayers, and may deserve some modification; and (*c*) the deduction of 2 percent of group insurance premiums and 10 percent of the increase in reserves for nonparticipating contracts, granted in phase II of the bill, would seem to create a competitive disadvantage for companies whose tax in effect will be based entirely on net investment income under phase I.

*9. Economic effects*

Finally, the severe tax increase contemplated by H.R. 4225 raises serious questions as to whether a tax burden of this magnitude may not tend to discourage savings through the purchase of life insurance, to the detriment of the Nation's economy. Life insurance is too important from a social and economic standpoint to be taxed in any but the soundest and fairest way.

This concern is well expressed in "Supplemental Views on H.R. 4245" filed with the Ways and Means Committee report by 10 of its members. We attach a copy of this supplemental report and commend it to you for your consideration.

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VI. Supplemental Views on H.R. 4245

The undersigned members of the Committee on Ways and Means have joined in expressing these supplemental views because of one principal concern that we share with respect to your committee's bill.

We are concerned that insufficient consideration has been given to the economic impact of the revenue implications of the bill H.R. 4245. We do not make the point that too little, just enough, or too much revenue is extracted from the insurance industry and its policyholders; we do make the point that the economic aspects of this issue must be further studied and evaluated before the Congress can have confidence that the tax burden imposed under your committee's bill is appropriate in magnitude and equitable in distribution.

The bill produces aggregate revenue for taxable year 1958 of $545 million. This is $45 million more than the 1942 formula would produce if applied to 1958 income. The first step in the bill, which deals with the taxation of investment income (earnings on policyholder savings), results in a tax increase of approximately $5 million more than the 1942 act which like step 1 of the bill applies only to investment income. Both the Treasury Department and the Congress have recognized that the 1942 act was based on an artificial formula which produced little or no revenue in 1947 through 1949 and now 11 years later would impose an inequitable tax burden on policyholder savings.

With respect to the 1942 formula the Senate Committee on Finance made the following statement in its committee Report No. 1571 of the 84th Congress at the time of favorably reporting the legislation (H.R. 7201) embodying the Mills-Curtis stopgap to the Senate: "Your committee did not feel able to give adequate consideration to the problems involved in the short time before adjournment. This left life insurance companies apparently subject to tax on 1955 income under the terms of the 1942 formula, which would involve a higher tax than was imposed under the House bill. Since your committee did not intend that this formula should come into operation * * *." However, it is clear that the new formula imposes a still greater total burden on policyholder savings than would result from the 1942 formula.

Compared with the Mills-Curtis stopgap law the bill increases the aggregate tax on life insurance companies for 1958 by approximately $226 million. Thus, the tax for 1958 will be more than 70 percent higher than that paid in 1957. Of this increase, $186 million is levied on the earnings on policyholder savings and $40 million will be derived from so-called underwriting gains. With respect to the Mills-Curtis formula it is significant to note that the revenue experience under that method of taxing insurance companies resulted in increasing tax collections each year it was in effect reflecting the growth experienced by the industry.

Testimony before the Ways and Means Committee disclosed that over half of the life insurance in force today does not involve savings features. Inflation and taxation have influenced this result. The trend toward pure protection and away from savings features is of great economic concern. Healthy expansion of our economy depends in a large measure on the rate of capital accumulation made available through private savings institutions such as life insurance companies. Taxes on investment income tend to reduce the interest credited to policyholder savings and such a tax burden further discourages saving through the purchase of life insurance.

In considering the revenue aspects of the bill it should also be recognized that life insurance companies are already heavily taxed by the States, possibly more heavily taxed than any other industry. These State taxes are unique and have no counterpart in the case of other thrift institutions. In enacting the McCarran Act Congress recognized the traditional and exclusive regulatory role of the States and impliedly evidenced a congressional intent to give priority to the States in taxing the insurance business. The State taxes on life insurance premiums will exceed $300 million for tax year 1958. When these State taxes are added to the revenue anticipated under the bill the aggregate exaction will exceed $845 million. Five years ago the combined Federal and State taxes were less than 50 percent of this figure. This trend in life insurance taxes is likely to increase the cost of insurance and to reduce the return on insurance savings to the point where the savings features of life insurance will be less attractive to the public.

Individual economic security is now being provided the public by life insurance companies, other thrift institutions, and through the social security system. It is sound public policy to encourage everyone to provide for his own security on a voluntary basis and our tax laws should encourage, not deter, such efforts. This bill, however, makes voluntary provision for one's own economic security relatively less attractive since it increases the tax on life insurance while investment earnings under the social security system are free from either Federal or State tax. This increases the advantage of the social security system over voluntary individual protection offered by life insurance companies, particularly if the latter must absorb taxes of the magnitude provided in the bill. Public awareness of this differential in cost will most certainly lead to increased demand for larger social security benefits and less incentive to build security on a voluntary basis.

The economic considerations set forth in these supplemental views must be evaluated objectively and thoroughly if we are to avoid possible impairment of the national economy and of the Federal tax base.

Daniel A. Reed, Richard M. Simpson, Noah M. Mason, John W. Byrnes, Howard H. Baker, Thomas B. Curtis, Victor A. Knox, James B. Utt, Jackson E. Betts, Bruce Alger.

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THE PENN MUTUAL LIFE INSURANCE CO.,
*Philadelphia, Pa., February 19, 1959.*

Re H.R. 4245, Life Insurance Income Tax Act of 1959.

Hon. JOSEPH S. CLARK,
*Senate Office Building,*
*Washington, D.C.*

DEAR SENATOR CLARK: Our company is, of course, very much concerned with this bill, which is intended as the permanent substitute for the stopgap legislation which has been enacted from year to year for the tax on life insurance companies, pending review of the suspended 1942 formula.

It is our conclusion that there should be new legislation this year so that the 1942 formula will not be revived, but that this bill, as passed in the House, needs amendment. The bill introduces a new concept in its revaluation of a company's reserves in determining taxable investment income. We believe that this, for example, should be modified so as to be based on a company's earned interest rate and not upon rates which have been assumed in determining a company's premium rates, since assumed rates of interest are not a proper measure of a company's taxable income.

Provision also should be made for extending to income derived from reserves on individual annuities and annuity options which have been elected under insurance policies the same treatment as has been made in H.R. 4245 with respect to qualified pension plans.

I think you may be interested in the attached memorandum, which outlines in a little more detail these and other points in an effort to explain our feeling that this bill needs amendment.

We understand that the intent was to write a bill which would provide the $500 million which would have resulted under the 1942 formula, and that this bill overshoots this mark considerably. We feel, of course, that it should not be permitted to exceed the original target, but we feel also that such a target is an improper measure of any new tax, since that formula was discredited many years ago as a proper basis for taxing life insurance companies. We feel, therefore, that the points mentioned in the memo should be considered without prejudice by comparison with a predetermined revenue goal.

Sincerely yours,

WILLIS H. SATTERTHWAITE,
*Vice President and Counsel.*

STATEMENT ON BEHALF OF THE PENN MUTUAL LIFE INSURANCE CO. ON H.R. 4245, THE LIFE INSURANCE INCOME TAX ACT OF 1959

H.R. 4245, which is about to be considered by the Senate Finance Committee after passage in the House, would provide a new basis for determining the Federal income tax to be paid by life insurance companies. The purpose of this statement is to make available to members of the Penn Mutual organization information on the effect this bill would have and the company's position with respect to it—particularly for the benefit of those who have expressed an interest in participating in the consideration of this vital subject through contact and discussion with their legislative representatives.

THE BILL PROVIDES FOR A GREATLY INCREASED TAX BURDEN

The bill is estimated to increase the amount of tax imposed on the industry aproximately from $300 million (on the basis applicable to 1957 income) to $550 million. Appreciation of the magnitude of this increase is confused by the fact that failure to enact a new bill does not mean that a tax at the $300 million rate will continue, but rather the revival of a formula adopted in 1942, abandoned in 1950 as unsatisfactory, and held in suspension ever since pending development of a satisfactory formula, ready to become operative automatically if a new law is not adopted.

THE BILL WAS DESIGNED TO MEET A PREDETERMINED REVENUE GOAL

H.R. 4245 is designed to replace the 1942 formula, and to provide a permanent basis for taxing life insurance companies. The bill is probably unique in being designed primarily to assure tax revenue in a predetermined amount—namely, the amount which, under the discredited 194" formula, could be expected to result if no bill at all were enacted. The establishment of this goal has had the unforunate result that emphasis has had to be placed on the tax take to the exclusion of consideration of the tax burden which millions of policyholedrs might properly be called upon to pay.

THERE SHOULD BE A NEW LAW

It is essential that the practice of repeated stopgap suspensions of the 1942 formula be terminated, and that a new basis of taxation be adopted which can be expected to have some degree of permanency. It is recognized, furthermore, that despite the validity of reasons why policyholders of life insurance companies should not be called upon for an increased tax burden, Congress, under the circumstances of the current situation, may determine that the company, already a substantial taxpayer, will have to accept a greatly increased tax. We believe that the bill properly recognizes that, while the interests of policyholders of both stock and mutual life insurance companies require similar treatment of both types of companies in most respects, additional provision needs to be made with respect to the proprietary interest of stockohlders.

CONSIDERATIONS WHICH SHOULD BE TAKEN INTO ACCOUNT BY CONGRESS IN DETERMINING THE FINAL FORM OF THE NEW TAX

1. *The 1942 formula should not apply by default.*—The 1942 formula is not a proper basis for a tax on life insruance companies. It should not be permitted to come into operation for 1958 or any other year by default in adoption of a satisfactory new act before March 15, 1959.

2. *The 1942 formula is not a proper measure for the 1959 act.*—The 1942 formula is not a fair and proper formula for the tax, and this has been recognized by the Treasury Department. The amount of revenue which could be expected under that formula should not be set as an arbitrary target which any new law must achieve, to the detriment of other factors which should be considered in determining what is a proper tax for life insurance companies.

3. *Life insurance companies pay heavy taxes to the States.*—Life insurance companies are already substantial income taxpayers and, in addition, are very substantial taxpayers to the States through premium taxes to a greater degree than other types of corporations.

4. *The tax should be considered in the light of its impact on individual policyholders.*—The increases of the tax on mutual life insurance companies must inevitably fall on individual policyholders, increasing the cost of their insurance and thereby decreasing their ability to save through the medium of life insurance.

While it is impracticable to tax the members of a mutual life insurance company directly for all income accruing to the common enterprise which they have set up to provide their insurance needs, the aggregate individual tax burden which would be imposed upon them if this could be done should be taken into account in determining the tax which is to be imposed on their corporation.

5. *The deduction for qualified pension plans should be extended to all annuities and settlement options.*—H.R. 4245 does take into account the fact that a deduction should be permitted with respect to investment income earned on reserves for qualified pension plans which are exempt from tax, and also for interest paid on policy contracts which will be taxable income to the payees. A similar provision should be made with respect to annuities generally and to proceeds of insurance held under annuity options, since the beneficiaries of such contracts or proceeds are currently subject to tax directly with respect to the interest element in payments to them.

6. *A mutual company's taxable income comes from its investments.*—In the case of mutual companies, the only true source of taxable income is income from investments. Approaches may be devised for determining taxable income of a life insurance company on a so-called total income basis, provided necessary safeguards are taken to adapt them for the protection of policyholders. A mutual company, because of the nature of its operation, develops no income in the form of gain from operations in addition to its investment income. The dividends which it distributes to its policyholders represent not a gain from the company's operations, but a refund of a portion of the premium paid which has been found to be in excess of requirements. It is because of this refund that mutual companies are able to compete with companies which charge a lower initial premium but on a nonparticipating basis. The policyholder dividend is a means of equalizing the cost in comparison with a nonpar rate.

7. *Change should be made in the formula for taxable investment income.*—H.R. 4245 provides for a determination of the tax in two steps, first on the basis of investment income and, second on the basis of gains from operations. This is done in such a way that the chief impact upon mutual companies is under step 1. This appears proper since step 1 relates to investment income. However, to the extent that the second step, in addition to the tax on investment income, imposes any tax on a mutual life insurance company's gain from operation, it goes beyond what we consider to be the proper basis of tax as stated above.

In devising the first step, provision has been made for a revaluation of reserves for tax purposes. To the extent that this makes it possible to consider a company's reserve interest requirements on its own record and not by the use of industry averages, we believe this is an improvement over prior formulas.

In the effort to reach the fixed revenue goal, use has been made of industry average and of assumed rates in determining the interest rate to be used in determining the portion of investment income which should be taxable. The result of this has been to provide a formula which will in fact greatly exceed the revenue goal of the draftsmen.

We believe the provision for revaluation of reserves should be based on the individual company's earned rate for the preceding year. If it is concluded that some averaging of rates be used, it should be an average of the individual company's earned rates.

WILLIS H. SATTERTHWAITE,
*Vice President and Counsel.*

STATEMENT OF AUSTIN J. TOBIN, CHAIRMAN OF THE CONFERENCE ON STATE DEFENSE AND EXECUTIVE DIRECTOR OF THE PORT OF NEW YORK AUTHORITY, ON THE ASPECTS OF H.R. 4245 RELATING TO THE TAX TREATMENT OF THE INCOME OF LIFE INSURANCE COMPANIES FROM STATE AND MUNICIPAL BOND INTEREST

This statement is restricted solely to the tax treatment in the proposed Life Insurance Company Income Tax Act of 1959 of life insurance company income from the interest on State and municipal bonds.

This statement is submitted for the Port of New York Authority, an issuer of such bonds, and for the Conference on State Defense, an organization of State and municipal officers and their associations, dedicated to the preservation of the constitutional immunity of State and municipal bond interest from Federal income taxation.

At the outset I must state that in our opinion the bill is unobjectionable from the constitutional viewpoint in its treatment of the interest on State and municipal bonds. We are gratified that Chairman Mills and the Ways and Means Committee have so carefully respected the requirements of the Constitution by avoiding any taxation of life insurance company income from this class of obligation. We appreciate the complexities of devising formulas which would accomplish the objective of taxing life insurance companies to the extent desired and at the same time scrupulously avoid any conflict with the constitutional requirements that Congress refrain from income taxation of State and municipal bond interest.

We do submit, however, for your consideration, a possible enlargement in the bill of the exemption for life insurance income from State and municipal bonds. This enlargement, from what the bill now provides, while admittedly going beyond what the Constitution requires, would go far to meeting a serious problem confronted by the States and municipalities at this time in accomplishing a critically necessary broadening of the market for their securities.

The mechanism which would accomplish this purpose, if it commends itself to the Congress, is quite simple. The pattern of H.R. 4245 pertinent to municipal bond interest is this: From the gross investment income which includes State and municipal bond interest (sec. 804(b)(1)(A)), deduction is permitted for the interest on State and municipal bonds (sec. 804(c)(5)) in arriving at net investment income. From this net there is then deducted under section 804(a) a "policy and other contract liability deduction" which is computed under section 805. This deduction includes deductions for investment yield on certain reserves. For our purposes, it is important to note that section 805(b)(5) permits the investment yield deduction to include the amount of the net investment income on adjusted reserves which is derived in the form of interest from municipal bonds, even though the full amount of such interest on total investments would already have been allowed under section 804(c)(5). In other words, the interplay of the full deduction of State and municipal bond interest from gross investment income under section 804(c)(5) and the deduction of investment yield as computed under section 805(b)(5) would result in duplicating deductions for State and municipal bond interest to the extent that the investment yield included State and municipal bond interest. The bill in its present form would then avoid the duplication in section 805(e) which requires the insurance company to add back to the taxable investment income otherwise computed a proportion of the municipal bond interest deducted under section 804(c)(5) which represents the duplicated deduction which forms a part of the deductions for investment yield under prior subdivisions.

In our view, it is perfectly constitutional to add back this duplicated portion to avoid duplicate deductions.

However, we submit that there is merit in not doing so, not because of any benefits life insurance companies might incidentally derive but because of substantial benefits which would accrue to State and municipal issuers of public securities in accomplishing a necessary broadening of a market for their bonds.

Most life insurance companies have not up till now invested in municipal bonds to the extent that a balanced portfolio program would lead us to expect, and for a very simple reason. The interest rates paid on these bonds are lower than they would otherwise be on the basis of their investment quality because of the fact of tax immunity. In effect, the investor in municipal bonds pays for his exemption by accepting a lower rate, and the States and municipalities are the beneficiaries and can provide more public services to the extent of their interest savings. However, the interest differential is based upon the value of the exemption to the average investor who pays tax on all of his net income.

Life insurance companies, on the other hand, by reason of the necessary deductions for earnings on reserves pay income taxes on only a relatively minor portion of their net investment income. The value of the exemption of municipal bond interest to a life insurance company which would pay tax on only 30 percent of its net investment income is much less than to a bank paying on 100 percent of the equivalent income. Therefore, the interest differential which the market has established for State and municipal bonds under what they would yield without tax exemption has been judged by many life insurance companies as too great a price to pay for the relatively smaller benefit of the exemption to them.

In order to wipe out this lessened attractiveness of State and municipal bonds to life insurance companies as compared with other corporations which are taxable in greater degree on their investment income, it would be necessary to eliminate the addition back of the stated proportions of municipal bond interest which is provided by section 805(e) and the corresponding provision in subpart C which appears in section 809(f)(1)(A). In section 805(e)(1) it would merely be necessary to delete the "(5)" which involves the reference back to tax-exempt interest; and in section 809(f)(1)(A) it would merely be necessary to delete subdivision (i) and renumber the succeeding subdivisions.

The need of the municipalities to find additional markets for their obligations is well known to the members of the committee. Highway needs, school rehabilitation and expansion, airport construction, the numerous public needs arising out of expanding suburban areas, hospitals, water supply, and all the other public purposes to which State and municipal activities are directed, have created and will continue to create an inexorable pressure on the need for borrowing at the local level. New bond offerings of State and local governments increased from $1.2 billion in 1946 to $7 billion in 1954. After a drop to $5.4 billion in 1956 the curve resumed its upward course and it is estimated that in the 1960's the total volume of such new offerings will exceed $10 billion a year.

This process has taken place along with a steadily rising average interest rate being paid on this State and local debt with no prospect for decline in the foreseeable future.

One effect of these pressures on State and local finances has been to generate more and more requests for increased Federal aid and also a greater willingness on the part of Congress to give such aid, as witnessed by the highway-aid and airport-aid programs.

We submit that if the Congress assists in expanding the market for State and municipal bonds in the way we have suggested, much will have been done to reduce the pressure for increasing Federal aid. Accordingly, whatever revenue loss our suggestion might cost the Federal Government, in the way of reducing anticipated revenue increases from the bill in question, it may well be that these costs will be offset in the long run by reduced need for Federal aid.

A study of interest-rate differentials on the impact of the present bill on life insurance companies convinces us that most of the advantage of our suggestion would accrue to the State and local governments. However, any remaining advantage to the life insurance companies would not be socially objectionable. The ownership of life insurance companies is not in the main lodged in extremely wealthy individuals who would receive a disproportionate advantage from the enlarged tax exemption which we propose. In many instances, life insurance is a vehicle for savings of persons with lower incomes.

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MEMORANDUM, MARCH 2, 1959

To: The Finance Committee, The U.S. Senate, Washington, D.C.
From: Joseph F. Clark, executive director, Municipal Finance Officers Association of the United States and Canada, Chicago, Ill.
Subject: H.R. 4245, relating to the taxation of the income of life insurance companies.

I have read the statement of Austin J. Tobin, chairman of the Conference on State Defense, and executive director of the Port of New York Authority, to the Finance Committee of the U.S. Senate on the aspects of H.R. 4245 relating to the tax treatment of the income of life insurance companies from State and municipal bond interest.

Since the objects of the Municipal Finance Officers Association are to improve methods of public finance, it is deemed appropriate and reasonable to offer some observations with reference to the Tobin statement which may be useful to the committee.

(1) It is noted that the Ways and Means Committee and its chairman have sought to comply with the requirements of the Constitution by refraining from taxing the income on State and municipal bonds held as investments of life insurance companies; that it thereby avoids any conflict with the constitutional interdict that Congress refrain from enacting legislation taxing the income of State and municipal bond interest. This effort on the part of the Ways and Means Committee and its chairman is not only laudable, but comforting.

(2) This association is nonpolitical and educational in character. It does not indulge in efforts to influence enactment of legislation proposed in the Congress, or in the legislative bodies of States, provinces and their political subdivisions, including local governments. Within the framework of its objectives, including to develop principles of economy in State and local governments, it has traditionally opposed the imposition of any taxation of interest on State and municipal securities since it believes the effects of such a tax would undoubtedly be reflected in a rise in interest rates on such securities, thereby adding to burdensome costs of State and local government debt.

(3) The heavy volume of current offerings of State and municipal long-term bonds (which amounted to $7.4 billion in 1958 and which probably will not lessen at least in the foreseeable future) which must be issued to finance the acquisition of the billions of dollars of essential capital improvements needed by States and local governments incident to the needs of expanding populations, implies the desirability to preserve the investment market for municipal bonds in every respect.

(4) The formula set forth in H.R. 4245 devised to accomplish the objective of taxing life insurance companies to the extent desired is, indeed, complex. Evidently it will accomplish the objective of the Congress as the bill now is written.

(5) The Tobin submission offers for consideration of the Congress an enlargement of exemption of income from investments in State and municipal bonds for life insurance companies. It suggests that if the Federal Government has a loss of revenue in the way of a reduction in anticipated revenue under H.R. 4245, it may well be that such loss will, in the long run, be reduced since it would serve to lessen Federal financial aids to the State and local entities. This viewpoint commends itself to the Congress and is pertinent for study by it during its consideration of the merits of the bill.

(6) The point made in the Tobin statement (p. 8) with reference to the investments by life insurance companies in municipal bonds and the reason why a balanced portfolio program has been less than the extent hoped for, is sound.

(7) This memorandum is prepared with the intention of being helpful and informative to the Congress in its deliberations of H.R. 4245.

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TRICO PRODUCTS CORP.,
*Buffalo, N.Y., March 2, 1959.*

Re taxation of group life insurance and pension funds (H.R. 4245).

Hon. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Washington, D.C.*

DEAR SENATOR BYRD: As employers of more than 3,200 persons in Buffalo, we were one of the first companies in this area to establish plantwide group life insurance and pension plans, on an insured basis. These plans have operated satisfactorily to the company and our employees during all these years. We are now disturbed, however, by the apparently discriminatory taxes applicable to these plans as compared with trusteed plans.

The difficulties, as we understand them, have arisen more from technical problems in drafting the proposed law than from any real intent to discriminate. After all the work that has been done on this bill, as passed by the House and now before your committee, it seems a shame not to get it right. We respectfully urge that sufficient time be allowed to go into this matter very carefully. More particularly, we believe that in all fairness the bill as passed by the House should be changed, (1) so as to exclude from the tax base all investment income, including capital gains and losses, attributable to the operation of pension plans, and (2) so as to make the deduction for contingency additions, in relation to group insurance operation, applicable uniformly to both mutual and stock companies.

Sincerely yours,

RUPERT WARREN, *Vice President.*

NATIONAL ASSOCIATION OF HOME BUILDERS,
*Washington, D.C., March 3, 1959.*

Hon. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building, Washington, D.C.*

DEAR SENATOR BYRD: Of prime concern to the homebuilding industry is an adequate and continuing source of mortgage-investment funds. Naturally we are interested in any Federal legislation which would have an effect upon these funds.

The Senate Finance Committee is now holding hearings on H.R. 4245, the Life Insurance Company Income Tax Act of 1959, which has already passed the House of Representatives. We understand that the effects of this bill, if enacted into law, are not fully know and, because of its technical nature, we are not in a position to predict any general economic effect it might have. However, we do urge the Senate Finance Committee to consider carefully any measure which would result in a lessening or disruption of private mortgage credit for our industry.

Since World War II, U.S. life insurance companies have made available some $35 billion in home-mortgage loans, half of which have gone into the FHA or VA programs. Since the life insurance industry is a prime source of home-mortgage credit, we ask careful deliberation of any tax measure which might cause any shift in these investment funds.

Sincerely,

CARL T. MITNICK, *President.*

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LIFE INSURANCE ASSOCIATION OF AMERICA,
*New York, N.Y., March 2, 1959.*

Subject: H.R. 4245, taxation of life insurance companies.

Hon. HARRY FLOOD BYRD,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: I am writing in behalf of the Life Insurance Association of America whose membership is composed of 118 stock and mutual companies. In the aggregate, these companies have in force over 80 percent of the life insurance in the United States.

Our association has cooperated with the Treasury and committee staffs in an effort to bring about a sound and equitable tax law for life insurance companies. Recently our governing bodies adopted a resolution on the pending bill, a copy of which is attached. This resolution expresses the policy of the association to accept the general pattern of the bill. The resolution also recommends modifications which will be presented by company witnesses at the hearings before your committee.

It has come to our attention that some companies are advocating that the 1942 act be permitted to apply to tax year 1958 so as to provide more time for the consideration of the pending bill. We realize that this legislation is quite complicated and have never advocated hasty consideration. If, in the judgment of your committee the time intervening between the hearings and March 15th is insufficient to afford ample opportunity to consider this subject, a reasonable delay to provide time for more thorough consideration can be granted and, in our opinion, shuld not preclude enacting legislation for tax year 1958. Certainly such a delay should not justify applying the 1942 act to tax year 1958.

Our association, together with other associations, has opposed the 1942 law as unsound and inequitable on every appearance before your committee since 1950. The Treasury has taken the same position. We opposed the 1942 law when it produced no revenue and also when the revenue thereunder would have been substantially less than that produced under some of the stopgap laws enacted during the past 8 years. The fact that the 1942 law would produce roughly $500 million in revenue for tax year 1958 does not in any way overcome the inequities that are inherent in its basic formula. To the contrary this high level of taxation under this abandoned formula compounds its many discriminations.

Those who advocate the 1942 law for tax year 1958 seem to feel that such a solution would be proper because the revenue produced would roughly equal the revenue that would be generated by the pending bill. This reasoning, however, completely disregards the tax consequences insofar as individual companies are concerned. A return to the 1942 act would produce the following inequitable consequences:

1. It would leave uncorrected for another year the tax inequities which the Ways and Means Committee sought to overcome through the pending bill.

2. Many companies would be required to pay an excessive tax on their investment earnings. Other companies with large operating gains as compared with their taxable investment income would be undertaxed.

3. The inequitable industry-averaging formula for the computation of the reserve interest deduction would be reintroduced, thus making it necessary for companies to pay a tax according to industry average interest requirements instead of on the basis of their own requirements.

4. New companies in business for more than 10 years, but operating with losses or only modest gains would pay an excessive tax.

5. The special relief provisions for small companies contained in the stopgap legislation enacted since 1955 and the more generous provisions for such companies in the pending bill would not be available.

6. The tax treatment of accident and health business in the 1942 law, which was enacted at a time health business was in its infancy, is unrealistic and would result in a considerable reduction in the burden of the tax in the case of some companies and an excessive tax in the case of others.

In this connection, a time problem similar to the current situation developed in 1950 when Congress enacted a life insurance company tax law applicable to tax year 1949. The legislative record was as follows: On October 10, 1949, a bill was introduced applicable to the taxation of life insurance companies for tax years 1947, 1948, and 1949. The Ways and Means Committee took no action on this bill, however, until January 24, 1950, when it favorably reported it. After passage in the House, hearings were held before the Senate Finance Committee on March 16 and 29, 1950. The Finance Committee reported the bill applicable to tax years 1949 and 1950 on April 10, 1950. The Senate passed the bill on April 15, 1950. As a matter of procedure the tax returns were postponed under provisions of the Internal Revenue Code.

After careful and adequate consideration of H.R. 4245 and any modifications proposed at the hearings, we hope that permanent legislation will be enacted on this subject applicable to tax year 1958 and thereafter. In view of all the circumstances taxing the life insurance companies under the 1942 act for 1958 is obviously unnecessary and would create many inequities.

Sincerely yours,

EUGENE M. THORÉ,
*Vice President and General Counsel.*

RESOLUTION ADOPTED AT THE BOARD OF DIRECTORS MEETING ON FEBRUARY 20, 1959

That this association's policy is to accept the general pattern of the new three-phase approach to the Federal income tax, to oppose strongly the high level of tax burden on the business as a whole, and to urge strongly that the burden be made substantially less onerous by at least changing the definition of the deduction rate for determining the policy and other contract deduction from the mean rate provided in the bill to the individual company average earned rate of interest for the tax year and the 4 immediately preceding years and by providing for the revaluation of life insurance reserves on the basis of such average earned rate.

(See also pp. 125, 524, and 624.)

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AMERICAN LIFE CONVENTION,
*Washington, D.C., March 2, 1959.*

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

DEAR MR. BYRD: For almost 10 years, life insurance companies have paid their Federal income taxes under a series of stopgap laws which expired at the end of each calendar year. This has been a matter of great concern to a business which must guarantee the cost of its product over a long period of time—as much as 50 years or even more.

Therefore we are very desirous that a permanent law may be enacted this year which will be practical in its operation and equitable in its effect both upon competing life insurance companies and their policyholders. Otherwise the archaic 1942 law will be reactivated. Our organization has gone on record against such law many times on the ground that it is outmoded, arbitrary, artificial, and inequitable.

Naturally we hope that a new and presumably permanent tax law may be passed as expeditiously as possible. However, in view of the necessarily complicated character of any bill dealing with this highly technical subject, we hope also that necessary time will be taken for careful study, due deliberation, and the reaching of mature conclusions.

We firmly believe that H.R. 4245, now before you for consideration, can be improved in important particulars and that in the aggregate it levies an oppresive tax on an institution of great social benefit to the Nation.

. The view of the industry on the details of this bill will be presented at the forthcoming hearings by well-qualified witnesses. The purpose of this communication is to make clear that our organization does not intend to pursue an obstructive course on the one hand nor to press for hurried or ill-considered action on the other.

Although it would be very desirable to have a new law by March 15, the final corporate income taxpaying date for 1958 taxes, it is even more important that the law enacted shall be sound legislation. We believe that if it should become necessary to provide a reasonable extension of the final taxpayment date (for which there is precedent), such means may be employed legally to provide sufficient time to perfect a law satisfactory to the Congress.

Yours sincerely,

CLARIS ADAMS,
*Executive Vice President and General Counsel.*

NOTE.- The American Life Convention is a trade association composed of 280 legal reserve life insurance companies, the combined membership of which has more than 95 percent of all life insurance in force in the United States.

(See also pp. 524, 625.)

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SNEED & VINE,
*Austin, Tex., February 28, 1959.*

Re H.R. 4245, 86th Congress, 1st session.

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

DEAR SENATOR BYRD: Pursuant to the directions of Mr. Russell M. Oram, of your committee staff, please find enclosed a statement presented upon behalf of the Texas Mutual Assessment Industry, composed of approximately 700 such concerns. We respectfully request that this statement be read into the record of the hearings on the above-captioned bill.

The problem of these concerns under H.R. 4245 occurs in that investment income is taxed without credit given for such investment income credited to the policyholders under policy contracts. Error occurs by reason of the definition contained in section 804(a) of the bill; the definition is phrased in language applicable to legal reserve type companies and thus omits any credit or deduction to those concerns operating on the mutual assessment plan. The result is an inequity to mutual assessment companies and their policyholders.

This identical problem arose with H.R. 7201, 84th Congress, and was corrected by the amendment to the act carried forward therein as section 804(b)(1)(E).

The suggested amendment contained in the enclosed statement does not alter or impair the principles involved in the bill but merely corrects what appears to be a technical error. Preferential treatment is not sought but rather merely an error corrected.

The consideration of this error by your committee will be sincerely appreciated.

Respectfully submitted.

ROBERT C. SNEED.

STATEMENT OF ROBERT C. SNEED, AUSTIN, TEX.

My name is Robert C. Sneed, an attorney of Austin, Tex., and I represent the Texas Association of Mutual Life Insurance Officials, a trade organization composed of managing officers of mutual assessment life insurance companies regulated by the commissioner of insurance and the State Board of Insurance of the State of Texas. Approximately 4 million persons are insured by Texas mutual assessment companies.

The particular problem of these companies with regard to H.R. 4245 is limited to the one question of whether or not the investment income from the reserve funds (called mortuary or relief funds under the Texas law) is such as to be within the definition of interest required to be paid under policy contracts defined in section 804(a).

In connection with the above query, the following statements are made as to such companies:

(1) At least 60 percent of all assessments or premium income, exclusive of membership fees, of such companies must be placed in the mortuary or relief fund of the company and from which fund claims are paid.

(2) The other portion of the assessment or premium is placed in a fund called expense fund and from which all expenses are paid.

(3) The mortuary or relief fund belongs exclusively to the policyholders, and in the event of dissolution of the company, all assets therein would be distributed solely to the policyholders, based upon their interest in the fund by reason of the amounts thereto paid.

(4) Under Texas law, the mortuary or relief funds of such companies may only be invested in such securities as are legal investments for reserve funds of stock life insurance companies.

(5) Under Texas law, mutual assessment companies issue life policies only without cash surrender or loan value.

(6) The mortuary or relief funds of these companies comply with the mutual assessment "life insurance reserve" definition contained in H.R. 4245.

(7) Policies of mutual assessment companies do not specifically provide for an assumed interest rate, but most concerns, in setting rates or frequency of assessments, rely upon an assumed interest factor so as to lower rates and reduce frequency of assessments. All investment income of mortuary or relief funds must be placed in such fund for the exclusive benefit of the policyholders. Therefore the resulting premium charge of the policyholder is thus computed in a manner almost identical to the principal of the legal reserve plan.

(8) Texas mutual assessment companies have no capital or surplus funds.

By reason of the foregoing it appears that the definition in section 804(a) would not include the investment income of the mortuary or relief funds of these companies, and thereby this investment income from funds designated elsewhere in the bill as life insurance reserves would be taxed as ordinary corporate income in the entirety.

It would thus seem that inadvertently a tax would be levied upon all the investment income of the policyholders' reserves of mutual assessment companies. Such would not appear to be intended from an overall reading of the bill, as this tax does not so apply to any other type of life insurance company.

The identical problem arose with H.R. 7201, 84th Congress, 1st session, and was cured by amendment adopted by the Senate Finance Committee and incorporated into such act as section 804(b)(1)(E).

Based upon such problems, the following amendment to H.R. 4245 is respectfully suggested, by inserting the following wording after section 804(c)(9), at page 12, line 14:

> "(10) ASSESSMENT COMPANIES.—A mutual assessment life insurance company or association is also entitled to deduct from 'gross investment income' in determining its 'net investment income' an amount equal to 3 per centum of its life insurance reserves."

Your consideration of the merits of this problem is sincerely requested.

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ARIZONA WATER CO.,
*Phoenix, Ariz., February 26, 1959.*

Re House bill 4245.

Hon. CARL HAYDEN,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR HAYDEN: It has come to our attention that House bill 4245 has been passed by the House of Representatives and is now receiving the consideration of the Senate Finance Committee. We are concerned with this legislation because included in its provisions is a relief from a tax which we feel has been discriminatory. We are referring here to the relief from tax on insured pension plan reserves.

When our company adopted a pension plan a few years ago we were most interested in obtaining the maximum guarantees possible. For this reason we selected a group annuity plan insured by a large insurance company. Under present tax laws our pension plan reserves have been subject to a tax assessed against the insurance company. This tax does not apply to uninsured plans and we feel, therefore, that we have been penalized because we wanted to adopt the soundest guarantees possible.

We feel that any measure which revises the tax situation for life insurance companies should provide relief from this discriminatory provision of present law. We, therefore, feel that at least the provisions as outlined in House bill 4245 should be carried forward into the final legislation. We will appreciate your consideration of this matter, and also would appreciate it if you would contact a Senator on the Senate Finance Committee in connection with this matter.

Sincerely yours,

CARL J. SCHMIDT,
*Vice President and General Manager.*

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THE H. B. A. LIFE INSURANCE CO.,
*Phoenix, Ariz., February 27, 1959.*

HON. CARL HAYDEN,
*U.S. Senator from Arizona, Washington, D.C.*

DEAR SENATOR HAYDEN: I am writing regarding H.R. 4245 which last week was passed by the House of Representatives and I understand a hearing will be held by the Senate Finance Committee on March 3. This is the bill relating to the taxation of life insurance companies.

I question the merits of this bill on two bases. One, that it has been introduced and rushed so quickly that few people have had a chance to understand it. Two, that the bill will be unfair in the following three provisions to smaller or newer life insurance companies which are nearly all stock companies. This is particularly true of the many companies here in Arizona.

1. "Section 804, taxable investment income (c)(9) small-business deduction. An amount equal to 5 percent of the investment income for the taxable year. The deduction under this paragraph shall not exceed $25,000."

The above provision is the only point or suggestion of relief to the smaller company. We consider ourselves a small company with assets of $1 million. This so-called relief for smaller company based on our 1958 experience would save us the tax on approximately $800 to $900 of income. Yet, the same paragraph for a company with about $10 million of assets would save them the tax on $25,000. This does not particularly seem to be relief to the smaller company as would be indicated by the wording in the paragraph.

2. Probably 80 to 90 percent of your larger companies are mutuals and most, if not all of these companies, set their policies on a reserve basis of 2 to 2½ percent. Stock companies such as ourselves, guarantee 3 percent. This same law allows this company to use the industrywide average rather than their own actual figures in deducting required interest from investment income. This will give far greater tax relief to the larger company than the so-called small business deduction.

3. I also note that under section 805, subsection (c) that this provides a transition period of 3 years, at the end of which insurance companies will not be taxed on their reserves for pension plans. Up until this time life insurance companies have been taxed on the reserves for pension plans the same as any other life insurance reserves. Only larger companies are interested in writing pension plans and undoubtedly to the larger companies receiving at the end of 3 years total exemptions of pension plans more than offsets increased tax rates that are to be charged by this bill.

It is generally conceded that the industry, as a whole, under the present bill will pay much higher taxes than under the Mills bill which was in effect for 1957. However, it would appear that the larger companies in a period of 3 years will be paying less and that the smaller companies are going to have to assume the additional tax burden. Undoubtedly, the larger companies prefer this to going back to the 1942 law which would properly place the burden of taxation on the larger companies.

I hope that we will eventually have permanent legislation for the taxation of life insurance companies. I understand the House held hearings for 2 hours. In addition, I have been informed that the hearings to be held by the Senate Finance Committte, that the schedule is filled so that some of the smaller companies that have requested to appear have been refused.

I have only had a copy of this bill during the present week and our staff has spent a great deal of time trying to understand and study the bill. To express it mildly, it seems terrifiely complicated and I am sure there are many provisions that we still do not understand that might be even more unfair to the smaller companies. The larger companies have the advantage in quickly understanding through a large staff of people, such proposed new legislation and protecting themselves accordingly.

Very truly yours,

GEO. E. RICHARDSON, *President*.

(See also p. 433.)

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STATEMENT OF JARVIS FARLEY

My name is Jarvis Farley. I am secretary, treasurer, and actuary of Massachusetts Indemnity and Life Insurance Co., a small stock company having its home office at 654 Beacon Street, in Boston. My purpose today is to suggest means for meeting more fully the expressed objectives of H.R. 4245, with small loss of tax revenue.

I believe that your committee, like the Ways and Means Committee, has placed considerable importance on avoiding a tax advantage to any type of company by comparison with its competitors. Stock companies, which typically are relatively small, can hold their place in competition with the giant mutuals only if the conditions of competition are fair and nondiscriminatory. The Ways and Means Committee recognized the need of stock companies to accumulate, before tax, a reasonable safety margin in order to offset the cushion which mutual companies have in their ability to cut policyholder dividends on their redundant premiums. (See bottom of p. 12 and top of p. 13 of the committee's report.) For that purpose section 809(d)(6) of H.R. 4245 provides a deduction for nonparticipating insurance equal to 10 percent of the increase in life insurance reserve attributable to nonparticipating policies. My request to you is that the present deduction be retained but that provision be made for an alternative deduction which, at a small price in terms of tax revenue, would much more nearly meet the objective of fair competitive conditions for the smaller companies.

The need for a safety margin deduction is directly related to the long-term risk which is associated with life insurance and noncancellable disability insurance.

The reserves which characterize such insurance are a necessary result of exposure to a long-term risk which increases as the policyholder grows older, but the reserve itself is not a reliable measure of the degree of long-term risk. All long-term policies provide protection against the insured risk, and whole life and endowment policies involve a substantial investment element in addition to the protection element. The reserve on such investment policies can be regarded as arising in part because of the investment element and in part because of the protection element, but no investment element is involved in the reserve on those policies which provide pure protection. As a result, the total reserve on investment policies is materially larger than the reserve on pure protection policies, but the degree of risk is materially higher on the protection policies. Thus a safety margin deduction based on reserves gives the smallest deduction to the protection types of policies that have the greatest need of a safety cushion.

A nonpar deduction based solely on reserves might apply equitably among companies if all companies wrote the same relative proportions of protection policies and investment policies. In actual fact, however, some companies write a much larger proportion of the pure protection type of long-term policies. Such companies are exposed to a greater degree of long-term risk and therefore have a proportionately greater need for the safety cushion which the nonpar deduction is designed to provide. If the safety cushion is based solely on reserves, as is now provided by section 809(d)(6) of H.R. 4245, those companies with the greatest need actually get the smallest deduction, so that in this respect the bill falls short of its objective of equalizing competition between stock and mutual companies. The companies which suffer most from this discrepancy are typically the smaller and newer companies.

A practical solution can be found by retaining the present nonpar deduction based on increase in reserves and by providing an alternative deduction based on premiums received under nonparticipating contracts. For most stock companies, including the large established companies, the alternative deduction based on premiums would be either less than or little greater than the deduction based on increase in reserves. That fact, combined with the further fact that mutual companies would not be affected at all, means that there would be little or no reduction in the taxes of the companies that provide the bulk of the tax revenue. Adding the alternative deduction based on premiums would provide relief where it is most needed, with little loss of tax revenue.

Specifically, it is recommended that section 809(d)(6) of H.R. 4245, containing the deduction for certain nonparticipating contracts, provide that the deduction be an amount equal to the larger of (*i*) 10 percent of the increase in the reserves for nonparticipating contracts (as provided in the House bill) or (*ii*) 5 percent of the net premiums for the taxable year attributable to certain nonparticipating contracts. The bill should contain an appropriate definition of the "certain nonparticipating contracts" for which premiums would be included. It might be considered desirable to exclude policies which are not characterized by long-term risk, such as very short-term policies, for example, but all types of policies which are characterized by a long-term risk should be included.

A company should not be required to make a permanent election between the two methods of computing the nonpar deduction. A small and growing company would normally, in time, grow into a typical established life insurance company. Such a company in its early years would probably use the deduction based upon premiums, but there would probably come a time when it should use the deduction based upon increase in reserve. The change from one method to the other should be allowed, but such changes would be infrequent. The law should permit each company to use for any year the method which develops the larger deduction for that year.

Attached to this statement is an appendix which describes the statistical basis for suggesting that the alternative nonpar deduction should be based on 5 percent of premiums. The appendix also includes a demonstration that the loss of tax revenue would be relatively small. For that small price, the desirable objective of preventing a tax loss from creating unequal and unfair competitive advantage would be materially improved from the viewpoint of the small stock companies.

I would like to call your attention to a different problem which is purely technical and does not involve any loss of revenue.

Section 818(c) of H.R. 4245 provides that where a company actually computes its life insurance reserves on one of the recognized preliminary term bases, it may elect to convert them to a net level premium basis in the computation of life insurance reserves for tax purposes. The conversion may be made by either of two prescribed methods. One is an exact revaluation, the other is a computation according to a prescribed formula. The prescribed formula is expressed in units of $1,000 of insurance, adjusted by a percentage of life insurance reserves. That formula can be readily applied to reserves on the life insurance benefit itself, which is expressed in units of $1,000, but is not applicable to reserves held against any benefit which is hot expressed in units of $1,000 of insurance. The formula seems to be inapplicable or inappropriate for use with reserves on accidental death benefits, on disability income or disability waiver benefits, or on noncancellable accident and health benefits, all of which are properly and necessarily included in "life insurance reserves". Thus a company with a substantial amount of any such reserve would be unable to use the approximate revaluation method, and would be required to use the exact revaluation method.

Any revaluation method should be such as to avoid an undue burden upon the administrative staff of the Internal Revenue Service, while at the same time giving every life insurance company taxpayer a reasonable choice between the exact revaluation method and an approximate revaluation method. Such a choice could be provided either by spelling out in the statute an alternative approximate revaluation method which is not keyed to units of $1,000 of insurance (107 percent of preliminary term reserves, for example) or by a provision permitting the Secretary to define by regulation one or more alternative methods which can be readily applied without requiring the Internal Revenue Service to test each and every alternative suggested by any individual life insurance company taxpayer.

## Appendix

This appendix describes a statistical study made for the purpose of determining the proper percentage to use in computing a nonpar deduction based on premiums, as an alternative to the deduction based on increase in reserves. The appendix also suggests a method of estimating the effect of the alternative deduction on tax revenue.

H.R. 4245 excludes group insurance and annuities from the nonpar deduction, and it is probable that accident and health insurance (other than noncancellable and guaranteed renewable contracts) would be excluded. Separate data for the various types of insurance were not available, so the study was based on companies having little or no volume of the excluded types of insurance. The data was taken from "Best's 1958 Life Insurance Reports," and only stock companies with $10 million or more of assets were included. A study based on more detailed information might refine the conclusions of this study.

The study computed for each company the percentage of premium which would produce a deduction exactly equal to 10 percent of that company's increase in reserve. For one-half of the companies that percentage was 5 percent or more. (The actual median percentage based on published data was 4.5 percent, but adjustment from preliminary term reserves to net level premium reserves, and other appropriate adjustments, would produce a median of about 5 percent.) Thus 5 percent was the average of most typical figures. A deduction of 4.4 percent of premiums would be greater than the reserve deduction for only one-quarter of the companies studied, and a deduction of 3¾ percent would be greater than the reserve deduction for only one-tenth of the companies studied.

By analyzing those figures it is possible to estimate the amount of tax loss which would result from allowing the alternative deduction at 5 percent of nonpar premiums, as follows:

1. There would be no tax loss from the 50 percent of stock companies for whom the deduction at 5 percent of premiums would be less than the deduction at 10 percent of increase in reserves.

2. For the 25 percent of stock companies for which the equivalent deduction would lie between 4.4 percent and 5 percent of premiums, the use of a deduction based on 5 percent of premiums would increase the deduction on the average by about 5 percent. The total increase in the deduction for that 25 percent of stock companies would, therefore, be equal to 1¼ percent of the total nonpar deduction of all stock companies. (25 percent of 5 percent is 1¼ percent.)

3. For the 15 percent of stock companies for which the equivalent deduction would lie between 3¾ percent and 4.4 percent, the use of a deduction based on 5 percent of premiums would increase the deduction on the average by about 15 percent. The total increase in the deduction for that 15 percent of stock companies would, therefore, be equal to 2¼ percent of the total nonpar deduction of all stock companies. (15 percent of 15 percent is 2¼ percent.)

4. For the 10 percent of stock companies for which the equivalent deduction would be less than 3¾ percent, a deduction based on 5 percent of premiums might average about 30 percent higher than the deduction based on reserves. The total increase in the deduction for that 10 percent of stock companies would, therefore, be about 3 percent of the total nonpar deduction of all stock companies. (10 percent of 30 percent is 3 percent.)

5. Adding the three figures computed in steps 2, 3, and 4, it appears that provision for an alternative deduction based on 5 percent of premiums would increase the aggregate nonpar deduction for all stock companies by about 6½ percent of the aggregate deduction based on 10 percent of increase in reserves.

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## Statement of John T. Acree, Jr., President, Lincoln Income Life Insurance Co., Louisville, Ky., and First Vice President, Life Insurers Conference

My name is John T. Acree, Jr. I am president of the Lincoln Income Life Insurance Co. of Louisville, Ky. This year I also happen to be first vice president of the Life Insurers Conference, which is a trade association with 94 member companies located principally in the South, Southwest, and Midwest. I have not had an opportunity, because of the rush, to have this statement approved by the Life Insurers Conference. For this reason I want to make it clear that what I say is on behalf of my own company. However, our company is quite typical of conference membership and I am sure that most conference members will agree with what I have to say.

We believe that the tax take under H.R. 4245, in its present form, is too high and that it should be modified in the Senate to grant relief in certain areas. We are realistic and appreciate the revenue needs of the Government. We are not contending that the $319 million, which would have been produced had the 1955 stopgap law been continued and applied to 1958 business, is the right figure;

however, we certainly do not believe there is any justification for a jump in one step to $550 million, to use round figures. This is considerably more than even the 1942 law would produce.

As life insurance companies go, the members of the conference, including my own company, are small companies. We have a vital interest in securing more adequate relief for small companies and also for newly organized companies, which usually are small. The relief in the bill, as it now stands seems to be geared to the small company relief for corporations generally. We do not believe that this is adequate in the life insurance field because of our special problems. Specifically, we think that the relief in sections 804(C)(9) and 809(d)(5) should be 25 percent instead of 5 percent.

We also believe that this bill should recognize the fact that the typical life insurance company loses money for quite a number of years after it is first organized. Because of this fact, section 812 should be changed so that the operating losses in the early years may be carried forward for say 15 years rather than for only 5 years.

I do not know just how much these relief provisions for small and new companies will cost the Government in revenue. I am sure, however, that any loss would be relatively insignificant. I am also sure that no large company would object to this relief. Anyone at all familiar with the life insurance business knows that a new life insurance company has a hard time getting started and competing with established companies. There is a need to build up surplus funds to provide security as the business increases and this need comes just at the time the companies are losing money. These new companies must compete with well-established large companies which do not have this problem.

There is another point which I should mention here, and that is the reserves of the small companies, generally speaking, are not quite so strong as the reserves of the large companies. The net result is that apparent earnings (which are subject to tax) on exactly the same loss experience and with exactly the same expenses will be more than with the large companies. The relief I have suggested will compensate, at least in part, for this fact.

We believe there should be some transition period to be applied where there is a substantial increase in tax. Secretary Anderson suggested this in his letter of April 10, 1958, and it has been discussed from time to time since. However, in the present bill, it seems to have been lost sight of. This in spite of the fact that the tax level contemplated last April was certainly no greater than the level of H.R. 4245 as it now stands.

It takes time for a company to adjust to an extra tax burden such as is now contemplated. All but 5 of the 94 member companies of the Life Insurers Conference are stock companies, and we issue policies at fixed rates which we can't increase. Consequently, it is particularly hard for us to adjust to a substantially higher tax. A mutual company, theoretically at least, may cut dividends. A transition period would be of material aid in permitting us to adjust to a tax level which on the average seems to be almost twice what we have been paying and for many companies, far more.

Since our companies are largely stock companies, the phase II deductions are of extreme importance to us. I refer particularly to the credit of 10 percent based on the increase in nonparticipating reserves and also to the 2 percent allowance on account of group premiums. We are not quite so much interested in this group credit as we are in the nonparticipating allowances because many of our companies do not do group insurance. Generally speaking, the 10 percent allowance based on the increase in nonparticipating reserves is probably acceptable.

It does not adequately provide for certain of our companies which need more security because of their types of business which produces relatively small reserves. This is a problem quite important to our small companies. We have many contracts of a hazardous and long-term nature and where the reserve is on average small in comparison with the hazards which we run. We are not asking protection against short-term contracts. We are speaking rather of contracts where we cannot get off the risk by our own election and which run for 5 years and more.

It is my suggestion that as an alternate to the allowance of 10 percent of the increase in nonparticipating reserves we be allowed instead 5 percent premiums on nonparticipating contracts of a duration of 5 years and more. This alternate allowance will better enable some of our companies to meet the competitive situation which we face with mutual companies and to provide a fund to be used in case we suffer bad losses which we are bound to suffer from time to time.

This suggested change involves an amendment to section 809(d)(6). We have no exact figures, but the revenue loss involved in granting the alternate deduction would not seem to be great and at the same time it would be quite helpful to our companies.

Our companies are very much concerned with competition. It is our hope that neutrality in taxation, as between stocks and mutuals, which we have had for many years, will be maintained to the fullest extent possible. I need not tell you that my company and the other stock companies do not object to paying their fair share of any tax. However, we are in a high competitive market with the mutuals which have about 75 percent of the assets and by far the bulk of the business. We would be very much concerned if there is any appreciable shift in the tax burden from the mutual companies to the stock companies. It is difficult enough right now for a young and small life insurance company to compete with the giants where there is equality in taxation. If we do not have this equality in taxation with the mutuals, the situation becomes well-nigh unbearable for us.

This bill seems to put us on just about a full corporate net income basis with, however, part of the net gains deferred until it is certain that they are actual gains. In view of this fact, we think we should receive the regular deductions which are allowed to other corporations, particularly tax-free interest and the 85 percent intercorporate dividend credit. There is some confusion about how these deductions work out under the present bill. The way it seems to work out for us is that our companies get only about 30 percent credit instead of full credit for tax-free interest and for dividends received. There is certainly no reason why we should not receive full credit. We do not object to a limit being placed on this deduction so that we may not receive tax free that part of interest required to maintain reserves. However, we think we should receive full credit just like others do if we choose to invest our surplus funds in stocks and in tax-free securities. Our reserve interest is, in fact, a debt and somewhat like interest due on a bond. If a regular corporation has bonded indebtedness and also has some tax-free interest, that corporation receives full credit for its tax-free interest and does not have to allocate some of this interest to its indebtedness. We think there is discrimination against us in this respect in the bill. We are referring particularly to phase II, but there is also merit in our opinion in a phase I deduction for tax-free interest and for dividends received. I understand that the cost of the phase II credit based on 1958 business is about $6½ million.

I want to thank you for the opportunity of appearing before you today to make this short statement. We are sure that your committee will recognize the special problems of our small and young companies.

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HOME LIFE INSURANCE CO.,
*New York, N.Y., February 27, 1959.*

Hon. HARRY FLOOD BYRD,
*Chairman, U.S. Senate Finance Committee,*
*Washington, D.C.*

DEAR SENATOR BYRD: On behalf of our policyowners, I should like to register with the Finance Committee a strong protest against the enactment of a bill (H.R. 4245) dealing with Federal income taxes on life insurance companies.

Home Life Insurance Co. is a mutual company and, like other mutual companies, has no stockholders and is not operated for profit. We are pleading on behalf of our policyowners since no other individuals connected with our company will benefit financially from any reduction in the proposed large increase in tax.

The enactment of the House bill would mean an increase of 70 percent or even more in Federal income tax applicable to mutual life insurance companies compared to the tax rate applicable for the preceding year, 1957. This would clearly be an unprecedented increase and in our opinion is entirely unjustified.

In the first place, any tax on mutual life insurance is a tax on millions of small savers, those thirfty individuals who, through their own efforts, are attempting to make provision for their own retirement as well as provision for their widows and children in event of premature death.

The average life insurance policy in force in all companies provides less than $4,000 in death benefits and less than 10 percent of the adult population has coverage in excess of $10,000. In fact, life insurance is the most popular form of thrift for small savers and yet it is more heavily taxed than any other form of savings.

Any substantial increase in tax, although collected from the companies, must be borne by these policyowners through reduced policy dividends or higher premium rates.

It should be kept in mind that life insurance is also heavily taxed by means of State premium taxes. If H.R. 4245 becomes law, the combined Federal and State taxes applicable to life insurance companies would be a big burden, more than double the burden of such taxes 5 years ago.

Even the authors of the proposed law, H.R. 4245, apparently recognized the desirability of granting some relief to pension plan funds placed with life insurance companies in order to minimize the discrimination against such pension plan funds compared with pension plan funds placed with trust companies or administered by other trustees. Yet, at the same time this proposed law would greatly increase the tax which will have to be passed on to the individual policyowners—the small savers who are attempting to make provision for their own retirement and for their own families.

Another important point is that a recent study indicates that mutual companies have 63 percent of the total life insurance in force and only 58 percent of the gain from operations, but under the proposed bill they would pay 72 percent of the Federal taxes which would be levied on the life insurance business. This we feel is an inequitable distribution of taxes to the millions of mutual policyowners.

In this connection, we should like to point out that there is a big difference between dividends paid to policyowners and dividends paid to stockholders. The object of a mutual life insurance company is to furnish insurance protection at cost and dividends to policyowners are merely premium refunds. Furthermore, it is necessary to take such policy dividends or premium refunds into account in order to make net cost in mutual companies comparable with nonparticipating premium rates of stock companies. Therefore, all such premium refunds should be taken into account in determining a company's operating gain for tax purposes. Furthermore, we feel it must be obvious that a company's taxable income should be no greater than its operating gain.

The proposed bill would also give an advantage to life insurance companies which use the highest interest assumptions in computing policy reserves. However, those higher interest assumptions produce lower reserves and are, therefore, less conservative. We feel that an income tax law should not encourage a less conservative basis of operation for an industry so vital to the future of millions of our citizens.

We, therefore, feel strongly that H.R. 4245 should be amended at least with respect to the following:

1. In determining the investment income subject to tax, we feel the "adjusted reserve" and the investment income deduction related thereto should be determined on the company's own earned interest rate either for the current year or the average of the last 5 years, whenever that rate exceeds the required reserve interest rate.

This will result in a tax which is more equitable between the various companies and will also eliminate the incentive to make a nonconservative interest assumption in the reserve basis.

2. For reasons already explained, the "Gain from operations" should be computed without any arbitrary limitation on dividends to policyowners and if the gain from operations is less than the taxable investment income, the company's taxable income should be reduced by at least 50 percent of the difference.

We earnestly hope you will concur that amendments to this proposed law are highly desirable and that you will lend your support to amendments which will, at least, somewhat reduce the large proposed increase in taxes and also make the law more equitable between various companies.

Sincerely yours,

T. A. STEMMERMANN,
*Vice President and Actuary.*

MEMPHIS, TENN., *February 26, 1959.*

Hon. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building, Washington, D.C.*

With reference to H.R. 4245, relating to the taxation of the income of life insurance companies, this is to apprise you as chairman of the Senate Finance Committee, just how the bill affects my small company. We understood the Treasury desires approximately 60 percent increase in tax revenues from the life insurance industry. We are not opposed to paying our proportionate part of this 60 percent increase, but this bill goes far beyond this percentage as far as my company is concerned, as the following figures show: (1) 1958 Federal income tax under 1942 revenue law (current law of the land) would be $88,000; (2) 1958 Federal income tax under H.R. 4245 as proposed by the House Ways and Means Committee, $212,000; as you can see this is an increase of approximately 242 percent. This we are definitely against. We are of the opinion that this situation should be reviewed very carefully during the 1959 year to see the full impact this bill will have on the entire life insurance industry and since the current 1942 law will produce the desired 60 percent increase the Treasury Department desires, we, therefore, ask that you vote against H.R. 4245 at this time.

ALVIN WUNDERLICH, JR.,
*President, National Burial Insurance Co.*

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HOME LIFE INSURANCE CO., OF NEW YORK,
*Richmond, Va., March 3, 1959.*

Hon HARRY F. BYRD,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: I am writing you regarding the proposed new law (H.R. 4245) which increases the income tax on life insurance companies to an amount which I feel is exorbitant and unfair.

I respectfully call your attention to the fact that life insurance has been called the poor man's bank. There are many millions more policyholders than there are income taxpayers which shows the popularity of life insurance as a form of thrift for small savers. This means, of course, that life insurance reserves represent the savings of individual policyholders and are greater than all individual savings accounts in all banks and more than the total of individual savings in savings and loan associations. Yet, life insurance taxes are three times greater than average taxes on other forms of thrift.

A recent study shows that while mutual companies have only 63 percent of the total life insurance in force and only 58 percent of the gain from operations; under the proposed bill they will pay 72 percent of the Federal taxes which will be levied on the life insurance business. I feel certain that you will agree with me that this is an inequitable distribution of taxes to a host of small mutual policyowners and citizens of our country.

You, sir, have the honor and responsibility of serving on the Senate Finance Committee and I earnestly hope that you will urge your associates on this committee to consider amendments on the proposed bill which will eliminate this inequitable treatment. Naturally, we must raise the necessary income for our country. My plea is, have a tax law which is nondiscriminatory and is not a 70 percent increase in taxes in a single year.

Sincerely yours

LAWRENCE C. REEVES, *Manager.*

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KETCHIKAN, ALASKA, *February 27, 1959.*

Re H.R. 4245.

Hon. E. L. BARTLETT,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BARTLETT: H.R. 4245, in general, raises the level of taxes on life insurance companies. The bill, from what I know of it, appears to be sound and from information that I have been able to obtain I do not believe that the insurance industry is seriously objecting to it. My hope is that the bill will pass the Senate in the same form as it passed the House. It contains a provision relieving a discriminatory tax on investment income for pension reserves.

I believe that the tax on investment income as it applies to insured pension reserves is discriminatory and ought to be removed because it adds to the cost of an insured pension plan.

An employer, for example, may select an insured pension plan in order to provide a sound guarantee basis for pensions for his employees but if he selected a bank-trusteed plan which has no guarantees, there would be no tax on investment income applying to the pension reserves. Therefore, the very nature of the discriminatory tax can put an insurance counselor in the position of not being able to recommend what he considers to be the best vehicle for funding a retirement plan.

I believe that this discriminatory tax should be removed and respectfully suggest that you support the legislation on the basis of retaining the proviso for removing the tax inequity gradually as provided for in H.R. 4245.

It is my understanding that hearings on the bill are scheduled before the Senate Finance Committee, or a subcommittee thereof, on March 3 and would appreciate your entering a supporting statement endorsing H.R. 4245 without further amendment.

Yours very truly,

W. K. BOARDMAN.

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STATEMENT OF GUILFORD DUDLEY, JR., ON BEHALF OF LIFE & CASUALTY INSURANCE CO. OF TENNESSEE

Life & Casualty Insurance Co. of Tennessee is a medium-sized stock life insurance company with home office at Nashville, Tenn., with 9,270 stockholders scattered over the United States. We do business in 18 States and the District of Columbia, and rank 52d in size, with $1,651,107,000 life insurance in force as of December 31, 1958.

First, this company remains firm in its conviction that the most equitable formula yet devised for the income taxation of life insurance companies is that embraced in the law in effect for the years 1955 through 1957. Furthermore, if that law were amended to change the credit for reserves from 85 percent to a percentage for each company based upon its actual individual company requirements, it would bring the total revenues to the Government to more than the $500 million sum which we understand to be sought by the Treasury Department for the year 1958.

I understand that other witnesses already have presented or will present this viewpoint more fully, but there is one major overriding consideration which I would like to outline.

There does not inhere in the net investment income approach discrimination within the industry. Net investment income is a common denominator of stock and mutual companies, of large and small companies.

Phase 2 of H.R. 4245 brings into being an obvious discrimination between stock and mutual companies. This is readily apparent from examination of table I on page 8 in the report of the Committee on Ways and Means accompanying the bill. Whereas the proportionate amount of total assets held by mutual companies as contrasted with stock companies is 75 percent to 25 percent, which proportion compares with the percentages of the estimated revenues to be derived under the 1942 formula, the 1955 formula, and phase I of H.R. 4245, yet the estimated $40 million to be derived under phase 2 is divided 30 percent from the mutual companies and 70 percent from the stock companies—almost completely the reverse of the revenues derived under the net investment income approach.

Further, if this bill should be enacted in its present form, we submit that within a year or two the revenues derived from mutual companies under phase 2 would substantially diminish and even approach zero, thereby accentuating the discrepancy in the comparative revenues derived from stock and mutuals which will exist for the year 1958. In fact, a mutual company would be considered as failing in its duty to its policyholders if it did not increase dividends within the limits of conservative practice so as to drastically reduce or eliminate the tax under phase 2 of the bill. The estimated amounts in table I of that report are based on the dividend practices of mutual companies under an entirely different tax law, and it is submitted that these practices will change with the change in the law.

We urge that there is manifest and serious discrimination against stock companies inherent in phase 2, and that for the sake of the amount of revenue to be derived from phase 2—7.3 percent of the whole for 1958 and in all probability a lesser percent in future years—the Government should not seriously alter the competitive balance between stock and mutual companies.

I would emphasize that we have the highest regard for the mutual life insurance companies, large and small, of this country. Yet this high respect does not diminish our opposition to their being granted a substantial competitive advantage by the operation of the Federal income tax law. We oppose any segment of the life insurance industry being granted such a competitive advantage over any other segment, and feel that you would share this opposition.

At this point I would like to set out the taxes which would be paid by this company on 1958 operations under H.R. 4245 and the 1942 and 1955 formulas:

| | |
|---|---|
| 1955 formula | $775,000 |
| 1942 formula | 1,200,000 |
| H.R. 4245 | 2,125,000 |

These figures, of course, do not take into account any possible effect of phase 3, which would apply only to years subsequent to 1958.

The increase to this company is 175 percent over the 1955 formula and 77 percent over the 1942 formula. By comparison the taxes for the entire industry under H.R. 4245 as appears from the report of the Committee on Ways and Means represent a 71 percent increase over the 1955 formula and a 9 percent increase over the 1942 formula. It is apparent, then, that the effect on our company is substantially more severe than the effect on the industry as a whole.

While the figures are not available to our company, but doubtless can be easily made available to this committee, we estimate that the experience of our company will be found to be the experience of stock companies as a group, and that the impact of the proposed bill, if enacted into law, will be found to fall most severely on stock companies and least severely on mutual companies.

If the committee concludes that it must reject the proposition that the net investment income approach alone is the fairest and most equitable method of taxing life insurance companies, and to the contrary concludes that the general principles embodied in phases 1 and 2 of H.R. 4245 should be enacted into law, then there are several specific amendments which we urge you to consider:

(1) The formula in phase 1 as now written discriminates between stock and mutual companies. The deduction rate for interest deducted under the "Policy and Other Contract Liability Deduction" is an average of (i) a company's investment yield, and (ii) the higher of the rate it assumed on reserves, or the rate the whole industry assumed on reserves. The use of the industry rate by a company whose own assumed rate is less than that of the industry results in a greater amount of deductible interest than such a company would otherwise be allowed. This benefit will accrue principally to the larger mutual companies for reasons which I will briefly state.

The facts of the life insurance business are that the mutuals in general have lower interest assumptions than do stock companies. They do this deliberately, not only for reasons of safety, but because a large part of the dividends they pay is based on interest earnings in excess of their assumed rate, and because their gross premiums have enough excess margin so that they are not affected by a lower interest assumption on reserves.

A stock company must set its gross premium rate as low as possible for competitive reasons, and this results in their interest assumptions being higher, or as close as possible to what the company actually expects to earn, within the limits of its ability to make such estimate over many years in the future. In any event, it is a fact that the interest assumed in the reserves of stock companies is higher on the average than that assumed by the mutuals.

We urge therefore that each company use its own assumed rate of interest in arriving at the deduction rate in phase 1. In addition, we suggest that this should not be the rate for only 1 year, but rather an average of the interest required on its reserves for a period of several years—we refer here to interest assumed on reserves, not to an average of interest that the company actually earns. We believe these two changes would have the following advantages:

(i) It would avoid the use of an industry average for interest assumed on reserves, which at best is an arbitrary figure when applied to any one company.

(ii) It would avoid a discrimination between companies, which in the main benefits mutual companies.

(iii) The use of the company's own assumed average for a period of several years would eliminate any undue penalty (as mentioned on the bottom of page 10 and the top of page 11 of the report of the Committee on Ways and Means) on a company whose assumed average was below the industry average for a temporary period of time.

(2) Phase 2 of the bill provides a 10 percent deduction for the amount of the increase in reserves on nonparticipating life business. We urge that it would be more reasonable and equitable to make this deduction 5 percent of nonparticipating premiums received.

The report of the Committee on Ways and Means states on page 7:

"This 10 percent deduction is designated to compensate stock insurance companies for the fact that since they do not have the 'cushion' of redundant premiums (which if the business does not go well a mutual company can use to offset losses but otherwise are paid back as policyholder dividends) they must have larger capital and surplus."

The report specifically mentions the lack of excess margin in nonparticipating premiums as the reason for the deduction. This reasoning is, in our judgment, exactly right. However, we question emphatically the fact that the deduction is based upon the increase in reserve rather than on the premiums themselves, as the acknowledged purpose of the deduction is to compensate for the lack of excess margin in nonparticipating premiums.

The excess margin, which mutual companies have and stock companies do not have, can be called upon by mutual companies to pay claims in times of crisis, such as wars, epidemics and periods of heavy financial losses. A mutual company has this excess margin at its disposal at any time it is needed by simply reducing or eliminating dividends to policyholders. For example, dividends were reduced by most mutual companies in the depression years of the early 1930's; and shortly thereafter, when serious losses were incurred by many companies, both stock and mutual, on their disability income business, dividends were sharply reduced by the mutual companies on policies containing such coverage. Inasmuch as stock companies have no excess margin to start with, they must compensate for this by building up correspondingly larger surplus amounts to meet such contingencies.

If stock companies are to meet future contingencies on the same basis as mutual companies, their additional surplus kept for this purpose should be based on the companies' total exposure to claims rather than on whatever increases in reserves they may have. The increase in reserve itself varies more with the age of the company and the type of business it has than it does with the company's exposure to claims.

For instance, a company might collect premiums of $1 million per year at the present time, and have an increase in reserve of $700,000. Twenty years from now the same company might still collect $1 million in premiums and have an increase in reserves of only $300,000 because of the greater age of its business and the correspondingly greater reserves released through deaths and maturities. Yet this same company would have more insurance in force, and more exposure to unexpected catastrophe in 20 years than it does at the present time.

In another situation, consider the example of a company that ceases to grow. It may not have any increase in reserves at all, yet it would still be collecting premiums and be exposed to contingency risks for many years to come. Such a company would have no further deduction for its nonparticipating business, but a mutual company that likewise had ceased to grow would still have the excess margin in its premiums available.

The fact that the relationship of premiums to increase in reserve varies so much between different companies, and even within the same company in different stages of its development, indicates strongly that premiums are a much more appropriate basis for this deduction. We firmly believe that a deduction for nonparticipating business based on premiums rather than on increase in reserves is much fairer for all types of companies in different stages of growth, and urge that H.R. 4245 be amended to make the deduction 5 percent of nonparticipating premiums received.

(3) As presently drafted, H.R. 4245 becomes effective for the year 1958, except that phase 3 and the provisions for capital gains and losses take effect for the year 1959. For the industry as a whole this is a 71 percent increase over the tax that would have been paid under the 1955 formula, and for our own company this is a 175 percent increase. We strongly urge that if this bill is enacted into law substantially in its present form, provision should be made for a transition period before the full impact of the tax comes into being.

While probably there are several good methods of accomplishing such transition, we would propose a 5-year transition period somewhat as follows: During the 5 year period each company would compute its tax under the 1942 formula and under the 1959 law. If the result under the 1959 law is greater than under the 1942 formula, then for 1958, the company would pay the amount computed under the 1942 formula plus one-fifth of the difference between the result under the 1942 formula and under the 1959 law.

For 1959, if the amount of tax under the 1959 law were greater than under the 1942 formula, the company would pay the amount computed under the 1942 formula plus two fifths of the difference, etc., until for the year 1962 the company would pay the whole amount computed under the 1959 law.

While we are not wedded to the particular method outlined above, we strongly feel that there should be some orderly and equitable transition from the tax paid by the company in 1957 to the tax paid in 1958 and the succeeding years, where there is a substantial difference in the amount of tax to be paid under the new law without a corresponding increase in net investment income.

Such a drastic increase in so large a factor in a company's operations as the Federal income tax can cause severe dislocation in the company's operations. We seriously doubt that any industry has previously been subjected in one tax year to the increase as great as would result if H.R. 4245 becomes law in its present form. The result for our company is substantially more severe than the results for the industry as a whole, and doubtless there are numerous other companies, on which the result is even more severe than ours.

(4) In all previous congressional hearings on the subject of the income taxation of life insurance companies, there has been emphasized the fact of the very substantial State taxes levied on the basis of premiums received. We strongly urge that H.R. 4245 be amended to give more adequate weight to this tremendous factor in the total picture of life insurance taxation. Specifically, we suggest that some type of credit, on a fair and reasonable basis, be granted against the Federal income tax for the premium taxes paid.

In addition to $865,000 in State and local taxes incurred in the normal course of business and which, in the main, are not unique to life insurance companies, our company incurred premium taxes of $956,000 during the year 1958. These premium taxes equal 79.7 percent of our estimated tax under the 1942 formula and 45 percent of our estimated tax under H.R. 4245, and obviously constitute a highly important consideration in our total tax picture. I am sure that the experience of other companies approximates our own.

Under the above-suggested amendment, a credit equal to 25 percent of the amount of premium taxes paid might be allowed against the tax levied under the Federal law. In making this suggestion we are fully aware, of course, that premium taxes are allowed as deductible expenses under the bill. Such deduction does not, however, take into account the unique character of these taxes and their exclusive application to the life insurance industry. Therefore, we feel that a credit along the line we have suggested should be incorporated into the proposed bill.

Turning aside, now, from suggested amendments to phases 1 and 2, we urge that phase 3 of the proposed bill be deleted entirely. In this connection it seems worthwhile to point out that the principle embodied in phase 3, that is, a tax based upon cash distribution to stockholders, has been studied and rejected many times in previous years. As recently as December 31, 1958, the principle was not included in the draft bill prepared by the Treasury Department in cooperation with the congressional staffs, which bill accompanied the report on the taxation of life insurance companies by the Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, submitted on that date. It only came into being for the first time as legislation in H.R. 4245. We urge that phase 3, and the principle embodied therein, should not be enacted into law for the following reasons:

(1) A tax based upon the concept of cash distributions to stockholders is completely without logic and without counterpart in the income tax laws of this country. Congress, the Treasury, and the industry itself are seeking an equitable and permanent formula for the taxation of the net profits of life insurance companies, and yet it is obvious that cash dividends paid by a stock life insurance company, or by any other business corporation, in no way measure the profits of that company. Two insurance companies may have almost identical statements, identical net investment income and identical net gains from operations, and yet the amount of cash dividends paid to stockholders each year may differ substantially, depending upon many factors that are within the discretion of the board of directors of the company.

It cannot be said under this situation that the company which paid the larger dividends had the larger profit, and therefore should pay the larger tax.

(2) All concerned are seeking within the best of their abilities a tax law for life insurance companies upon a principle and formula that will be permanent within the foreseeable future and not subject to review from year to year.

We believe, however, that if a principle so completely without logic as a tax based upon cash distribution to stockholders is enacted into law, it cannot stand the test of time and its deficiencies will gradually come into being for companies not affected at the outset. It is purely an expedient, and without any attempt at moralizing, we feel that expediency in the long run does not bear fruit in government or in business.

(3) As a corollary to the tax based on cash distribution to stockholders there is included a provision regulating surplus. This, of course, is simply section 102 of the Internal Revenue Code carried over into the law taxing life insurance companies.

Whereas such principle may be appropriate in the tax laws apply to an ordinary business corporation, yet with respect to a stock insurance company, any provision penalizing the accumulation of surplus is, in our judgment, diametrically opposed to the public interest.

Life insurance is a long range business, projecting guaranteed payments by contract far into the future. It is impossible for anyone to state at any given time a limit on the amount of surplus which a stock life insurance company should accumulate in the interest of meeting its future contractual payments to its policyholders. In fact, I think it would be almost impossible for a stock life insurance company to accumulate too much surplus in consideration of the interest of its policyholders. Inflation is with us today, and the mortality contingencies in an atomic age are a possibility that none of us like to contemplate.

There is a vast difference between placing a limit on the surplus which may be accumulated by a mutual company and placing a limit on the surplus to be accumulated by a stock company. This point needs no development as it is a known principle of mutual life insurance that the net premium of a mutual company can be and is adjusted by the amount of dividends returned, whereas the nonparticipating premium of a stock life insurance company is fixed and cannot be increased.

Therefore we recognize that a penalty againsts surplus accumulated beyond a certain point must necessarily be a part of a tax based on cash distributions to stockholders to prevent circumvention of such a tax levy, but we insist that such restriction on surplus is against the interests of policyholders of stock life insurance companies, and that to the contrary the accumulation of surplus should be encouraged.

(4) To the extent that phase 3 results in additional tax, it accentuates the discrimination between stock companies and mutual companies. The only way to prevent such a discrimination would be to levy a similar tax on dividends to policyholders, and of course such a levy is likewise without logic. I am sure that the mutual companies do not seek such competitive advantage, but this advantage must necessarily result for ever tax dollar that is paid under phase 3, or there would have to be a corresponding tax against the mutual company.

With phase 3 included in the law a stock company and a mutual company with identical statements would necessarily be taxed differently, the mutual company paying the lesser tax, either in the beginning years of the proposed new law, or in future years when the penalty against accumulation of surplus comes into play. We cannot believe that Congress intends to enact into law a principle which would bring about this result.

## SUMMARY

(1) We urge the historical approach to the taxation of life insurance companies, the investment income approach, as being the most equitable yet devised after years of study by government and industry. Admittedly this approach has shortcomings but we feel they are outweighed by its advantages.

(2) However, if this committee cannot accept the investment income approach as the sole basis for taxation, then we urge your attention to the specific amendments which we have proposed.

(3) In all events, we urge this committee to reject the principle, completely new and without counterpart in our tax laws, of a tax based upon cash distri-

bution to stockholders. Although this principle would not affect the taxes our company would pay for 1958, and although we cannot accurately estimate how it would affect the amount of taxes our company will pay in the future, we are certain that this principle cannot yield a fair and equitable result over the years to stock life insurance companies as a group, or from one company to another within the gorup, it cannot meet the fundamental test of equality of taxation, and is diametrically opposed to the public interest.

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STATEMENT OF CLARENCE J. MYERS, PRESIDENT OF NEW YORK LIFE INSURANCE CO.

Speaking for the New York Life Insurance Co. and myself, we ask that particular attention be given by the Senate Finance Committee to the points covered in this brief statement.

### 1. WE APPROVE THE GENERAL STRUCTURE OF H.R. 4245 BUT CONSIDER ITS TAX BURDEN EXCESSIVE

Let me amplify my position. In general, this bill applies corporate rates of taxation to the income of life insurance companies as measured on three component bases: Investment income, underwriting gains, and capital gains.

Since 1921, the tax laws have been based only on income earned upon the sums held for policyholders' protection. We approve the proposed broadening of the tax base because it affords a more equitable pattern for taxing the various classes of insurance and the various kinds of companies. It contemplates taxing investment income and gains derived from underwriting, and an apportionment of the impact of these two sources upon the diverse companies affected.

Unfortunately, the impact of taxation under this bill is so heavy as to continue, in an aggravated degree, a serious discrimination against life insurance as a thrift medium for millions of policyholders. More specifically, it would—

(*a*) Continue the arbitrary handicap that has long been suffered by our business as a thrift institution competing with other such institutions. This handicap has arisen partly from Federal taxation of our investment income at an effective rate higher than that imposed on other savings institutions and partly from the burden of State taxation uniquely borne by our industry.

(*b*) Accentuate the dampening effect of taxation on the public's inducement to save and thus increase inflationary pressures. It would also curtail the supply of capital funds which nourishes the Nation's healthy economic growth.

(*c*) Discourage the public's natural incentive to build personal security on a voluntary basis, and thus would augment demands for additional social security.

While we believe that the general structure of H. R. 4245 is satisfactory in principle, we hope that the social and economic consequences of the tax burden will lead the committee to adopt amendments to this bill which will alleviate the discriminations cited above.

There are two defects which we regard of particular importance. One concerns the "deduction rate" of interest. The other concerns the statutory limitation upon the deductibility of policy dividends on participating insurance, in determining taxable income. Both defects can now be remedied with simple amendments. These are described in sections 3 and 4 of this statement.

### 2. WE CONSIDER H. R. 4245 TO BE A SOUNDER BASIS OF TAXATION THAN THE 1942 FORMULA WHICH WOULD BECOME THE TAX BASE IN THE ABSENCE OF NEW LEGISLATION

In previous hearings on this subject, it has been emphasized repeatedly that perpetuation of the 1942 formula would be a serious mistake. The Under Secretary of the Treasury made it clear last fall that this was the view of the Treasury Department. The House Ways and Means Committee has associated itself with that view. The Senate Finance Committee, in approving the stopgap tax bills that have been enacted in recent years, has repeatedly expressed dissatisfaction with the 1942 formula.

Hence, it would not seem necessary to argue at length the defects of the 1942 formula. In brief, it is unsatisfactory in two principal respects.

(a) It apportions the tax among companies and among classes of insurance solely on the basis of investment income. Such a tax tends to discourage the types of insurance which combine protection and savings in favor of temporary term insurance upon which little or no tax is levied. It seems clear that a proper tax basis should take account of other gains and losses.

(b) It taxes investment income at an effective rate which is subject to substantial variations, because of the arbitrary and inflexible interest rate which the statutory formula provides as one of the elements to be used in determining each company's deduction for "required" interest. This artificial tax formula actually produced negligible revenue for the Treasury in the years 1947 through 1949. It could produce an unbearably heavy burden of taxation under other circumstances. It falls far short of meeting the Treasury's need for a stable, dependable source of revenue.

3. FORMULA FOR DEDUCTION RATE UNDER SECTION 805(b)(2) IS DISCRIMINATORY

H. R. 4245 embodies a new concept for determining taxable investment income by establishing a deduction rate of interest for each company. This deduction rate is to be used in two ways, as a basis for revaluation of policy reserves and as the rate deemed required on such revalued reserves for tax deduction purposes. Such a deduction rate, if properly defined, would represent a significant improvement over previous methods of determining the reserve interest deduction.

However, the deduction rate as defined in section 805(b)(2) is based partly upon the average interest rate assumed for reserves by the individual company (or the corresponding industry average, if greater) and partly upon the company's own investment yield rate.

Basing the deduction rate, even partially, on the rate arbitrarily assumed by each individual company for reserve purposes is unreasonable because—

(a) It discriminates against companies which have chosen a conservative interest basis, as compared with the many companies with less conservative reserve interest assumptions than the industry average.

(b) It permits tax results to influence management decisions with respect to reserve interest assumptions. This is an undesirable pressure in an industry so heavily relied upon by the small savers.

(c) It taxes a considerable portion of investment income which (i) in the case of nonparticipating insurance (policies on which no dividends are paid or promised) is required under the interest assumptions made in fixing premium levels (not reserves), to maintain safety and meet policy obligations as they mature, and (ii) in the case of participating insurance is required to provide net costs to policyholders which are competitive with those available through nonparticipating insurance.

We believe that these defects in section 805(b)(2) could be largely overcome by defining the deduction rate to be simply each company's investment yield, earned on the average during the 5 years ending with the current tax year.

The use of the 5-year average earned rate, in brief, would produce the following improvements:

(a) More equitable and less onerous burden on policyholder savings.
(b) Each company's tax based solely on its own experience.
(c) Influence of management decisions or assumptions minimized.
(d) Greater smoothness, stability, and predictability of the deduction rate attained.

4. THE LIMITATION ON THE DEDUCTION OF DIVIDENDS TO POLICYHOLDERS IN COMPUTING TAXABLE INCOME CONSTITUTES UNFAIR DISCRIMINATION AGAINST PARTICIPATING POLICYHOLDERS

H.R. 4245 provides that all insurance companies are to be taxed on the "gain from operations" whenever that is smaller than investment income. However, under section 809(g), the taxable gain from operations for a participating company would not be less than the company's taxable investment income. Such a tax floor results from an arbitrary and unfair disallowance of a deduction for policy dividends to the extent that such dividends would reduce gain from operations below taxable investment income.

Thus, for all practical purposes, only a nonparticipating company can have a tax that is less than 52 percent of its taxable investment income while participating companies must pay a tax at least equal to 52 percent of their taxable investment income.

Similarily, no nonparticipating company will pay a tax in excess of 52 percent of its gain from operations. On the other hand, many participating companies would pay taxes considerably in excess of 52 percent of their gain from operations (after full deduction of policy dividends).

These results defeat the proper operation of the basic principles that (*a*) premiums charged for participating policies, less dividends paid to the policyholders, represent the net charge for participating insurance, just as the premium charged for nonparticipating policies represents the net charge for nonparticipating insurance and (*b*) a participating company's true net income does not exceed its gain from all operations after full deduction of policy dividends.

The illustration on the following three pages shows the unfair discrimination against a company issuing only participating insurance as compared with a company issuing only nonparticipating insurance.

*Tax consequences of H.R. 4245 for two competing life insurance companies—participating and nonparticipating—which provide identical insurance at identical net costs to policyholders*

I. BASIC ASSUMPTIONS

| Financial position | Beginning of year | End of year | Average for year |
|---|---|---|---|
| Life insurance in force | | | $50,000,000 |
| Assets | | | 11,000,000 |
| Reserve liabilities | $9,800,000 | $10,200,000 | 10,000,000 |
| Capital and surplus | | | 1,000,000 |

RATE OF INTEREST

| | Percent |
|---|---|
| Actually earned on mean assets during year | 3½ |
| Assumed for valuation of reserve liabilities | 2½ |

PREMIUM AND DIVIDEND RATES

| | |
|---|---|
| Participating company | $24 premium per $1,000 in force.<br>$4 dividend to policyholders per $1,000 in force.<br>$20 net cost to policyholders per $1,000 in force. |
| Nonparticipating company | $20 premium per $1,000 in force. |

II. COMPARATIVE SUMMARIES OF OPERATIONS

| Calculation of gain from operations before Federal tax (from annual statement) | Participating company | Nonparticipating company |
|---|---|---|
| 1. Premium income | $1,200,000 | $1,000,000 |
| 2. Net investment income | 385,000 | 385,000 |
| 3. Total income | 1,585,000 | 1,385,000 |
| 4. Benefit payments (death, maturity, surrender) | 730,000 | 730,000 |
| 5. Increase in reserve | 400,000 | 400,000 |
| 6. Commissions and other insurance expenses, including local taxes, etc. | 185,000 | 185,000 |
| 7. Total charges against income | 1,315,000 | 1,315,000 |
| 8. Gain from operations | 270,000 | 70,000 |
| 9. Dividends to policyholders | 200,000 | |
| 10. Net pretax gain from operations (from annual statement) | 70,000 | 70,000 |

*Tax consequences of H.R. 4245 for two competing life insurance companies—participating and nonparticipating—which provide identical insurance at identical net costs to policyholders*—Continued

III. CALCULATION OF ALTERNATE TAX BASES AND FEDERAL TAXES OF THE 2 COMPANIES

| | Participating company | Nonparticipating company |
|---|---|---|
| Investment income basis: | | |
| Adjusted reserve (based on "deduction rate" of 3.125 percent) | $9,375,000 | $9,375,000 |
| Deduction allowed for interest (at 3.125 percent) on the adjusted reserve | 292,969 | 292,969 |
| Taxable investment income (TII) (the excess of item 2 above, over $292,969) | 92,031 | 92,031 |
| Operating gain basis: | | |
| Gain from operations (item 8 above) | 270,000 | 70,000 |
| Taxable gain from operations (TGO) | 92,031 | 70,000 |
| Maximum deduction allowed by sec. 809(g) for mutual dividends and for nonparticipating reserve increase | 177,969 | 0 |
| Taxable income (TGO when less than TII) | 92,031 | 70,000 |
| Net pretax gain from operations (item 10) | 70,000 | 70,000 |
| Tax at 52 percent of taxable income | 47,856 | 36,400 |
| Net gain from operations after tax | 22,144 | 33,600 |
| Tax as percentage of net pretax gain from operations | 68 | 52 |

Thus, the tax on the participating company is 68 percent of the net pretax gain from operations, whereas the tax on the nonparticipating company is 52 percent of such gains. The participating company must pay $11,456 more than the nonparticipating company even though both companies have the same pretax gain from operations, i. e., $70,000.

Such a tax discrimination would adversely affect the competitive position of the participating companies and their accumulation of surplus generally considered appropriate, whatever the kind of company, for the protection of contract obligations.

Accordingly, we believe that H.R. 4245 should be amended by deleting entirely the limitation on the deductibility of dividends to policyholders in computing taxable income. Naturally, any partial relaxation of that limitation would reduce the extent of the discrimination. In our opinion, an excellent way of achieving this relation would be to allow a deduction for 50 percent of any negative difference between net gain from operations (computed after a full deduction for policyholders' dividends) and net investment income.

5. WE APPROVE THE DEDUCTION FOR INVESTMENT YIELD ON PENSION PLAN RESERVES

When this deduction is fully effective in 1961, it will largely remove the existing unfair discrimination against insured pension plans, as compared with trusteed pension plans, whose investment income is tax free.

Although we should like to have this fully effective for 1958, it represents an important improvement over existing tax laws. More specifically, this deduction should be granted because—

(*a*) Life insurance companies are being unfairly excluded by existing tax law from the pension field which is essentially an insv ance operation and in which they pioneered.

(*b*) Small- and medium-sized businesses and their employees are particularly penalized by the existing discrimination.

(*c*) The proposed tax abatement will be passed along through premium adjustments and dividends for the benefit of insured pension owners and beneficiaries.

(*d*) None of this tax abatement will be reflected in lower premiums or higher dividends to the owners of regular individual insurance policies. Consequently, the relative competitive position of life insurance companies in the market for regular individual insurance policies will remain undisturbed by this feature of H.R. 4245.

6. EXCESSIVE TAXATION

The tax revenue on 1958 operations under H.R. 4245 has been estimated at about $550 million. In addition, life insurance companies must pay over $300 million in special State and local taxes on 1958 operations. Together these total $850 million. This is close to 6 percent of the total net premium (i.e., premiums less dividends) received in 1958. In other words, about $6 out of every $100 in net premiums paid by the policyholders is taxed away by the Federal and State Governments.

We believe this is an unreasonably high tax on thrift. It tends to discourage self-reliance. It can only serve to discourage people from protecting themselves and their families through the ownership of life insurance.

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THE CONNECTICUT MUTUAL LIFE INSURANCE CO.,
*Hartford, February 27, 1959.*

Hon. THOMAS J. DODD,
*Senate Office Building,*
*Washington, D.C.*

DEAR TOM: As you know, the serious matter of Federal income tax on life insurance companies is scheduled for hearings before the Senate Finance Committee starting March 3. Because this tax measure has serious implications for all life insurance policyowners and beneficiaries and, more specifically, because of the unique position of leadership of Connecticut and Hartford as the recognized insurance capital of the world, your interest in this proposed legislation is, I know, particularly keen.

It may, therefore, be of interest and help to you to have the viewpoint of the Connecticut Mutual.

To start with, the House Ways and Means Committee has brought out a bill which, overall, is sound from a technical standpoint. Admittedly, this is an extremely difficult subject because of the complexities of life insurance company operations. These, in turn, are due to the long-range contractual commitments which we have with policyowners and beneficiaries, many of these contractual guarantees potentially running for a period of as much as 100 years.

There can be no quarrel either with the fact that there have been some companies, primarily small speciality companies in which the stock is closely held, which have been enjoying a very advantageous tax advantage as compared to companies which are more orthodox in their operations and which write the usual lines of life insurance and annuity coverage. To this extent, the House Ways and Means Committee has done an excellent job.

However, what has proved shocking to the business is the terrifically increased rate of taxation which is being proposed. Estimates are that for the entire business the tax will increase from the $315 million yield had the present Curtis-Mills bill been renewed for 1959 to $545 million under the proposed legislation. This is an increase of over 70 percent. It is doubtful whether any important business or industry has ever before been asked to assume an increased tax burden of this proportion in any 1-year period. When such an increased tax burden is proposed for an institution which is the most poular form of savings in the United States and which is already the most heavily taxed form of savings, the proposed increase in taxes becomes even more unconscionable.

About 120 million Americans are owners of life insurance. Obviously, the overwhelming majority of these people are of modest income. Furthermore, these are people who are endeavoring to provide financial security for themselves and their families through their own efforts, thereby relieving other individuals and the taxpayers generally from the need of supporting them.

I know that you are further aware of the great need of our economy for long-term savings and capital funds for investment. The small accumulations of millions of life insurance policyowners form the greatest pool of savings available for long-term investments existent in this Nation. It is these long-term investments which help to build schools, hospitals, roads, and industrial plants. These long-term investments help industry to buy equipment and machinery, resulting in greater efficiency of operation and in greater productivity. Such greater productivity, in return, results in more real earnings for the workingman and in a higher standard of living.

You also are undoubtedly aware of the fact that more than 60 percent of the life insurance sold and in force in the United States is entrusted to the mutual companies. Therefore, taxes imposed on companies such as ours are direct taxes on policyowners and beneficiaries. This company, as such, does not pay 1 cent in taxes. Every dollar of our assets belongs to the policyowners and beneficiaries. Consequently, every dollar of additional tax which this company pays is a dollar less than would otherwise be paid to our policyowners and beneficiaries.

From this point on, I should like to discuss primarily the tax problem as it affects our company. It would be inappropriate for me to speak for any other company. I must say, however, that this unfair proposed increase in taxes falls with approximately equal force on the policyowners and beneficiaries of all life insurance companies, large or small, stock or mutual. And I need not add that this company has the highest regard for the other fine life insurance companies, stock or mutual, operating in Connecticut.

The question naturally arises as to what is a fair tax on life insurance policyowners and beneficiaries. First of all, it is necesary to consider just who these policyowners and beneficiaries are upon whom this tax is being levied. The Connecticut Mutual has somewhat over 500,000 policyowners. The company also has slightly over $4 billion of life insurance in force. On the average, then, each policyowner has $8,000 of insurance in force in this company. For this insurance, they pay on the average a premium of about $170 per year. This modest amount of insurance represents less than one and one-half times the average income of all families in the United States.

It need not be stated that the Connecticut Mutual, along with all other life insurance companies, sees it as its responsibility and duty to pay a fair share of Federal taxes for the support of the necessary business of Government. Additionally, our companies expect to pay a fair share of State taxes for the support of the necessary business of our State governments and for the costs of the State supervisory programs of life insurance operations.

Historically, both by Supreme Court decision and by congressional legislation, the various States were conceded by the Federal Government to have the major right to impose taxes on life insurance operations. Accordingly, for many years, taxes paid to the various States far exceeded the taxes paid to the Federal Government. In more recent years, however, the tax take of the Federal Govrnment has increased at an even faster pace than that of the State governments, until today taxes paid to the Federal Government are greater than those paid to the various States.

For example, in 1958 the Connecticut Mutual paid taxes, exclusive of real estate and special taxes, to the various States in the amount of $2,154,000. In the same year, the Connecticut Mutual paid $3,537,000 in Federal income taxes. This represents a 50 percent greater tax paid to the Federal Government than to the various States.

Although the tax increase for all companies under the proposed legislation would be over 70 percent, the tax impact on the Connecticut Mutual would be even heavier. Under the previous law, we would pay on 1958 operations $3,850,000. Under the proposed law, our Federal tax would be $7,163,000, an increase of 86 percent.

What, then, is a fair tax on these policyowners? There can be no definitive measure of a fair tax, but there are at least two yardsticks which can be used to measure the fairness of such taxes.

The first of these yardsticks is to compare taxes on life insurance savings with taxes on all other forms of savings. It has already been pointed out that life insurance is the most popular form of thrift, with some 120 million Americans owning one or more policies of life insurance. Life insurance reserves, representing the savings of these individual policyowners, are greater than the total individual savings accounts in all banks and more than the total of savings in savings and loan associations.

Life insurance is already more heavily taxed than any other form of thrift. Indeed, the income from life insurance funds is already taxed three times as heavily as the average income from 19 other forms of thrift and savings. On this basis of comparison, it is clear that life insurance is already paying more than its fair share of the tax burden which it is now proposed to increase by an additional 70 percent.

There is one other comparison which would seem to be very valid. In a mutual company such as this, dividends have been paid to our policyowners for each of the 113 years since the company was founded. These dividends are paid from the savings resulting from careful selection of risks, from efficiencies and economies in operation of the company, and from interest earnings beyond those required for the fulfillment of our long-time contracts with policyowners and beneficiaries. In large measure, these dividends are a refund of premiums paid by the policyowner. However, there is an element of income to the policyowners, specifically that resulting from the excess of interest earned on policyowners' funds over and beyond the rate of interest required to meet the company's contractual obligations to its policyowners and beneficiaries. If it were practical to do so, the Federal income tax could be imposed on each policyowner and beneficiary individually on that amount of real income which he receives from his life insurance dividends and interest payments. If such taxes were paid by the individual policyowners and beneficiaries, we have estimated that these taxes would amount to, roughly, a little less than $2,500,000 for Connecticut Mutual policyowners and beneficiaries. This compares with the $3,850,000 which the company normally would be paying in Federal income taxes in 1959, and with the $7,163,000 which the company would pay if the proposed tax revision becomes law.

On this latter basis, then, the policyowners and beneficiaries of the company would be paying over 180 percent more in taxes through the tax imposed on their company than they would pay through a tax imposed on them individually.

How can relief be attained, while at the same time still increasing the tax yield to the Government and maintaining equity between all types of companies?

H.R. 4245 should be amended. This could be done by using a 5-year individual company average for computing the reserve interest deduction so as to treat each company individually and avoid basing the tax on industrywide averages which favor some companies and penalize others.

It should also be amended by allowing mutual companies proper deductions of any deficit that may arise if operating gains fall short of investment income.

Such amendments would still leave the Treasury with about the same tax take as they would receive if the 1942 law became effective. Such a tax take would, in itself, increase the tax burden on life insurance companies by a far greater extent than would seem reasonable.

I apologize for having written in such detail. On the other hand, I know of no briefer way of dealing with what is admittedly a very complex and a very important problem. It is, of course, my hope that you will agree with the viewpoints expressed above and that you will work toward a fair mitigation of the proposed tax burden.

My very best regards to you.

Most sincerely,

CHARLES J. ZIMMERMAN, *President.*

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NATIONAL ASSOCIATION OF MOTOR BUS OPERATORS,
*Washington, March 5, 1959.*

Re H.R. 4245.
Hon. HARRY FLOOD BYRD,
*Chairman, Committee on Finance,*
*Senate Office Building, Washington, D.C.*

DEAR SENATOR BYRD: The National Association of Motor Bus Operators is the national trade association for the intercity motorbus industry. It serves as spokesman for nearly 1,000 companies which account for about three-fourths of the intercity motorbus transportation in the United States.

On behalf of these companies, especially the smaller companies of this group, we should like to call your attention and endorse the provisions of section 805(c) of the Life Insurance Company Income Tax Act of 1959 (H.R. 4245), relating to a deduction for investment yield of pension plan reserves.

This association is in complete agreement with the following statement which appears in the report of the Committee on Ways and Means accompanying H.R. 4245:

"The more favorable treatment of qualified pension and profit-sharing business is believed necessary in view of the fact that the net investment earnings of a qualified pension or profit-sharing trust are completely exempt from tax while they are accumulated in the trust. Generally speaking, it is the smaller employers who forced to set up insured pension plans rather than trusted pension plans becase of the higher risk and higher expenses connected with the operation of a small trust. A higher tax on these earnings in the hands of insurance companies than in the hands of trustees would generally be discriminatory against small businesses."

We followed with interest the testimony presented on this bill before your committee on March 3. This testimony concerned two additional facets of section 805(c) on which we would like to comment. We urge that the deduction for investment income on qualified pension plan reserves be made effective immediately rather than in successive steps between now and 1961. This aspect was discussed by Senator Kerr and Mr. Lindsay.

We also endorse the statement of Mr. Carrol M. Shanks, president of the Prudential Insurance Co. of America, which urged that the provision be modified to insure that capital gains derived from qualified pension funds also be exempt from tax.

It is our feeling that the enactment of section 805(c) will be of substantial assistance to the smaller companies in our industry and that such enactment will remove a substantial number of the inequities between funded pension plans and trusted pension plans.

Cordially yours,

A. W. KOEHLER, *Secretary-Manager.*

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MORTGAGE BANKERS ASSOCIATION OF AMERICA,
*Washington, D.C., March 5, 1959.*

Re H.R. 4245.

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

DEAR SENATOR BYRD: The Mortgage Bankers Association is an association of over 2,000 members drawn from life insurance companies, savings and commercial banks, fire and casualty companies, abstract and title companies, trust companies and private investment funds investing a substantial portion of their assets in first liens on real estate, and mortgage companies whose principal business is the originating, financing, closing, selling, and servicing of mortgage loans on real estate.

The association is concerned about the proposal to increase by a substantial amount the Federal income taxes to be paid by life insurance companies.

The association's concern arises from its intimate knowledge of the vital part played by life insurance companies in providing funds for the financing of the Nation's homes and from its fear that a substantial increase in Federal taxation will adversely affect the availability of funds for this purpose. Its reasons for apprehension are the following:

1. A substantial tax increase may raise the cost of life insurance and hence diminish the popularity of life insurance as a medium for savings and the total amount of funds available for investment from this source.
2. An increase in the amount of tax paid by life insurance companies will be certain to force the pension accounts of these companies into the tax-sheltered area of trusteed operation, from which the mortgage market receives little benefit.
3. An increase in taxes will divert a significant volume of life insurance investment from taxable obligations, including mortgages, to tax-exempt securities.

The members of this association have themselves experienced the depressing effect on insurance company investments in mortgages when other forms of long-term obligations are available, the yield on which is equal to, or greater than, that which can be obtained from mortgages. If in addition to these normal competitive forces, an insurance company is faced with a substantial increase in taxes if it invests in mortgages, and the ability to avoid such tax increases entirely if it invests in tax-exempt obligations, we are certain that the amount of money flowing into mortgages will be immediately curtailed in a very substantial manner.

In view of these considerations, the association believes that the question may be seriously raised as to the probability that the increase in revenue to be obtained from this source may in the end be much less than expected and that, instead, the final result may be to the detriment of the economic expansion of the country, which life insurance companies have so effectively served in the past.

Sincerely yours,

SAMUEL E. NEEL.

(Whereupon, at 5:25 p.m., the committee took a recess, to reconvene Wednesday, March 4, 1959, at 10:10 a.m.)

# TAX FORMULA FOR LIFE INSURANCE COMPANIES

WEDNESDAY, MARCH 4, 1959

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

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

Present: Senators Byrd, Kerr, Frear, Long, Douglas, Gore, Talmadge, Williams, Carlson, Bennett, Butler, and Curtis.

Also present: Elizabeth B. Springer, chief clerk; Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The commitee will come to order.

The first witness is Mr. Richard C. Guest, Massachusetts Mutual Life Insurance Co.

Mr. Guest, will you come forward. You may proceed, sir.

## STATEMENT OF RICHARD C. GUEST, VICE PRESIDENT, MASSACHUSETTS MUTUAL LIFE INSURANCE CO., SPRINGFIELD, MASS.; ACCOMPANIED BY CHARLES BRIERLEY, SECOND VICE PRESIDENT, MASSACHUSETTS MUTUAL LIFE INSURANCE CO.

Mr. GUEST. I am Richard C. Guest, vice president and a director of the Massachusetts Mutual Life Insurance Co., of Springfield, Mass., I am a fellow and a past president of the Society of Actuaries. I served as a representative on the five-man team made up of two association staff men and three company men who worked with your staff and the staff of the Treasury at the request of Secretary Humphrey.

I have with me Mr. Charles Brierley, second vice president of the Massachusetts Mutual, to help me answer any questions which you may wish to ask.

My company favors the enactment of H.R. 4245 with but little change largely in detail. On the whole it is a fine approach to a very difficult problem in design and draftsmanship. My testimony will deal with two or three requirements involving no general change in form.

(1) Deduct rate: We believe that, in making changes in the original revaluation approach discussed at the hearings in November, to produce more revenue, the deduct rate has unfortunately emerged in a defective form. In writing a life insurance tax bill de novo, we think it would be regrettable to continue the use of interest rates (*a*) depending upon discretionary actuarial assumptions sometimes made many years ago the use of which introduce discrimination, and

(*b*) an industry average rate introduced merely to alleviate the discrimination caused by the use of (*a*) both of which are subject to discretionary manipulation to save taxes.

(2) Burden on savings: Moreover the resulting burden, we believe, is altogether too heavy on the savings of millions of policyholders.

(3) Five-year average recommended: We recommend the use of an individual company 5-year average deduct rate in place of the deduct rate now in the bill for the following reasons:

(*a*) The tax on savings would be more equitable and less onerous.

(*b*) The deduct rate could not be manipulated.

(*c*) The deduct rate would relate to each individual company. No industry average would be involved.

(*d*) The use of a 5-year average would avoid fluctuations.

(4) Insured pensions: We are indeed pleased to see that this well-designed bill includes provisions to reduce the discrimination against insured pension plans. Just for the record, we are stating briefly four important considerations in relation thereto:

(*a*) Existing large plans are rapidly going on the tax-exempt trusteed unguaranteed basis.

(*b*) The extra cost to small industries who cannot take the chances involved in uninsured plans is over 7 percent in discriminatory tax cost under the 1955–57 stopgap law. It would have been much larger in the new law if these provisions had not been included.

(*c*) Continuance of this discrimination in a new tax law would be self-defeating since the proportion of trusteed plans is increasing so fast that the tax on the remaining small plans would soon have become inconsequential.

(*d*) The extraordinarily keen competition between insurance companies and trust companies as well as the insurance intercompany competition usually involving in all cases, large cases, multiple bids will guarantee that any tax savings will quickly reach the buyers of such plans and cannot possibly affect the costs of other insurance coverage.

(5) Deductibility of policyholder dividends: In the bill, dividends to policyholders are deductible so long as the gain from operations exceeds the taxable investment income. On the other hand when the total gains are less than the taxable investment income they are not deductible. It is difficult to see why dividends should be fully deductible in the first instance and nondeductible in the second. This nondeductibility in the second instance has an undesirable and unfair result. It virtually prevents the deductibility of operating losses however heavy from the taxable income of mutuals or stock companies who have a substantial amount of participating business. This discrimination against mutuals should be eliminated.

Here I wish to make a comment having to do with the report of the Treasury Department. In the Treasury testimony, it is stated that—

> If the net operating gain is less than the taxable investment income or if there is an actual net operating loss, the bill provides for the appropriate recognition of underwriting losses.

The paragraph means that dividends are deductible to arrive at an additional tax provided "taxable investment income" exceeds the gain from operations but they are completely nondeductible in case the gains fall short of the "taxable investment income."

In 1958 our normal addition to surplus was $6 million. We would have had to suffer $23 million of extraordinary losses——

Senator KERR. May I ask if you are still reading from the Treasury report?

Mr. GUEST. I am commenting on the Treasury report.

Senator KERR. I was a little confused.

Mr. GUEST. Yes; I am still commenting on the Treasury report.

We would have had to suffer $23 million of extraordinary losses in the year 1958 before beginning to get our first dollar of tax relief under the bill as now written. This peculiar characteristic of the method of arriving at the "actual net operating loss" would be practically disastrous to small mutual companies.

That is the end of my comment.

This discrimination against mutuals should be eliminated.

That the full implication that dividends should be fully nondeductible in any phase of the bill was not intended by the Ways and Means Committee is indicated by the statements of Chairman Wilbur Mills:

> I would like to observe that this deduction of policyholder dividends is from the company's standpoint merely a matter of price reduction—

and—

> part of it [the dividend] is a return to the policyholder of an excess premium that the same policyholder was required to contribute when he joined the mutual organization.

This situation can be overcome by a simple amendment like that in appendix (A).

The amendment in the appendix is merely illustrative, it has not yet been carefully examined by any outstanding drafting lawyers.

The bill provides for taxation of 50 percent of the excess of operating gains over taxable investment income. The amendment would provide a corresponding deduction of 50 percent of any amount by which operating gains fall short of the taxable investment income. In either case dividends would be fully deductible.

I have a suggestion on a small company allowance.

It is also suggested that there be included in the amendment a special small company allowance of an extra 50 percent of any amount by which the gains from operations fall short of the taxable investment income up to an amount not exceeding $50,000 of taxable income. Stated another way, there would be allowed a deduction for 100 percent of the first $100,000 of shortages and 50 percent thereafter.

In judging the desirability of the amendment we might consider two requirements:

1. Again quoting Chairman Wilbur Mills:

> * * * to lay to rest the argument that this bill gives mutual companies an unwarranted tax advantage over stock companies in allowing a deduction for policy dividends.

2. To restore a reasonable tax deduction of extraordinarily heavy losses in both stocks with participating business and mutuals.

I believe we can all agree with Mr. Mills that dividends to policyholders are essentially price adjustments. That policyholder dividends represent a return of premium overpayments, and not profits, has been recognized many times by the courts, the State legislatures, and even by Congress.

Thus in the well known case of *Mutual Benefit Life Insurance Co. v. Herold* (198 Fed. 199 (D.C. N.J. 1912), affirmed 201 Fed. 918 (C.A. 3, 1913), certiorari denied 231 U.S. 755), the Court said:

> This excess payment represents not profits or receipts but an overpayment—an overpayment because, being entitled to his insurance at cost and having paid more than it cost, he (the policyholder) is equitably entitled to have such excess applied for his benefit.

In *Penn Mutual Life Insurance Co. v. Lederer* (252 U.S. 523 (1920)), the Supreme Court said:

> It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder.

Moreover, in 35 States policyholder dividends are allowed as a deduction from gross premiums in computing premium taxes, recognition of the fact that such dividends are a return of premium overpayments. Congress itself has made this same recognition by expressly providing in the District of Columbia premium tax statute that all dividends are to be deducted in determining the premiums to be subjected to tax.

In the following short, simple table No. 1, there is a demonstration that nonparticipating premiums differ very little from the average net cost of participating insurance after dividends have been deducted. Hence, as a matter of experience, we see that dividends are in effect price adjustments to make it possible for mutual companies to use adjusted prices which will permit them to compete with nonparticipating premiums.

Appendix B demonstrates that even in a company with the highest level of reserves, and the highest level of surplus in the business, if such a company should elect to pay out each year in the form of policyholder dividends all of its current earnings except enough to pay its Federal taxes the tax advantage gained thereby would be small.

This amendment should now be examined as to the two criteria set up earlier in this testimony in the light of the foregoing demonstrations and citations.

By the way, the table covers historical data. I also examined the illustrative scales relating to business issued in 1958, and I found a similar situation exists on the basis of illustrations purporting to show what the costs might be in the future as compared with nonparticipating premiums.

The result is quite parallel to the table.

The CHAIRMAN. The table will be inserted in the record.

(The table referred to follows:)

TABLE I.—*Policyholder dividends are price adjustments*

1(A), AGE 35, ISSUED IN 1928[1]

| | Whole life | | 20-pay life | | 20-year endowment | |
|---|---|---|---|---|---|---|
| | Premium | Average cost | Premium | Average cost | Premium | Average cost |
| Mutuals, 20-year average | 27.74 | 20.42 | 37.79 | 20.68 | 51.27 | 42.48 |
| Non-par | | 20.33 | | 20.03 | | 41.48 |

1(B), AGE 35, ISSUED IN 1938[2]

| | Whole life | | 20-pay life | | 20-year endowment | |
|---|---|---|---|---|---|---|
| | Premium | Average cost | Premium | Average cost | Premium | Average cost |
| Mutuals, 20-year average | 27.64 | 20.63 | 37.05 | 30.64 | 50.53 | 44.15 |
| Non-par | | 21.77 | | 31.75 | | 43.63 |

1(C), AGE 35, ISSUED IN 1948[3]

| | Whole life | | 20-pay life | | 20-year endowment | |
|---|---|---|---|---|---|---|
| | Premium | Average cost | Premium | Average cost | Premium | Average cost |
| Mutuals, 10-year average | 24.22 | 21.30 | 39.08 | 33.80 | 51.32 | 45.69 |
| Non-par | | 22.47 | | 34.72 | | 47.96 |

[1] Figures, where possible, based upon 10 typical mutuals including the mutual which has been particularly noted for its low net costs.
[2] Figures, where possible, based upon 12 stock companies including the 3 largest stock companies.
[3] Non-par figures adjusted for difference in valuation standards where necessary.

Mr. GUEST. Requirement No. 1: It has been demonstrated that over any substantial period of years the participating price-adjusted costs are very close to the nonparticipating premiums of the same period. It has also been demonstrated that the temporary tax saving which a company might make by paying out all current earnings except enough to pay the Federal tax is small. No competent trustworthy management of a mutual life insurance company would impair the financial strength of its company by foolishly paying out $4 in order to save $1 in tax. Moreover surplus could not be reestablished in the future except after heavy corporate taxation.

Requirement No. 2: The amendment would reduce by 50 percent although it would not remove the discrimination against participating insurance.

Appendix B shows the amount by which in the calendar year 1958 the taxable investment income exceeds the gain from operations in a number of specific small companies distinguished by letters rather than by corporate names. It is to be expected that small mutuals and small stocks operating wholly or in part on a participating basis must pay policyholder dividends reasonably competitive with nonparticipating costs and participating price-adjusted costs in order to stay in business and progress. Because of their size, it will not be unusual for such small companies to have relatively large losses which should be deductible before taxes through an amendment like that in appendix A.

Appendix C is a corresponding table including larger companies. Because the larger companies have a greater spread of risk, and are more stabilized in organization and development, it is to be expected that an amendment such as in appendix A will have a very moderate permanent impact and only occasionally a significant imapct in the event of great catastrophes such as the Texas City chemical explosion, a sudden and unexpected large change in morbidity rates as was experienced in 1957, or suddenly severe mortality such as in the influenza epidemic.

Now some remarks on the deduction of the 2 percent of group premiums within the specified limit.

Since this 2 percent deduction is required by New York State and Missouri so that it is applicable quite generally to the industry, although it is not included in the definition of reserves in this bill, it is nevertheless quite similar in character. Hence, it should be treated within the bill as closely as possible as if it were a reserve. The bill provides for taxation of 50 percent of the excess of operation gains over taxable investment income. The amendment would provide a corresponding deduction of 50 percent of any amount by which operating gains fall short of the taxable investment income. In either case there would be a full deduction of the 2 percent of group premiums.

As to proposed extension of the loss carryover for newly organized companies. It is our recommendation, as I believe it is the recommendation of all companies, that in the case of recently organized companies or newly organized companies the loss carryover feature be extended to 15 years from the date of organization, as it would apply to the taxable years intervening between the effective date of H.R. 4245 and the expiration of the 15 years from the date of the organization of the new company.

Now some remarks on my own company's proportion of the total proposed taxload.

It seems to us that the taxload of an individual company should be closely related to what we call adjusted gross receipts. We define adjusted gross receipts as the premiums less the policyholder dividends, if any, plus the investment income.

Upon examination we find that based upon H.R. 4245 our tax would be 1.60 percent of the total tax burden of about $560 million whereas our adjusted gross receipts amount to only 1.36 percent of the industry total adjusted gross receipts.

The introduction of a 5-year moving average as a deduction rate as recommended in this testimony would result in our proportion of the total taxload being 1.52 percent. In other words, applying this measure to either the original bill, or the bill as we recommend that it be amended as to the deduction rate, calls for a taxload on my company larger than our proportionate share.

At this point, I would like to put in another comment having to do with this same question.

The CHAIRMAN. Without objection.

Mr. GUEST. On this question of our proportionate taxload, I have the following statement: To judge the discrimination in any of these tax laws, I will use a rough illustration based upon my own company. Our tax under the 1942 law is just about $1.50 per thousand of insurance in force, including group insurance.

At this rate the total tax on the industry would be $750 million on the total $500 billion of insurance in force.

If we used a rate of a dollar and a quarter per thousand, much lower than our rate, to take a count of the high proportion of group insurance and term insurance in the industry figures, the total tax would be $625 million. Hence, we believe the 1942 law should never be permitted to be used. There is need for a new law to avoid this tax discrimination, and the new law should become effective immediately.

Now, I have a comment about capital losses.

The life insurance business has an almost unique problem in connection with the tax treatment of capital losses. Perhaps this could be better illustrated by an example. Let us assume that a life insurance company is paying Federal income taxes at the rate of $10 million a year. Let us also assume that, in an extreme period of economic crisis, the company experiences capital losses at the rate of $10 million per year for a period of 5 years, and this could readily happen. Obviously, there is no possibility whatsoever that the company could experience capital gains during the various 5-year carryover periods sufficiently large to offset these staggering capital losses.

The time is too short for you to give this very important question adequate consideration. We respectfully suggest that you put this matter on your agenda for early consideration.

I am sure that the staffs of our associations and of our companies will be most happy to cooperate with you in that connection.

(The material previously referred to follows:)

### Appendix (A)

### Draft Amendment

LIMITATION ON CERTAIN DEDUCTIONS.—If the gain from operations computed without any deductions under paragraphs (3), (6), and (7) of subsection (d) exceeds the taxable investment income, and such deductions taken without regard to this paragraph would reduce the gain from operations below the taxable investment income, then the gain from operations shall be an amount equal to the amount of the taxable investment income reduced by 50 percent of any excess of such taxable investment income over the gain from operations which would result if the deduction under paragraph (6) of subsection (d) were limited to $100,000.

If the gain from operations computed without any deductions under paragraphs (3), (6), and (7) of subsection (d) is less than the taxable investment income, each of the said deductions shall be allowed only to the extent of 50 percent of the amount allowable without regard to this paragraph, and the deduction under paragraph (6) of subsection (d) shall be further limited so as never to exceed $50,000.

In computations under this paragraph, a loss from operations shall be considered as a negative gain from operations.

## APPENDIX (A)

### ALTERNATE DRAFT AMENDMENT

(g) LIMITATION ON CERTAIN DEDUCTIONS.—

(1) IN GENERAL.—The amount of the deductions under paragraphs (3), (6), and (7) of subsection (d) shall not (after the application of subsection (f)) exceed the greater of the following amounts:

(A) $100,000; or

(B) the sum of—

(i) the excess, if any, of (*a*) the gain from operations for the taxable year computed without regard to such deductions, over (*b*) the taxable investment income for the taxable year, and

(ii) the lesser of (*a*) 50 percent of such deductions computed without regard to this paragraph; or

(*b*) 50 percent of the excess, if any, of such taxable investment income over the gain from operations for the taxable year, computed without regard to this paragraph.

In computations under this paragraph (1) a loss from operations shall be treated as a negative gain from operations.

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## APPENDIX (B)

*Federal income tax bases and dividends to policyholders, mutual companies, 1958*

| Company | Taxable investment income (1) | Gain from operations (2) | (1)−(2) (3) | Dividends to policyholders (4) | (3)÷(4) (5) |
|---|---|---|---|---|---|
| A | $523 | −$1,456 | $1,979 | $1,458 | $136 |
| B | 1,507 | 1,283 | 224 | 2,095 | 11 |
| C | 223 | 193 | 30 | 558 | 5 |
| D | 1,398 | −729 | 2,127 | 2,562 | 83 |
| E | 68 | 50 | 18 | 155 | 12 |
| F | 3,110 | 1,572 | 1,538 | 8,200 | 19 |
| G | 4,621 | 3,737 | 884 | 7,523 | 12 |
| H | 6,787 | 3,669 | 3,118 | 12,853 | 24 |
| I | 984 | 675 | 309 | 1,095 | 28 |
| J | 7,797 | 5,704 | 2,093 | 10,424 | 20 |
| K | 962 | 501 | 461 | 2,607 | 18 |
| L | 6,707 | 5,157 | 1,550 | 11,162 | 14 |

## Appendix (C)

*Federal income tax bases and dividends to policyholders, mutual companies, 1958*

[Thousands of dollars]

| Company | Taxable investment income (1) | Gain from operations (2) | (1)−(2) (3) | Dividends to policyholders (4) | (3)+(4) (5) |
|---|---|---|---|---|---|
| A | $803 | $1,161 | 0 | $2,277 | .............. |
| B | 332 | 631 | 0 | 607 | .............. |
| C | 9,342 | 7,191 | $2,151 | 17,234 | $12 |
| D | 533 | −1,450 | 1,979 | 1,458 | 136 |
| E | 1,507 | 1,283 | 224 | 2,005 | 11 |
| F | 223 | 193 | 30 | 558 | 5 |
| G | 1,398 | −729 | 2,127 | 2,562 | 83 |
| H | 13,785 | 10,755 | 3,030 | 28,235 | 11 |
| I | 68 | 50 | 18 | 165 | 12 |
| J | 83,700 | 64,900 | 18,800 | 160,600 | 11 |
| K | 1,738 | 2,249 | 0 | 4,213 | .............. |
| L | 3,110 | 1,572 | 1,538 | 8,200 | 19 |
| M | 4,621 | 3,737 | 884 | 7,523 | 12 |
| N | 53,041 | 28,709 | 24,332 | 92,507 | 26 |
| O | 17,000 | 7,610 | 9,390 | 36,900 | 25 |
| P | 138,845 | 115,809 | 23,036 | 310,380 | 7 |
| Q | 1,583 | 1,704 | 0 | 5,897 | .............. |
| R | 14,800 | 8,700 | 6,100 | 29,900 | 20 |
| S | 28,400 | 19,800 | 8,600 | 44,085 | 19 |
| T | 20,700 | 13,952 | 6,748 | 33,326 | 20 |
| U | 59,375 | 52,245 | 7,130 | 110,105 | 6 |
| V | 38,000 | 32,500 | 5,500 | 82,000 | 7 |
| W | 13,565 | 12,263 | 1,302 | 21,713 | 6 |
| X | 6,892 | 5,953 | 939 | 9,797 | 10 |
| Y | 6,787 | 3,669 | 3,118 | 12,853 | 24 |
| Z | 130,700 | 74,000 | 56,700 | 305,400 | 19 |
| AA | 970 | 988 | 0 | 1,905 | .............. |
| BB | 93 | 190 | 0 | 493 | .............. |
| CC | 984 | 675 | 309 | 1,095 | 28 |
| DD | 7,797 | 5,704 | 2,093 | 10,424 | 20 |
| EE | 3,181 | 4,147 | 0 | 7,381 | .............. |
| FF | 962 | 501 | 461 | 2,607 | 18 |
| GG | 6,707 | 5,157 | 1,550 | 11,162 | 14 |
| HH | 281 | 298 | 0 | 381 | .............. |
| Total | 671,903 | 480,097 | 188,089 | 1,372,988 | 14 |

## Appendix (D)

**Demonstrates the small temporary tax saving the strongest mutual could make by paying out all current earnings except enough to pay Federal income taxes based upon a large mutual which has an average valuation rate of 2½ percent and a surplus of over 9 percent of liabilities. All figures were prorated down so that the taxable investment income in this table is $1,000.**

| | |
|---|---|
| 1. Dividends to policyholders | $2,000 |
| 2. 2 percent of group life and A & H premiums | 100 |
| 3. 10 percent of increase in nopar reserves | 0 |
| 4. Total | 2,100 |
| 5. Phase I taxable investment income | [1] 1,000 |
| 6. Operating gain before tax | [2] 833 |
| 7. Excess of phase I over phase II computed without limitation on item 4 | 667 |
| 8. Deduction (lesser of ½ of (7) or ½ of (4))[3] | [2] 333 |
| 9. Adjusted tax base | 667 |
| 10. Tax on (8) | 333 |
| 11. Savings in tax | 167 |

[1] Based upon H.R. 4245 using 5-year average earned rate for the "deduct rate" and using 50 percent instead of 52 percent for easy arithmetic.

[2] $833 or one-half item 7 is the lowest operation gain before tax that the company can permit and still have the $333 necessary to pay the $333 tax on $667 in item 9 from current surplus earnings.

[3] Assuming all of item 4 is deductible to determine the "gain from operations" in item 5 and a deduction allowed amounting to one-half the excess of the "taxable investment income" over the "gain from operations," item 5.

The CHAIRMAN. Thank you very much, Mr. Guest. Are there any questions?

Senator CARLSON. I have a question.

As I looked over your table, I noticed you have whole life policies, you have 20-year pay life policies, and 20-year endowment, and you have broken that down on premiums and rates and costs.

I am interested in finding out whether the dividends that are paid to policyholders of a mutual company contain any interest or other investment income.

Let us assume this situation:

Policies with premiums payable for 20 years, and then the policy is paid up for life with no more premiums payable after the end of the 20th year. Now, dividends are paid every year, and suppose we are in the 30th year, dividends have been paid for 10 years after the last premium was paid. Now, during the last 10-year period, will not the dividends be paid out of interest or other investment income?

Mr. GUEST. In my company, and in most companies, there is consideration given in the premiums themselves for the fact that there will be a price adjustment in that period following the time when the policies are paid up. So that there is income which appears as taxable income there. But it is offset in another year by a compensating price adjustment.

There were several questions yesterday having to do with price adjustment, and with your permission, I would like to anticipate questions of this type by reading this short statement, which is better than I could give extemporaneously.

Senator CARLSON. I would certainly appreciate any help I can get on it, because to me it is a problem.

Mr. GUEST. Statistically, dividends are revealed to be simple price adjustments. In my company, when the actuaries calculate nonpar rates for riders, they test these rates as do the stock companies by the use of projected earned rates. When they calculate participating rates other executives ask that the proposed rates be revealed in two parts for a few typical ages: One, the minimum cost involved which is essentially a nonparticipating cost premium; two, the price adjustment for participating operation.

This price adjustment for participating operation is set by joint discretionary action outside of the province of the actuary, himself, considering the actuary's minimum and corresponding competitive nonpar rates.

Our president is an actuary who spent many years of his life in a stock company issuing predominantly nonparticipating business.

Senator CARLSON. Mr. Guest, I can easily understand that premium adjustments can be made during the years when you pay premiums, but the question I was asking is where you get the money to pay the dividends, following the expiration of the premium payments which you can leave in a company to build up the value of the estate, or you can withdraw. You have been helpful, but I am not sure I see it yet. Again I come back to the company interest——

Mr. GUEST. The premium includes a price adjustment margin, and the effect of that is that the tax impact of that adjustment appears at one time, whereas it is offset at another time.

The impact is there. The adjustment is there, but it does appear in different years of the tax returns with a result on the average basis in accordance with the price adjusted premiums.

Senator CARLSON. That is all, Mr. Chairman.

Senator BENNETT. May I pursue that just a minute?

Taking two examples, take the case of the man who dies 1 day before the policy becomes due, and he draws dividends only up to the actual termination date of the policy, then he gets less of an adjustment in price, because you still have some of his overpayment left to you.

If, in fact, the man who lives and allows dividends to accumulate, to build up for 10 years more, or 20 years more, you can still consider this added accumulation is a return of excess price.

Now, are you saying that is the kind of thing that averages itself out in your overall calculations?

Mr. GUEST. Yes, Senator Bennett.

In the probabilities we have to consider the accidental death loss rates, the morbidity loss rates and we have to take into account the probability of the continuance of the policy in force. We say we use the lapse rate in that connection, and where we get a divergence like you have mentioned, Senator Bennett, the lapse rate has to be considered in balancing out the condition you mentioned.

Senator BENNETT. Then, in effect, you expect that if you could take a period in time, 5 years, 10 years, and average the total of the dividends paid in that period and relate them to the premiums paid, or deduct them from the premiums paid, that would, in effect, bring those premiums into balance with the nonparticipating premiums, but with respect to a particular policy, to a single policy, some of those whom you would insure on a participating basis will not in effect recover the overpayment, while others will actually recover more.

Mr. GUEST. That is right, this is a corporate tax and not an individual tax, and when we use the averages in the operation of the corporation we arrive at a balance which is sound from the standpoint of corporate taxation.

Senator BENNETT. Thank you very much.

The CHAIRMAN. Mr. Guest, what is your estimate of the loss of revenues——

Mr. GUEST. You mean the all-industry loss?

The CHAIRMAN. No; loss of revenue to the Government in the pending bill by your suggestions.

Mr. GUEST. The figures that I have available indicate that the revenue under H.R. 4245, without amendment, would be about $558 million.

A shift to the 5-year average rate for the deduct rate would represent a cost in revenue of $44 million.

The introduction of the 50 percent factor in the negatives having to do with step 2 in participating business would cost $35 million, making a total of about $79 million.

The CHAIRMAN. Are there any further questions?

Senator KERR. In your statement, Mr. Guest, you bring a new word into the picture to me, and I am sure it is the right word, and I just wanted to know a little more about it. Morbidity rates. "Sudden and unexpected large change in morbidity rates."

Is that word used to refer to a contingency in your actuarial calculations made necessary by the possibility of excessive tragedies?

Mr. GUEST. I apologize for using a word which is idiomatic in the insurance business.

Senator KERR. It is in the dictionary; I have looked it up. [Laughter.] But here is what the dictionary says, "Morbid state or character," and I didn't think you were pointing that pistol at this committee. [Laughter.]

Mr. GUEST. I assure you I was not.

Senator KERR. Nor describing the environment in which you find yourself, but it is the first time I had heard it.

Mr. GUEST. It might be appropriate in this later connection.

Senator KERR. Well, I was wondering.

Mr. GUEST. We use it in connection with the whole field of sickness insurance. I intended to cover the situation which existed in 1957 when at least the same number of people became sick; and because there was more insurance more and more of them took advantage of hospital care, which meant extraordinary increases in cost; where they just became conscious of the possibilities——

Senator KERR. You mean that your policyholders just became conscious in 1957? [Laughter.]

Mr. GUEST. They become more and more conscious as the years go on of the benefits which we have to give them, and they become more and more conscious of the great possibilities of what we call our major medical coverage, and people who become sick and have long hospital periods and have heavy medical costs can run up an individual claim to as much as $5,000 or $10,000.

Now, those claims have been going up very rapidly. Moreover, the cost of hospitalization is going up rapidly, and I am sorry to say that in the medical profession there are those who charge extra fees because there is insurance which will take care of the extra fees on top of what would be normal fees for surgery without insured coverage.

Those are the things that I meant to cover by this possibly misplaced word, although it has idiomatic standing in our business.

Does that answer your question, Senator Kerr?

Senator KERR. I am sure it does. I am just sure it does or you would not say it would. [Laughter.]

Mr. GUEST. Thank you very much for the confidence you place in me.

Senator KERR. When it is transcribed I am going to read it very carefully and see if I cannot find enough in it to convice me.

Further, in reference to the deduction of 2 percent of group premiums within the specified limit, the last two sentences, the amendment would provide a corresponding deduction of 50 percent of any amount by which operating gains fall short of the taxable investment income.

In either case there would be a full deduction of 2 percent of group premiums.

If I understood the witness who preceded you, he took the position that provision should be made for the full deduction of this 2 percent of group premiums until it reached a certain ceiling.

Mr. GUEST. Yes.

Senator KERR. Is your position the same as his, or is it your position that there should be a full deducation of the 2 percent of group premiums although the deductions taken might already have reached the ceiling which he indicated would be adequate?

Mr. GUEST. My position is the same as the position of Mr. Shanks, the limit being one-half of a year's premiums.

Senator KERR. I see.

That is all.

The CHAIRMAN. Are there any further questions?

Senator FREAR. Just a couple.

I am sorry I was not here for all of the presentation. Did I understand, Mr. Guest, you to say that if your amendments to the bill are accepted—would the amendments to your bill deduct from the Treasury's income from the present legislation before us?

Mr. GUEST. I will repeat, Senator Frear. On the amendment suggesting the use of the 5-year average, the impact on Treasury income would be $44 million.

On the negatives, related to participating business under phase 2, there would be another $35 million, or a total of $79 million.

Senator FREAR. And you figure the legislation as it now stands would give the Treasury $558 million?

Mr. GUEST. Yes.

Senator FREAR. And if we deduct $79 million from that, we get a figure something like $479 million.

Mr. GUEST. $479 million, yes,

Senator FREAR. You recognize that the Treasury and its budget or the President and his budget is expecting about a $500 million income from life insurance taxes. Do you propose any way to make up the difference between this $479 million and $500 million?

Mr. GUEST. I do not. I endorse the position taken by several people, including the representative of the Treasury, that it is highly important that we get a good tax bill. If incidentally it involves a few million dollars one way or the other in current revenue, that is insignificant compared with the importance of getting a good tax bill.

Senator FREAR. I have great sympathy with what you say. How do you feel about a balanced budget? [Laughter.]

Mr. GUEST. I think the budget should be balanced, but this is peanuts when it comes to that question.

Senator FREAR. Yes, sir; but, you know, peanuts make a bag after a while. [Laughter.]

I thank you. You have answered the question.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Mr. Guest, I have a few rather simple questions to ask.

The first question I should like to ask is whether the policyholder is ever taxed on investment income which he earns on his investment with mutual insurance companies, that is, laying aside underwriting, and operational gains. Is he ever taxed on his investment, rather, either on cancellation or on death?

Mr. GUEST. That question could stand a very considered and very carefully worded answer.

On surrender where the contract is terminated before it matures——

Senator DOUGLAS. Not cancellation?

Mr. GUEST. Either on surrender or on maturity, the personal income tax laws provide for the taxation of the increment of the value received, the excess of the value received over what has been paid for the contract by the policyholder. That is covered in the personal income tax laws.

Senator DOUGLAS. In practice, is this carried out?

Mr. GUEST. Oh, yes, we have to provide that on individual cases for our policyholders when they surrender, and they, in turn, file those statements which we provide for them, with the Internal Revenue Department in connection with their tax returns.

Senator DOUGLAS. You think that is in practice done a great deal?

Mr. GUEST. Yes, Senator Douglas, it is. We send out thousands of them a year.

Senator DOUGLAS. What about on death?

Mr. GUEST. Well, on death, the Congress has considered that especially in the light of the circumstances, and there is special legislation which was revised in the most recent Code to cover that in the way in which the Congress has in its discretion decided it should be covered.

To quite an extent there is exemption. I would not want to cite precisely what it is. But that has been decided as a matter of discretion by the Congress.

Senator DOUGLAS. Yes. But without going into the question what should be, I am trying to find out what is. As a practical matter, is the investment income which the policyholder earns taxed on death, taxed to his estate on death? I am just asking for the present situation, without regard to——

Mr. GUEST. After an exemption granted by Congress, it is taxable; and then if the settlement, if the money is left under settlements with the companies, it is in turn taxed to the individual.

Senator DOUGLAS. But in practice, is not the income untaxed?

Mr. GUEST. There has been quite a lot of exemption granted by the Congress, yes, in that connection.

Senator DOUGLAS. Is not the major portion of the income untaxed?

Mr. GUEST. I think that is a fair statement, although would you wish that we would give a more considered statement of that in the record?

Senator DOUGLAS. Oh, yes; I would be very glad to have it.

(The statement referred to follows:)

## TAXATION OF POLICYHOLDERS AND BENEFICIARIES OF LIFE INSURANCE CONTRACTS

### SURRENDER PRIOR TO MATURITY

If the policyholder surrenders his policy prior to maturity and calls upon the company to pay the cash value, he is subject to tax on gains as set forth in section 72(e) of the code. This section provides that he is taxed upon any amount he receives in excess of the amount of premiums he has paid, after the premiums are reduced for policyholder dividends. This gain, if any, is taxed as ordinary income. As a general rule, losses are not recognized. Thus, as soon as the policyholder actually has income at his disposal, it is included in his income for tax purposes.

In the light of the testimony heard by the committee, it should be explained that little or no gain is realized in the vast majority of surrender cases and for this reason the Treasury does not require that the life insurance company make an information return, if the policy surrendered is one which was purchased and paid for by the insured, and the company can ascertain this from its records (sec. 1.6041-1(d) (1) (ii) of the regulations under the Internal Revenue Code of 1954). Most companies will, however, furnish to the taxpayer any information he needs in computing his taxable gain.

### BENEFITS PAYABLE TO THE POLICYHOLDER DURING HIS LIFETIME AFTER MATURITY OF THE POLICY

The tax treatment of payments received on maturity but during the lifetime of the policyholder is set forth expressly in the Internal Revenue Code at section 72, dealing with life insurance and annuities. Special rules apply for benefits under qualified pension plans under sections 402 and 403, but in either case the purpose of the statute is clear, that of including in income all amounts which exceed the cost of the life insurance to the policyholder. If benefits are received as an annuity, then the annuity rule applies and the tax burden is spread over the period during which payments are made. If any sums are held for the production of interest, the interest is included in gross income (sec. 72 (j)). Special treatment is provided to reduce the impact of lump-sum payments, through, in effect, a 3-year spread under section 72(e)(3), or through capital gains provisions applied to any lump-sum payment of qualified pension benefits under sections 402 and 403. However, there is no question as to the amount subject to tax. Payments by the insurance company under these sections are subject to information return reporting under section 6041 of the code and section 1.6041-1(d) of the regulations.

### ANNUITIES AND PENSIONS

The entire amount received by a policyholder or beneficiary of a life insurance, endowment, or annuity contract is subject to inclusion in his income to the extent it exceeds the consideration he has paid for the contract. Section 72 is generally applicable to annuity payments, and sections 402 and 403 deal with payments under qualified pension plans. As previously indicated, section 72 provides several methods for the inclusion of this income, but all of these methods contemplate that the entire amount of income realized shall be taxed.

Provision is also made for the inclusion of these amounts in the income of the beneficiaries of annuitants to the extent that they are paid to survivors.

### DEATH BENEFITS

Death proceeds are generally exempt from income tax under section 101(a) of the Internal Revenue Code of 1954, and have been so exempt since the earliest days of the Federal income tax. This exemption has always been looked upon as an act of legislative discretion in recognition of the public policy of protecting survivors from the financial impact of the loss of life. Various assertions have been made from time to time that the exemption is a matter of tax logic rather than legislative grace, but they have not been fully developed because the issue has never been raised in practical form. One point sometimes made is that if this death benefit were taxed, there would in equity need to be some setoff for the loss of earning power for which the insurance could be looked upon as indemnity, so that the amount received under the policy could not in any event be considered pure profit. Be that as it may, if it is agreed that the public policy behind the present exemption is sound, then it would follow that any attempt to take away the benefit indirectly by an offsetting tax on the company would be in contravention of that policy.

The entire amount of any proceeds of policies or contracts owned by the decedent is included in his gross estate and is subject to the estate tax. This, of course, applies whether or not there would have otherwise been a profit to the decedent and is the same treatment accorded other property subject to the estate tax, which includes any values due to income accretion as well as the basic property itself.

The death benefit exemption is carefully limited. If the proceeds are held at interest, the interest is subject to tax under section 101(c) of the code. If the proceeds are paid in installments, any amount in excess of the lump-sum benefit at death is taxed under section 101(d), subject, however, to an additional exemption of $1,000 per year allowed only to the decedent's spouse. In the event that the premiums were paid by an employer under a pension or profit-sharing plan qualified under section 401 of the code, the proceeds, to the extent attributable to those premiums, are taxable to the beneficiaries. (See sec. 1.402(a)-1(a)(4)(ii) (*b*) and (*c*) of the regulations.) Taxable income includes the proceeds of insurance which are in the nature of alimony payments under section 101(e) and the excess over cost of proceeds of policies which during the lifetime of the insured were transferred for a valuable consideration, except in special cases, under section 101(a)(2).

POLICYHOLDER DIVIDENDS

Policyholder dividends fully discussed elsewhere in these hearings have always been regarded as a return of premium to the policyholder. To the extent that they are paid to the policyholder, they reduce his cost of insurance and thereby increase the amount of any taxable gain, when gain is realized. To the extent that policyholder dividends plus any other payment under the contract exceed the cost of the contract to the policyholder, they are included in income (sec. 72(e) (1) of the code and sec. 1.72-11(b) of the regulations thereunder).

Senator DOUGLAS. May I follow that up with this question: If the policyholder is not taxed on the investment income which he earns on his investment, or to the degree to which he is not taxed, why would it not be appropriate to tax this amount in the hands of the insurance companies?

Mr. GUEST. There again you have asked a very broad question.

Senator DOUGLAS. It is a broad question.

Mr. GUEST. It is hardly for me to say that the Congress was indiscreet when it waived the tax on the individual.

Senator DOUGLAS. We are trying to write a good tax law, and you have not hesitated to criticize the Congress and the House on certain of its proposals. Now I am asking about this question.

Mr. GUEST. May I include that statement in the memorandum, which I would like to prepare carefully, because this so involved, Senator Douglas, that it should not be just a rough extemporaneous statement.

Senator DOUGLAS. I know, but I am trying to find my way through the jungle with the only instrument I have, namely, by question and answer.

Mr. GUEST. I hate to get into another facet of this, but I might say, Senator Douglas, that if you were to assume that even though the Congress has exempted to a large extent, because of public policy, the taxation of these increments of which you speak, at the date of death, even in the face of that if you feel that they should be taxed at the corporate level, I might say that the increments being income to individuals, in your presupposition, should not be taxed at the corporate rate, but should be taxed at a very much lower rate, what might be considered an average rate, possibly 20 percent instead of 52 percent.

However, the question already has been settled by Congress, and I have nothing further to offer you by way of explanation, unless you have another question.

Senator DOUGLAS. Then you would not oppose taxation of these surpluses in the hands of insurance companies?

Mr. GUEST. May I ask you to repeat the question?

Senator DOUGLAS. Then you would not oppose, since you have no opinion on this matter, you would not oppose taxation of this investment income which lies in the hands of insurance companies?

Mr. GUEST. I certainly would oppose it, Senator.

Senator DOUGLAS. Then you do have an opinion on it.

Mr. GUEST. I have an opinion. I meant to say I had no explanation. I have an opinion.

Senator DOUGLAS. You have an opinion, but not the justification for the opinion.

Mr. GUEST. Oh, yes; I have a justification for the opinion. I think the Congress was right. I think it is a little brutal, as a matter of public policy, to put a tax upon death benefits.

Senator DOUGLAS. This income is not taxed to the individual and not taxed to the company. Why do you think it should not be taxed to the company, either in full or in part?

I have not made up my mind on this question, but am simply probing for the response, pro and con.

Mr. GUEST. I can understand you are taking a completely objective view and trying to get the answers.

Senator DOUGLAS. That is right.

Mr. GUEST. I can only repeat that it has been decided by the Congress. I am in sympathy with the decision which was made by the Congress. I think it is a good one. I think it is in the public interest, and if the question comes up again I would vigorously support the position now taken by the Congress.

Senator DOUGLAS. You like it.

Mr. GUEST. Yes, sir; I do.

Senator DOUGLAS. But you are not able to tell why you like it.

Mr. GUEST. I think it is in the interests of good public policy that at the extreme period when the breadwinner is lost suddenly, there should not be inserted at that critical moment a tax on increments accrued during the lifetime of the insured.

Senator DOUGLAS. You draw no distinction as to the question whether the entire amount of investment income should be taxed or only the excess over the amount credited to his account? You draw no distinction?

Mr. GUEST. The first phase of this bill, Senator Douglas, does essentially just that. It arrives at a proportion of the investment income which we call taxable income, and if I might put in the record, I have a statement on that which will clarify, possibly, one or two questions asked yesterday.

The method we suggest to separate out the taxable investment income from the total taxable income involves two steps: One, the reserves for each company are revalued at the current earned rate by rule of thumb method, which it is agreed is quite reliable, in order to arrive at what might be considered standardized reserves.

Two, the interest that is to be considered deductible from net investment income, not taxable income, to arrive at the taxable investment income is found by multiplying the company's standardized reserves by that company's current earned rate.

Three, the use of the 5-year average company earned rate turns up a larger tax base in 1958, but over a period of years would average out to the same level as if the current year's earned rate were used. In fact a little higher on the upswing.

Senator DOUGLAS. When you send your considered reply to the committee, would you send a copy of that directly to me so that I may look at it?

Mr. GUEST. I would be very happy to do that, Senator Douglas.

The CHAIRMAN. Are there any further questions?

Senator BENNETT. Mr. Chairman, I would like to ask a question or two, on this same subject on which Senator Douglas has been talking or questioning.

Proceeds from a life insurance policy are subject to the same conditions in estate taxation as any other assets of the decedents, are they not? Are they not used to calculate the gross amount of the estate which is subject to tax, and are they not, therefore—are they not subject to the same overall $60,000 exemption which applies to estates, so that if there has been an accumulation which the policyholder has not drawn down in advance of his death, that accumulation increases the net amount of his estate subject to tax? Is that a fair statement?

It may be fair but it is not clear, so I will start over again. [Laughter.]

Mr. GUEST. I do not understand your question.

Senator BENNETT. If I have a policy for $5,000, and I decide to leave the dividends with the company and not take them out, and at my death that policy pays $6,000, then does not that $6,000 go into the estate?

Mr. GUEST. That is right, Senator Bennett.

Senator BENNETT. And is it not subject to the estate tax minus the exemptions?

Mr. GUEST. That is right.

Senator BENNETT. And all the other conditions. And in that respect, is it not in exactly the same situation as any other asset which might be found in my estate?

Mr. GUEST. That is right.

Senator BENNETT. Now, if on the other hand, during the life of the policy, during the life of the policyholder, he had taken the dividends in cash when they were available to him at the anniversary of every policy, would those dividends have been subject to the tax on personal income? That, I think, may be the crux of the question.

Mr. GUEST. No, not at the moment when he takes them. If subsequently—there are two possibilities subsequent to that.

Senator BENNETT. May I stop at this point before you go on?

If they are not subject to the personal income tax when he receives them as dividends, are they then considered to be a return of premium?

Mr. GUEST. For the moment they do not enter in at all because the premium does not enter into the personal income tax either. But there are two possibilities: One, if he surrenders the policy or it matures before death, then the amount by which the surrender value or maturing value he receives exceeds what he has paid diminished by the price adjustments, is taxable to him as then current income.

Senator BENNETT. But up to that time you consider those so-called dividends as price adjustments and you allow them to diminish the amount of his payments.

Mr. GUEST. Neither the dividend nor the premium have anything to do with his tax return.

Senator BENNETT. As long as during his lifetime, but the excess or the amount by which the proceeds of the policy have been increased actually enter into his estate tax.

Mr. GUEST. Yes.

Now either on surrender or maturity, there enters his personal income tax the amount by which the maturing or surrender value exceeds what he has paid, in case of death, that is another story, which is handled, as I said, according to the specific action of Congress.

Senator BENNETT. Yes. But in case of death—that I think you you have already answered—that excess enhances the value of his estate, and therefore becomes subject to the estate tax.

Mr. GUEST. That is true as to dividends which have accumulated to his account, Senator Bennett.

Senator KERR. Well, is his total insurance not a part of his estate and taxable from the standpoint of inheritance tax other than exemptions which the Congress has provided for the value of the estate generally and certain insurance elements of the estate?

Mr. GUEST. Yes, Senator Kerr.

Senator BENNETT. That is all.

Mr. CHAIRMAN. Are there any further questions?

That is all, Mr. Guest.

The next witness is—I beg your pardon, Senator Gore.

Senator GORE. May I ask a question?

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Guest, you quoted certain court opinions in your prepared statement. Was tax liability an issue in either of those cases?

Mr. GUEST. May I ask for legal advice on that? There is a man here I think can answer that.

Senator GORE. Yes, indeed.

Mr. GUEST. May we have Mr. Eugene M. Thore, general counsel of the Life Insurance Association of America, answer the question?

The CHAIRMAN. Mr. Eugene M. Thore.

Mr. THORE. Both of these cases are tax cases, as I recall.

Senator GORE. Were they Federal income tax cases?

Mr. THORE. Yes, they were.

Senator GORE. Thank you.

Mr. Guest, you quoted the courts and other people on dividends to policyholders, what would be your definition of a dividend?

Mr. GUEST. In simplest terms it is a price adjustment. I expanded a little on that, Senator Gore, a little while ago to the best of my ability.

Senator GORE. I would like to read you the definition given in the Life Insurance Fact Book, page 117.

> A refund of a part of the premium on a participating life insurance policy. It is a share of the surplus earnings apportioned for distribution and reflects the difference between the premium charged and actual experience.

Now, I would like to cite the annual report of our own company, Massachusetts Mutual Life Insurance Co., schedule M:

"Method by which dividends are calculated:"—I am not reading some of the clauses. I am omitting parts of the schedule to get to the essentials.

Mr. Chairman, I ask that this page of the annual report of this company be printed in the record at this point.

The CHAIRMAN. Without objection, the insertion will be made.

(The document referred to is as follows:)

ANNUAL STATEMENT FOR THE YEAR 1958 OF THE MASSACHUSETTS MUTUAL LIFE INSURANCE CO.

SCHEDULE M

Method by which dividends are calculated: Policies issued on or after October 16, 1947, and prior to November 4, 1957.

The dividend for each $1,000 of insurance, with or without provisions for disability is the sum of three items determined as follows, net premium and reserves being computed in accordance with the Commissioners Standard Ordinary Table of Mortality and interest at the rate of 2½ percent per annum.

*Premium paying policies*

(1) Loading item.—The amount by which the loading exceeds an expense charge which varies by kind, age, sex, policy size and year of issue.

(2) Mortality item.—A savings from mortality, equal to the amount at risk multiplied by a factor which varies by attained age and sex.

(3) Interest item.—Excess interest on the initial reserve at the rate of 1.2 percent.

*Paid-up policies*

Excess interest and a saving from mortality, calculated as above stated, less expenses equal to $0.05 per M of sum insured.

Senator GORE. I shall read the essential parts and not the explanatory statements.

"The dividend for each $1,000 of insurance, with or without provisions for disability or accidental death benefits is the sum of three items determined as follows"—here are the three items: One, "loading item"; two, "mortality item"; three, "interest item."

Your own company's statement shows that you determine the amount of dividends partially by calculation of earnings. You said, when you gave your definition, that it was in its simplest terms. Your company does not use the simplest terms, does it?

Mr. GUEST. Is that the end of your question?

Senator GORE. Yes, if you are ready to answer. If not we will give you more time.

Mr. GUEST. I repeat that in simplest terms it is a price adjustment.

When you are operating with a corporation involving over $6 billion of insurance in force, and large amounts of premiums, and you are arriving at what should be the final price adjustment in each year, and how that should be distributed between individual policyholders, a simple statement by the actuary that a price adjustment should be made does not fulfill the requirement and great detail is involved.

Senator GORE. In practice?

Mr. GUEST. In practice, in arriving at price adjustments they are calculated on the level where they should be, if under the same conditions we were operating on a nonparticipating basis. It is very involved, but that is the end result, the price adjustment, and we have to be very careful and very discreet as to how it should be distributed so that each one gets his fair price adjustment.

Senator GORE. Is that your answer?

Mr. GUEST. Yes, sir.

Senator GORE. Now I have a general question, Mr. Guest, on the bill. You have suggested changes and amendments. Would you be so good as to explain to me just how, under the bill, an increased earnings rate would affect the amount of the deduction for life insurance reserves? I ask you to explain the provision in the bill, and then, of course, I would like for you to explain how that differs from the provision which you suggest.

Mr. GUEST. Oh, yes.

The bill has a—what I might call a compound rate involved as a deduct rate. That compound rate involves the company's earned rate and some assumed rates industrywide and individually, as the case may be.

If the earnings in my company increase——

Senator GORE. You mean earnings or earnings rate?

Mr. GUEST. The earned rate, if the earned rate in my company increases, then the total net investment income will increase correspondingly.

In turn, after the deduct rate, based upon the higher rate, has been applied to the revalued reserves, there would emerge a larger difference than there would have been had the current earned rate not increased.

Senator GORE. Would an increase in the earnings rate, under the formula in the pending bill, increase the amount of deduction, not only for your company, but for all companies?

Mr. GUEST. Yes. But the result—the reason for the formula involving a deduction from the total interest earned is essentially to arrive at the interest at the earned rate on the surplus.

Senator GORE. For the moment, let us lay aside the reasons. I hope you will appreciate the difficulty that one who is not schooled in this field, but who has a thousand and one other fields which he has to attempt to understand, faces in questioning an expert in the field. So I am trying to understand the bill and your suggestion.

You have just said that an increase in your earnings rate would increase your deduction.

Mr. GUEST. Not as much as it would increase the investment income, so that when I diminish the increased investment income by the increased deduction, I still get a larger tax base.

Senator GORE. But not in proportion to your increased profits.

Mr. GUEST. Oh yes, because in either case the result is the interest applied to the surplus.

Senator GORE. All right.

Now coming to your suggested change: Would the formula which you suggest give to the increased earning rate approximately twice the effect upon the deduction rate as the provision in the pending bill?

Mr. GUEST. I am not sure that I understand your question. Charlie, do you understand that question?

Mr. BRIERLEY. No.

Mr. GUEST. I may have to call on Mr. Brierley to answer it.

Senator GORE. Would you be so kind as to present the meaning——

Mr. GUEST. Would you repeat the question, Senator?

Senator GORE. All right. I will repeat the question. I think the answer is yes, but maybe it is not. My question is, would your suggested change in the formula, not have the effect of giving to an increased earnings rate approximately twice as much influence in determining the life insurance reserve deduction as the formula in the pending bill?

Mr. GUEST. I think the answer is no.

Senator GORE. Would you agree to that, Mr. Brierley?

Mr. BRIERLEY. I believe I have to agree with that.

Senator GORE. With which one?

Mr. BRIERLEY. With Mr. Guest's answer. [Laughter.]

Senator GORE. I thought if you agreed with me, I could understand the low tones in which you were speaking.

Senator KERR. Would the Senator yield? Did the witness say he believed he would have to agree with it or that he should agree with it? [Laughter.]

Senator GORE. Let us approach this in a different way. Perhaps I should not ask you to give a yes or on answer to an involved question. I did so because of my own difficulty in understanding the involved answer which you might give otherwise.

Mr. GUEST. Believe me, Senator, your difficulties are no greater than mine, because I am not quite sure of the question.

Senator GORE. Well, I would say your difficulties are of a different nature.

What would be the difference in its effect upon the amount of deduction, thereby affecting your free investment income, between the formula which you suggest and the formula written in the bill with respect to an increased earnings rate?

Mr. GUEST. I would say that the effect of my suggestion would be more—would give a more moderate reflection of the increase in the tax base than would be given by the draft bill.

Senator GORE. How much more moderate?

Mr. GUEST. I don't know. I haven't calculated it.

Senator GORE. Moderation is a good word.

Mr. GUEST. I do not know precisely. It may be that some of the staff of our associations could answer that question, but I don't know the answer, and I know you would not want me to guess.

Senator GORE. One of the important provision in this whole bill is the determination of a tax base on income from investment.

Mr. GUEST. Yes.

Senator GORE. As a witness before the committee, you have suggested an important change. I know you will want to suggest to the committee its effect upon this important feature in the bill. I can understand that you might not be prepared to answer it now, but if not, would you be so kind as to supply as readily, and as quickly as possible, to the committee and to me, an answer to this question?

Mr. GUEST. You know I am thinking of the remarks that probably are being made by two dozen people sitting in the audience, "Why doesn't Dick answer this question, it is stupid."

Senator GORE. You mean they are stupid, or you?

Mr. GUEST. No; I am stupid. [Laughter.]

Mr. GUEST. The difference in 1958 of $44 million due to the use of the 5-year average is an exact appraisal now industry-wide.

The only change in the impact due to a change in the earned rate in the future would be proportional to the increase in the earned rate. I think that is an accurate statement.

Senator GORE. Well, I will ask you to supply——

Mr. GUEST. In other words, if the difference is $44 million now and the earned rate went up a certain percentage, the $44 million would increase by, I think, the same percentage.

Senator GORE. I do not want to get into the position of allowing an increased interest rate structure for the country to result in less taxes paid by the insurance industry.

Mr. GUEST. Believe me, Senator, that cannot happen within this bill.

Mr. BRIERLY. I think you will find that in dealing with the particular bill we are dealing with a fixed amount of investment income. Now another year, as the rate goes up, the amount of income also increases.

While your deduction rate would be higher and would create a higher deduction, your balance or your taxable investment income would go up because the total investment income also goes up.

You see, in this particular instance we are dealing with a fixed investment income, and changing rates would apply in the bill——

Senator GORE. My question did not relate to a fixed investment income. My question related to an increase in earnings rates applied to the formula which Mr. Guest had suggested.

Mr. BRIERLEY. Yes. Well, changing the earnings rate as we are suggesting here and producing a larger deduction, it still applies to the same investment income in total for the year.

Now another year, if the rate goes up, the entire income also increases, and produces a higher tax base.

Senator GORE. I want to ask both of you again: If, in the long run, say 5 years—this is permanent legislation, we hope—if, in the long run, the formula you suggest would not give to an increase in earnings rates twice the effect on deduction rates as the formula contained in the bill? If so, I would like to know.

Mr. GUEST. I do not think it is as simple as that, but if you will give me the privilege to answer that in the record later on, I think that is not true.

Senator GORE. Well, you shall certainly have that privilege, and I thank you for offering to do so.

(The statement referred to follows:)

**The following analysis has been made using characteristic model company figures assuming an increase of one-tenth of 1 percent in the net earned rate. At the request of Senator Frear, the analysis also covers the impact of a decrease of one-tenth of 1 percent in net earned rate.**

**Model Company: $105 million assets; 3 percent life insurance reserves of $73,500,000.**

**Balance: (*a*) Other interest bearing reserves, (*b*) other noninterest-bearing liabilities, (*c*) unassigned surplus.**

TABLE A.—*Increasing earnings rate*

| | H.R. 4245 | | 5-year average flat earned rates 4 percent in past 4 years | | 5-year average previously increasing at 0.10 points per year | |
|---|---|---|---|---|---|---|
| 1. Earned rate......percent.. | 4.00 | 4.10 | 4.00 | 4.10 | 4.00 | 4.10 |
| 2. Valuation rate.......do.... | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 |
| 3. Revaluation rate....do.... | 3.50 | 3.55 | 4.00 | 4.02 | 3.75 | 3.85 |
| 4. Assets...................... | $105,000 | $105,000 | $105,000 | $105,000 | $105,000 | $105,000 |
| 5. Reserves (3 percent)....... | $73,500 | $73,500 | $73,500 | $73,500 | $73,500 | $73,500 |
| 6. Revaluation percentage... | 95.00 | 94.50 | 90.00 | 89.80 | 93.50 | 91.50 |
| 7. Revalued reserve........... | $69,825 | $69,457 | $66,150 | $66,093 | $67,987 | $67,252 |
| 8. Interest earned ........... | $4,200 | $4,385 | $4,200 | $4,305 | $4,200 | $4,305 |
| 9. Deduction (7)×(3).......... | $2,444 | $2,466 | $2,646 | $2,657 | $2,550 | $2,599 |
| 10. Tax base..................... | $1,756 | $1,839 | $1,554 | $1,648 | $1,650 | $1,716 |
| 11. Tax at 52 percent ......... | $913 | $956 | $808 | $857 | $858 | $892 |
| Increase in earned rate percent.. | +2.50 | | +2.50 | | +2.50 | |
| Increase in deduction .do.... | +.90 | | +.41 | | +1.83 | |
| Increase in tax..........do.... | +4.71 | | +6.06 | | +3.96 | |

**NOTES**

(1) The increase in the deduction under the 5-year average after several years of instant earned rates is less than the increase under H.R. 4245 and, more in the case of several years of increases.

(2) The tax increases much more than at the rate of increase in earned rate.

(3) We see the moderating effect on the deduction rate of using a 5-year average instead of the current earned rate.

TABLE B.—*Decreasing earned rate*

| | H.R. 4245 | | 5-year average previously level rate of 4 percent | | 5-year average previously decreasing at 0.10 points per year | |
|---|---|---|---|---|---|---|
| 1. Earned rate ....percent.. | 4.00 | 3.90 | 4.00 | 3.90 | 4.00 | 3.90 |
| 2. Valuation rate......do.... | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 |
| 3. Revaluation rate....do.... | 3.50 | 3.45 | 4.00 | 3.98 | 4.25 | 4.15 |
| 4. Assets.................... | $105,000 | $105,000 | $105,000 | $105,000 | $105,000 | $105,000 |
| 5. Reserves.................. | $73,500 | $73,500 | $73,500 | $73,500 | $73,500 | $73,500 |
| 6. Revaluation factor percent.. | 95.00 | 95.50 | 90.00 | 90.20 | 87.50 | 88.50 |
| 7. Revalued reserve.......... | $69,825 | $70,192 | $66,150 | $66,297 | $64,312 | $65,047 |
| 8. Interest earned........... | $4,200 | $4,095 | $4,200 | $4,095 | $4,200 | $4,095 |
| 9. Deduction (3) × (7)....... | $2,444 | $2,422 | $2,646 | $2,639 | $2,733 | $2,699 |
| 10. Tax base................. | $1,756 | $1,673 | $1,554 | $1,456 | $1,467 | $1,396 |
| 11. Tax, at 52 percent ........ | $913 | $870 | $808 | $757 | $763 | $726 |
| Increase in earned rate percent.. | −2.50 | | −2.50 | | −2.50 | |
| Increase in deduction...do.... | −.90 | | −.26 | | −1.24 | |
| Increase in tax..........do.... | −4.70 | | −6.31 | | −4.85 | |

NOTES

(1) The deduction under the 5-year average method falls off faster than the corresponding H.R. 4245 deduction.
(2) The drop in the tax corresponds to the increase in the tax on the upswing.

Senator GORE. Even the pending bill is questionable, in my mind, as to its formula. I have more doubts about the formula you have suggested. Thank you, Mr. Chairman.

The CHAIRMAN. Are there any further questions?

Senator FREAR. I think if the gentleman is going to answer the question from the Senator from Tennessee, he also ought to reflect, if the interest rate goes down, what effect it would have on the deductions.

The CHAIRMAN. That will be understood.

Mr. GUEST. Is that a question from you, Seantor Frear?

Senator FREAR. In the answer you are going to give to the Senator from Tennessee for the record, I wonder if you would not also submit the same figures assuming that the interest rate were lower.

Mr. GUEST. I did, in the prepared statement which I read in the record, say that the 5-year moving average over a period of years would be the same as the individual rate of the company. That being the case, the——

Senator FREAR. I do not want to get this, and I do not want to complicate it any more——

Mr. GUEST. We will put it in the record.

Senator FREAR. Because I think it is rather more complicated now. But if there is an increase, as the Senator from Tennessee suggested, that the decrease effect was double on one side, or the increase on the other, what would happen if the increased side were decreased? Would the decrease then be half the amount? [Laughter.]

If that is not complicated, we will try to make it so. [Laughter.]

Mr. GUEST. If the secretary will give me an accurate transcript of the question, I will try to answer it.

Senator FREAR. For the record, sir; you do not have to do it now. I am sure this reporter here is all right. He is pretty accurate.

Senator BUTLER. Mr. Guest, what you are really saying is that the theory of the House bill is an oversimplification of a very complex problem. You suggest that even in those cases where you have a negative under step 2, you would like to go into your investment income without suffering a tax liability, which you contend is nothing but a return of premium, is that right?

Mr. GUEST. That is right, Senator Butler.

Senator BUTLER. Where have we missed? What is the missing ingredient that the mind of the average man does not grasp in this situation?

Now, I will say that up to this point it seems to me apparent that if you had a negative after step 2, you have got only one place to go to pay that dividend, and that is out of step 1, which is investment income. Why is that not encroaching upon something other than premiums or excess premiums? Why is that not an encroachment on the income?

Mr. GUEST. I would like to make two comments on that.

As I understand it, this is a corporate income tax, total income tax, total net income tax. Phase 1, as I understand the language of the bill, is a separation out, a compartmentalizing, shall I say, of that phase of a corporation's total income which can be given the tag "investment income."

That is all it is. It is a part of the total income. And where we are having trouble is when the part gets larger than the whole. We part company, and we don't go along the same track.

It is when the part of the total taxable income becomes larger than our visible corporate income as a whole that the trouble emerges.

I think there was misunderstanding in the House. On the other hand, I think Chairman Wilbur Mills was quite aware that possibly they had used an atomic bomb to solve a question which might more properly have been handled by a Daniel Boone rifle.

I think that is the trouble. We now are suggesting that we pinpoint by amendment a solution which will be a rifle approach, rather than a bombing approach, and which will not violate the concept in the Treasury, in the House, or in the Senate, and will come up with a reasonable bill.

The CHAIRMAN. Are there any further questions?

Senator WILLIAMS. Mr. Guest, I just have one question.

First, I would like to thank you for your testimony and your recommendations to the committee, and they will certainly be considered. But my question is this:

Just suppose none of your recommendations were accepted by the committee; would you then prefer the enactment of H.R. 4245 as it was passed by the House, or would you prefer the existing law?

Mr. GUEST. I can't speak for the industry.

Senator WILLIAMS. I am asking you for your own personal opinion.

Mr. GUEST. We would prefer the draft bill to the 1942 law, which we think is intolerable.

Senator WILLIAMS. That answers my question. Thank you.

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. Mr. Guest, in your statement you state:

It is our recommendation, as I believe it is the recommendation of all companies, that in the case of recently organized companies or newly organized companies whose carryover feature be extended to 15 years from the date of organization, and it would apply to the taxable years intervening between the effective date of H.R. 4245 and the expiration of 15 years from the date of the organization of the new company.

I have had several representatives of newly organized companies contact my office and make substantially the same statement.

Would you please elaborate in the record your reasoning behind that suggestion?

Mr. GUEST. It costs a lot of money in paid-in capital and surplus or in some other sort of support to organize a new life insurance company.

It is inevitable that that newly organized life insurance company will sustain losses in the early years of its organization.

Many that are organized in, shall I say, "imaginative States" many fail even to survive. Those who survive have sustained heavy losses, and when they emerge to the point where they begin to get some gains, something coming back, say in 6 or 8 or 10 years, I think it is only fair that those earnings up to say 15 years should be first diminished by the heavy losses inherent in the organization and development of the new corporation before they would become taxable.

Senator TALMADGE. Let me see if I understand you correctly.

We will assume a new small company organized with a capitalization, in 1958, of $1 million. Of course their assets, presumably, would be invested and receive earnings. Under the present law and past laws those earnings would be taxed, would they not, regardless of the company's operating loss?

Mr. GUEST. That is right, Senator Talmadge.

Senator TALMADGE. So they have paid taxes while they are incurring a heavy loss.

Mr. GUEST. That is right.

Senator TALMADGE. Would this loss be attributable to the reason that for newly formed companies the acquisition cost is exceedingly high?

Mr. GUEST. Both the acquisition cost and the organization cost is high. I wouldn't use the word "exceedingly," I would use the only word "high."

Senator TALMADGE. How many years would it normally take for a new company to get into the status where it would have an operating or underwriting profit?

Mr. GUEST. I think that depends largely upon the ability and capacity of the organizers. To some extent it might be fortuitous. But I would be surprised if even a well-managed organization could emerge to show profits in much less than 10 years.

Senator TALMADGE. Your recommendation, then, would be to amend the act so as to carry forward losses for a period of 15 years?

Mr. GUEST. Yes; that is my recommendation, sir.

Senator TALMADGE. Thank you, Mr. Guest.

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

Senator GORE. One further question:

Mr. Guest, in the bill the deduction to which I referred is described as "policy and other contract liability deduction."

Would it be correct for me to assume that this deduction from your actual income from investment is proposed, or allowed, because your company and other companies need such a deduction because of the liability of your company to its policyholders?

Mr. GUEST. That is precisely right.

Senator GORE. Now, if your assumed earning rate is 3 percent, and your actual earning rate is 4 percent this year, and we assume that your deduction is sufficient to meet the reserve liabilities and needs of the company, why should that deduction be increased next year? Although your earnings are 5 percent instead of 4, your needs have not increased.

Mr. GUEST. To answer that question, I will have to back up just a little, with your permission.

The whole operation of phase 1 is divided into two parts: One, the revaluation, and two, the calculation of the amount of deductible interest before taxes.

Now, in order to get standard treatment for all companies so there won't be discrimination between companies, this method of revaluation has been devised related to the then-current rate, or some adjusted rate related to that, to arrive at liabilities for tax purposes which are similarly calculated as between companies without discrimination.

That having been done, the deductible interest required to balance out the whole tax concept is that current deduct rate, multiplied by the revalued reserves.

Senator GORE. You say—will you repeat that phrase, tax concept. What did you say?

Mr. GUEST. The whole concept of the phase 1 of this bill.

Senator GORE. So the purpose is to arrive at a tax concept rather than the needs of the company?

Mr. GUEST. No, sir; that isn't true. Here is where we are apart, and I will try to bring us together. I know we are apart, but I am not sure that I can express myself in the way in which I can get over to the record.

Your concept is related to the official assumed reserves for solvency purposes.

Senator GORE. Well, let's just stop right there and look at that one again and see if we understand ourselves.

If I understand you, and if you understand me, according to the theory of the bill, is it not correct to say that we assume that an addition to reserves, and thereby a deduction from income is needed, sufficient to maintain that solvency to which you refer, sufficient to meet the liabilities, the contingent and reserve obligations of the company?

Mr. GUEST. That is true, Senator Gore, but——

Senator GORE. If we understand that, we have made a great accomplishment. [Laughter.]

Senator GORE. I am interested to see what this "but" is.

Mr. GUEST. In the terms of the bill in order to eliminate discrimination which otherwise would exist between companies taxwise, the reserves required to fulfill all the obligations are revalued for tax purposes, standardized——

Senator GORE. Not revalued for tax purposes?

Mr. GUEST. That is right.

Senator GORE. Not because of the reserve needs of the company. Go ahead, now.

Mr. GUEST. Well, I will amend that statement, as I see it. [Laughter.]

Senator GORE. All right.

Mr. GUEST. When you revalue, using the higher interest rate you come up with lower reserves, and the lower reserves, if they are going to fulfill the obligations, require higher interest in the future. When you lower the reserves the interest rate, deduct rate, must be higher.

In this process we have used the high current earned rate which results in extremely low reserves, but the equation is in balance in this tax return on a different level of valuation.

Senator GORE. Then your answer is that the reason why you think this concept should be agreed to is to preserve equity and prevent discrimination as between competing companies in the field?

Mr. GUEST. That is precisely right, Senator Gore.

Senator GORE. Well, I have great difficulty in agreeing to the concept that because a company earns more, though its needs are not greater, that we should nevertheless increase its deductions, thereby reducing the so-called free income from investment which is the base upon which the tax liability is calculated.

Mr. GUEST. I follow you up to the "thereby." There is a larger deduction, but the result of the subtraction is still positive, as it should be.

Senator GORE. Well, is the 10-for-1 ratio for recasting reserves an accurate ratio for your company, for instance?

Mr. GUEST. Yes, sir; it is.

Senator GORE. It is an accurate one for your company?

Mr. GUEST. Yes, sir. I could speak with some authority on that.

Senator GORE. You think it is for the industry?

Mr. GUEST. Yes; I do. We developed statistics, and I used our electronic calculating equipment, which calculates a million times a minute, for 3 weeks, day and night, doing that.

Senator GORE. Only Senator Kerr can do that for this committee.

Mr. GUEST. Thanks for bracketing me with him.

Senator GORE. No; I was bracketing your machine with him.

Mr. GUEST. When we were in consultation with your joint committee and the Treasury, we explored that very, very conscientiously, and came up with that 10-for-1 on which we agreed, and which subsequently has been discussed with the Treasury and with the joint committee, and it is agreed that it is a reasonable proximation.

Senator GORE. Well, along with your answer to the other questions I propounded, I would like for you to take a little time and also give a studied answer to this latter question as to why, when your company earns at a greater rate, your deduction should be increased, though your needs have not increased.

(Mr. Guest subsequently submitted the following for the record:)

Although the bill basically is drafted in such a form as to involve a deduction to arrive at the taxable investment income, phase (1) of the bill, insofar as it relates to revaluation and deduction, can be restated as follows:

The taxable investment income consists of two items both positive—

(a) assets equal to the revalued reserves multiplied by the excess, if any, of the current earned rate over the deduct rate; and

(b) the excess of the assets over the revalued reserves multiplied by the earned rate.

This restatement applies whether the deduct rate is (1) the current earned rate or (2) a mean of the current earned rate and the theoretical assumed reserve interest rate as in the bill or (3) a 5-year moving average of the net earned rates.

The restatement clarifies the way in which the deduct rate necessarily is a built in part of the whole revaluation-for-standardization procedure to arrive at a tax base highly sensitive to change in the earned rate. Any change in the earned rate should completely control the deduct rate and the revaluation. There should remain no artificial impact dependent upon either the assumed reserve interest rate, or the earned rate of any preceding year except as it may enter a 5-year moving average for the deduct rate.

In a revaluation method there are two steps:

(1) The reserves are revalued on the new interest assumption (the deduct rate).

(2) The deduction is calculated by multiplying the revalued reserves by the deduct rate.

After revaluing the reserves at a higher deduct rate, thereby reducing the reserves substantially, the company must in the future earn at least the deduct rate which was used in the revaluation otherwise the combination of revalued reserve and deduct rate would indicate a condition of deficiency in the statement as revised for tax purposes which in the absence of extra surplus would indicate technical insolvency.

Within the bill, whether we use the mean deduct rate or the 5-year average, the deduction does increase when the earned rate increases. The two methods vary only to the degree that the mean rate involves, to some extent, the original actuarially assumed interest rate. The use of the pure 5-year average avoids any discrimination between companies.

Mr. GUEST. Well, I would like to put it in the record now that when you earn a higher rate, by the bill I am required to revalue my business at that higher rate, which in turn shows larger surplus, the interest related to which is fully taxable under this corporate return, so I think it is a matter of emphasis we are speaking of, Senator Gore. I will give it careful consideration.

Senator GORE. Yes, give it a lot of emphasis, because you have suggested a double emphasis compared with what the bill now calls for.

Mr. GUEST. If I may be permitted, I haven't quite agreed to that.

Senator GORE. Let me qualify my statement by saying as I interpret your suggestion.

Mr. GUEST. That is all right.

Senator GORE. Thank you, Mr. Chairman.

Senator BUTLER. Mr. Guest, while we would amend the bill as you have suggested, would it alleviate your problem to have your negative carried over as a loss for future years, and if so, have you any estimate of what it would cost in revenue?

Mr. GUEST. The answer to the question is that it would be no help, and I have no idea what the accumulated cost would be. It would get to be quite large, and any reasonable result of those extraordinary losses would be deferred into quite a number of years later instead of their being deducted in the year in which they should be deducted in a normal tax procedure, as in the case of other types of industries.

If Ford has no earnings, they pay no tax.

Senator BUTLER. But you are a little different, because you do have earnings. You don't have them in one category, but you do have substantial earnings in another category. What I was suggesting for your thought was that maybe you could carry over the loss, or carry over the negative into future years without disturbing the calculations under step 1.

Mr. GUEST. My answer to that is I think it wouldn't be effectual. Moreover, I have a feeling that Treasury and your joint committee might take a dim view of it.

Senator BUTLER. I don't know that. I was just suggesting that maybe it might be something you might think about.

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

(See also p. 682.)

The next witness is Mr. Charles A. Taylor, the Life Insurance Co. of Virginia.

## STATEMENT OF CHARLES A. TAYLOR, PRESIDENT, THE LIFE INSURANCE CO. OF VIRGINIA, RICHMOND, VA.

Mr. TAYLOR. Thank you, Senator.

My name is Charles A. Taylor. I am president of the Life Insurance Co. of Virginia, in Richmond. I am speaking for that company, which is a stock company, nearly all of whose business is nonparticipating.

H.R. 4245 seems to me a well thought out bill and its authors seem to me deserving of thanks from life insurance people for having recognized and provided for so many of the peculiarities of the life insurance business, particularly the competitive situation between stock and mutual companies.

Once we life insurance people become resigned to the fact that the U.S. Government does not intend to recognize, in Federal income tax laws, the heavy burden of taxation imposed upon us by the States, I believe we will begin to see virtues in H.R. 4245. Naturally we are reluctant to give up the fight for recognition of the burden of State taxation but since I believe that a lost cause, my discussion will be limited to several points where, I believe H.R. 4245 can be improved materially without sacrifice of principle and without sacrifice of much of its capacity to produce revenue.

The first has to do with subpart B which imposes a tax on investment income and is currently nicknamed "phase 1." The concept of determining a reserve interest deduction by revaluing life insurance reserves to conform to the actual rate of interest earned by each individual company is ingenious, workable and equitable. However, the modification of this concept in H.R. 4245 by using, instead of the actual rate of interest earned by each company, the mean of that rate and the rate of interest assumed by each company, seems to me unfortunate and unnecessary.

Apparently the reason for using the mean of the actual and assumed interest rates, instead of the actual rate alone, was that the latter did not produce enough revenue. But greater revenue can be produced in another way, without abandoning principle.

What's wrong with the introduction in part of the assumed interest rate is that this rate is to a large extent, within the control of companies and is necessarily somewhat artificial and selected by companies for practical reasons. The provision in H.R. 4245 for basing taxes in part upon the assumed rate might well place a premium, through a tax inducement, upon weakening policy reserves.

The suggestion many of us would make is that instead of using the mean of the assumed rate and the actual rate, the bill be amended to use instead the average of the actual rates earned by each company over the latest 5-year period. This would produce a great deal more revenue, under present conditions, than the actual rate for a single year, but not quite as much as under H.R. 4245 as now written.

In making this suggestion, I am quite aware of the fact that much the greater part of any immediate tax reduction from this source would go to the mutual companies and to those stock companies who have a great deal of participating business. But I believe that, by sticking to sound principles and avoiding temptations toward weakening the structures of our companies, we will all be better off.

The second thing I would like to discuss relates to subpart C, popularly known as "phase 2." This imposes what may be a partial or interim tax on gains from operations other than investment income. To me, this part of the bill, when considered in connection with subpart D, "phase 3," constitutes the genius of the concept behind the bill. If phases 1 or 2 do overlook any part of a company's gains from operations, they must eventually be taxed under phase 3. However, by permitting under phase 2 reasonable amounts to be added, as a company grows, to safety margins for the protection of policyholders, the bill recognizes one of the most important aspects of the life insurance business: The pressing necessity for safety margins beyond the policy reserves required by law. Moreover, by permitting somewhat greater margins for nonparticipating business and by limiting any operating loss deduction due to policyholders dividends, from phase 1 the bill recognizes the practical differences between guaranteed cost of nonparticipating life insurance, from the participating type, and largely eliminates the danger that nonparticipating insurance can be injured competitively through underpricing due to a tax advantage.

I believe that under this bill, nonparticipating companies can live and grow, while paying the full corporate tax on all earnings (although some part may be deferred), but the deductions under phase 2 are a vital part of that competitive balance. If the 10 percent deduction of the increase in nonparticipating reserves; the 2-percent deduction of group insurance premiums, and the deferment of a part of the income under phase 2 are changed, it will be a very difficult matter for nonparticipating companies to maintain the degree of safety needed for competitive purposes. We must have substantial equality with the mutual companies. At this point I would like to ask permission to file as an addendum a memorandum prepared by Mr. Henry F. Rood, senior vice president of the Lincoln National Life Insurance Co., covering the need of the 10 percent deduction for nonparticipating policies.

The CHAIRMAN. Without objection it may be done.

Mr. TAYLOR. Thank you, sir.

(The statement referred to follows:)

NEED OF A POLICYHOLDERS' PROTECTIVE FUND
Insurance Co.

(By Henry F. Rood, senior vice president, the Lincoln National Life)

The statutory reserves of a life insurance company are based on fixed rates of mortality and interest established in accordance with the laws of the various States. They represent the present value of the company's future obligations less the present value of the net premiums the company expects to receive both figured on the basis of these fixed rates.

So long as expenses, death claims, and interest rates remain reasonably close to the assumptions made, the statutory reserves plus the future premiums to be collected will be adequate to meet the death claims as they arise. Situations may occur, however, where the statutory reserves will not be adequate to protect the policyholders against insolvency. These may be due to—

(1) Sudden catastrophies such as epidemics, wars, or depressions when mortality rates soar or capital losses are heavy.

(2) Long-term changes in trends such as the higher expenses caused by inflation or the decline in interest rates resulting either from general business conditions or from a controlled economy.

Examples of these various situations are illustrated below:

(1) *Mortality.*—Mortality rates vary as the result of war, epidemic, disaster, and depression. According to the "1958 Life Insurance Fact Book," the ordinary policyholder death rate in 1957 was 6.1 per thousand, about 5 percent higher than the record low of 5.8 in 1956. This increase was due to the Asian flu epidemic. There have been other significant variations in the death rate by years. It rose from 7.5 in 1915 to 10.3 in 1918, a war and flu year. Similarly, it rose from 6.8 in 1927, a prosperous year, to 7.8 in 1934, a depression year. Again it increased from 6.7 in 1942 to 7.9 in 1945, a war year, and went back to 6.7 in 1946 when hostilities had ceased. These are industry average; the fluctuations for individual companies were even greater.

Comparison of average death rates can be misleading because of the changes in distribution of business by age of insured and duration of policy, but it is informative to make such comparisons over a short period of time.

There is no reason to assume that any of the factors which might have pronounced adverse effects on mortality have been eliminated. The results of war, depression, epidemics, and disaster are but too familiar. The group insurance writers, in particular, have a concentrated hazard which renders them particularly subject to adverse mortality experience resulting from epidemics and disasters such as the Texas City explosion.

(2) *Interest.*—Interest rates change in accordance with the supply of and demand for funds but for long periods may be subject to artificial controls such as existed from World War II until 1951. Since life insurance companies are long-term investors, the rate of interest they can earn on their assets rises sluggishly when interest rates turn up but quickly reflects a downturn because of refundings. In 1930 the industry earned a 5.5 percent and 4 years later only 3.92. Similarly, interest dropped from 3.23 percent in 1944 to 2.88 percent in 1947. The rate of decline between 1930 and 1947 was 48 percent, but the rate of recovery since 1947 has not been nearly so rapid. This is understandable as borrowers are quick to refinance loans when interest rates are falling but do not repay in advance obligations bearing favorable rates of interst during period of rising interest rates. The record shows how quickly and drastically interest earning can plummet in event of depression or war.

(3) *Expenses.*—It is unnecessary to dwell long on the subject of inflation. Everyone knows that salaries, rents, equipment prices, taxes, and other operating expenses have all increased tremendously. One large company noted a rise of more than 40 percent during the last 10 years in its annual administration cost per policy during renewal years in spite of much greater mechanization.

(4) *Capital losses.*—During the period from January 1, 1930, to December 31, 1938, the 26 largest companies suffered capital losses of $693 million on mortgage loans, bonds, stocks, and real estate as compared with $12¼ billion held at the beginning of that period.

The existing situation with respect to life insurance company assets is even more important. According to the "1958 Life Insurance Fact Book," the American life insurance industry had aggregate assets of $101.3 billion at the end of 1957 and surplus of $8¼ billion or 8.12 percent of total assets.

This surplus was computed by carrying nearly all bonds at amortized values and mortgages at par value regardless of the current value of these assets in the market place, which some might claim was the true criterion of their value. Certainly market value is what a company can obtain for these investments if it is forced to sell them to meet, for example, a run on cash values or catastrophic death claims. I think everyone will agree that such market value cannot be ignored in computing the real surplus position of the life insurance companies. If such investments were valued at their market values under present conditions, the companies' surplus would be very much less than those shown in their statements, and in many cases would be critically low.

The reason for this is that most bonds and mortgages owned by life insurance companies today have market values well below their amortized or par values, respectively. This is true for two reasons:

(1) A sharp rise in interest rates has brought about a decline in the market prices of fixed-dollar securities. For example, the Victory loan 2½'s of 1972–67, which were offered to the public at par in 1946 and which for years, thereafter, sold at premiums above par, are now selling below 88.

(2) The credit standing of some bonds and mortgages has deteriorated, causing them to decline in market value. For example, the bonds of many formerly prosperous railroads and some industries, and even some municipal bonds, have declined sharply in market value for this reason.

Of these two factors, the former is the most important one under today's conditions. Unfortunately, it is not possible to demonstrate the full effect on market values of the recent rise in interest rates.

However, the effect may be demonstrated by a sampling process and this has been done in table I. The bond issues included in this table were purchased as new issues by one life insurance company over the years 1940–55, inclusive, and they are still owned by it. They are largely bond issues of high quality and an attempt was made to exclude any issue whose decline in price may be partly due to a deterioration in good standing.

It will be noted that for the 41 issues listed, the average book or amortized value was 101 and the average quoted market value was 87.7, indicating a shrinkage of market below book of over 13 percent on average. The current market values of these listed bonds are now somewhat below those quoted for December 31, 1957, due to a subsequent rise in interest rates.

The second reason why some bonds held by life insurance companies today sell well below their amortized values is a decline in credit standing of the obligor. This is true of many railroad bonds today. At the end of 1957 the railroad bonds, other than equipment trust obligations, owned by one substantial life insurance company had quoted market values which were on average 15 percent below the value used in determining surplus. Due to the further decline in railroad credit in 1958, these bonds are quoted at still more depressed levels. In 1958 the country's two largest railroad systems were operated in the red for several months.

Another area of present loss and trouble for life insurance companies is turnpike and bridge revenue bonds. A number of such bonds are not even having their interest earned at present, let alone any provision for return of principal, and such bonds are selling at deep discounts below their amortized values. Some, indeed, are now rated as nonamortizable and must be written down by their holders to their depressed market values.

The industrial bonds held by life insurance companies today were largely acquired through direct purchase and are now the largest single category of bonds owned by them, making up nearly one-fourth of the total assets of the life insurance industry. This type of bondholding has not yet been tested by really adverse business conditions. Such bonds have been acquired very largely during the postwar period of high economic activity, rather continuous inflation, and low business mortality. Prior to this period, life insurance holdings of such industrial bonds were relatively small.

During such a period as that through which we have just passed, there is a tendency to lose sight of the risk factor in investments and it is, therefore, healthy to take a look at the long-term experience. Such a look is provided by the corporate bond study recently published by the National Bureau of Economic Research. This monumental study covered the history of corporate bonds in this country from 1900 to the beginning of 1944. It included the experience on some $56 billion of corporate bonds, including all issues of $5 million and over, of which there was a record, and a sampling of smaller issues. In table II is shown the proportion of outstanding bonds which were in default in the various years over this period. It will be noted that defaults remained at a fairly low level for an extended period of years up to 1931, after which they began to rise rapidly, reaching a peak of 15.3 percent of all outstanding bonds in 1940, which was over one-seventh of all corporate bonds then outstanding. It should be borne in mind that when a bond held by a life insurance company goes into default it must immediately be written down to market value and experience has shown that this market value may be one-third or less of the former amortized value. It is worth noting that of all industrial bonds outstanding in 1900, or issued in the following 43 years, 15 percent went into default. This may give some idea of the exposure to risk of the very large industrial bondholdings of life insurance companies today.

While common stocks now constitute a small part of life company assets, there is a tendency for these to grow in importance and some life insurance companies have already achieved substantial holdings of these. Under present valuation rules, such stocks must be valued at market values so that the ability of a life insurance company to own them depends very much on whether the company has enough surplus to absorb downward market fluctuations. In the past these downward fluctuations have been substantial, as is shown in table III. This table shows the percentage declines which have taken place in the Dow-Jones Average of 30 industrial stocks during the present century. The largest such decline was from April 1930, to July 1932, of 86 percent, which we can only hope will not be repeated. However, there were seven other occasions since 1900 when this stock average declined from 40 to 50 percent. There were also four periods in the generally prosperous years since World War II in which this average declined from 14 to 25 percent.

In order to provide a cushion against these losses, whether they be sudden catastrophies or a gradual erosion because of inflation or a change in trends, it is necessary for life insurance companies to carry a policyholder protective fund in addition to the statutory reserve.

Some of the factors which determine how large a company's policyholder protective fund should be are:

(1) Size of company.
(2) Interest rate used in computing reserves.
(3) Amount of group and accident and sickness business.
(4) Level of premium rates.
(5) Proportion of participating and nonparticipating insurance.

It seems clear that a large company needs less surplus in relation to its assets than does a small company as fluctuations are likely to be smaller. Table IV shows the ratio of capital and surplus to assets as of December 31, 1957, for 39 mutual and 59 stock companies grouped by size of total assets. It indicates that the ratios drop as the size of the company goes up.

Since a higher rate of interest produces a lower reserve it is obvious that of two companies of similar size and type of operation, the one using the higher rate of interest to compute its reserves will have the smaller reserves and will need to hold the larger surplus. For example, a company with 3½ percent reserves would require more surplus than a company with 2½ percent reserves. Employing the generally accepted formula that a 1 percent higher interest rate produces a 10 percent lower reserve, it may be concluded that the additional surplus needed would be equal to 10 percent of the reserve. Since nonparticipating companies generally use higher interest rates for reserves than participating companies, they require more surplus. Table V indicates that the stock companies have an average valuation rate of 2.980 percent as compared with 2.725 percent for the mutual companies. To take into account this factor alone the stock companies should carry more surplus than the mutual companies, the additional amount being 2.55 percent of the reserves.

With respect to the third point, it is evident that a large surplus is needed because of the catastrophe hazard involved in group insurance. A factor based on a percentage of premium income is most appropriate for this purpose and several States require a special group contingency reserve based on such a formula.

The size of the surplus should undoubtedly be related to the purposes for which it is intended and should vary by company. It is difficult, if not impossible, to find a theoretically exact formula. One based upon past experience might not be appropriate because of changes in operations. For example, a reserve for mortgage loan losses based on those of the thirties might not be applicable today because so many more loans are regularly reduced by monthly amortization and others are guaranteed in full or in part by the Government.

There is considerable merit, however, in examining the ratios of capital and surplus to reserves for the companies during a period when management decisions were not influenced by tax considerations. Table VI shows that in 1928 and again in 1957 when companies had an opportunity to accumulate the capital and surplus needed in the judgment of management that stock companies held amounts equal to 15 to 16 percent of reserves and mutuals maintained 8 to 9 percent. During the depression years these figures dropped, but as rapidly as possible they were restored. For all member companies of the American Life Convention the ratio of capital and surplus to reserves at the end of 1957 was 7.22 percent for mutuals and 14.41 percent for stocks, a difference of slightly over 7 percent.

It should be remembered that many stock companies issue both participating and nonparticipating business. Consequently the 7-percent differential between stock and mutual companies does not represent the full additional amount which is needed for nonparticipating policies. In event of serious loss, a company issuing participating insurance has two ways of recouping its losses. It may reduce dividends to policyholders or it may draw upon surplus. A company which issues only nonparticipating policies, however, must recover all losses from surplus and it is axiomatic that a larger surplus or policyholder protective fund is needed for nonparticipating insurance than for participating policies.

An attempt has been made to determine how much larger the fund should be for nonparticipating business. The first step was to show the historic difference as indicated in table VI. This demonstrates that management, when not influenced by tax considerations, has traditionally believed that at least a 7-percent differential is advisable.

The actual reason for the difference arises from the fact that dividends to policyholders can be reduced under participating policies. It seemed appropriate, therefore, to consider—

(1) the additional margins found in participating premiums as compared with nonparticipating premiums;

(2) the relationship of 1 year's dividends to reserves;

(3) the amounts recovered by a representative group of mutual companies through reduction in dividends during the depression years of the thirties and the war years of the forties.

Table VII compares participating and nonparticipating premiums for a group of representative companies. Various distributions of business by age and year of issue were tried, and the results indicated that nonparticipating premiums are about 15 percent lower than participating rates.

The ratios of 1929 dividends to reserves on December 31, 1928, are shown below for five well-known mutual life insurance companies:

| | Percent |
|---|---|
| Company A | 3.15 |
| Company B | 5.29 |
| Company C | 6.02 |
| Company D | 5.93 |
| Company E | 6.00 |

The actual dividend levels of these five companies, compared with the 1929 dividend scales, are shown in table VIII for the 16-year period ~~1930 to 1945~~. During these years the companies experienced deflated asset values, adverse mortality and disability experience, and a long period of declining interest rates. Consequently, the reductions in dividends were rather severe.

The problem of estimating the present value of the reduction in dividends for these five companies is not an easy one. Two different methods were used. First, an estimate was made on the basis of the reductions in dividends as shown in table VIII. The effect of mortality rates, high depression termination rates, and interest were considered. This procedure indicated that the value of the reduction in dividends on December 31, 1929, for each of the five companies was equivalent to from 1.15 to 2.53 years' dividends based on the 1929 projected scale. Multiplying these factors by the ratios of dividends incurred in 1929 to December 31, 1928, reserves produced ratios averaging 9.1 percent of reserves for these companies.

The second method consisted of evaluating the reducing ratios of dividends paid in each year to the reserves at the beginning of that year. This produced a value on December 31, 1929, of dividend reductions averaging 15.2 percent of reserves on that date.

There are reasons to believe that the first method produces too low a figure and the second too high a ratio, but they indicate the probable range. It might be appropriate to take the mean of 12 percent. This is the amount which should be allowed for nonparticipating policies in addition to any policyholders' protective fund for all ordinary business.

TABLE I.—*Comparison of book and market values*

| Year of issue and purchase | Bond issue | Book value Dec. 31, 1957 | Market value Dec. 31, 1957 |
|---|---|---|---|
| 1940 | Central Maine Power 3¼s 1970 | $103.8 | $93.0 |
| | Detroit Edison 3s 1970 | 103.5 | 95.0 |
| 1941 | Pacific Gas & Electric 3s 1971 | 102.9 | 94.0 |
| 1942 | Florida Power & Light 3¼s 1972 | 103.6 | 90.0 |
| 1943 | Delaware Power & Light 3s 1973 | 103.0 | 88.0 |
| | Iowa Power & Light 3¼s 1973 | 105.0 | 88.0 |
| 1944 | Birmingham Electric 3s 1974 | 100.6 | 82.0 |
| | Central New York Power 3s 1974 | 101.4 | 92.0 |
| 1945 | Buffalo Niagara Electric 2¾s 1975 | 103.2 | 90.0 |
| | Central Illinois Electric & Gas 3s 1975 | 101.7 | 83.0 |
| | Continental Baking 3s 1965 | 101.0 | 93.0 |
| 1946 | American Telephone & Telegraph 2⅝s 1986 | 100.2 | 82.0 |
| | El Paso Electric 2¾s 1976 | 100.0 | 81.0 |
| | Socony Mobile 2½s 1976 | 100.0 | 87.0 |
| | Selected Industries 2¾s 1961 | 100.2 | 91.0 |
| 1947 | American Telephone & Telegraph 2¾s 1982 | 101.6 | 86.0 |
| | Arkansas Power & Light 2⅞s 1977 | 100.4 | 86.0 |
| | International Bank 1972 | 101.1 | 92.0 |
| | R. H. Macy 2⅞s 1972 | 99.1 | 88.0 |
| | May Department Stores 2⅝s 1972 | 100.5 | 84.0 |
| 1948 | Dayton Power & Light 3s 1978 | 100.7 | 90.0 |
| | Michigan Bell Telephone 3⅛s 1988 | 101.6 | 89.0 |
| 1949 | Alabama Gas 3½s 1971 | 100.3 | 85.0 |
| | California Oregon Power 2⅞s 1979 | 102.0 | 84.0 |
| | Food Machinery & Chemical 2⅝s 1969 | 100.5 | 89.0 |
| | Sperry Corp. 3⅛s 1969 | 100.2 | 77.0 |
| 1950 | Appalachian Electric Power 2⅞s 1980 | 102.0 | 85.0 |
| | Atlantic City Electric 2⅞s 1980 | 100.5 | 85.0 |
| | Commonwealth Edison 2⅞s 1999 | 100.2 | 78.0 |
| 1951 | West Texas Utilities 3⅛s 1981 | 102.0 | 94.0 |
| | Tennessee Gas Transmission 3⅛s 1971 | 98.5 | 90.0 |
| | Borden Co. 2⅞s 1981 | 100.0 | 88.0 |
| | International Bank 3s 1976 | 100.0 | 89.0 |
| | Sylvania Electric 3⅛s 1971 | 99.0 | 89.0 |
| 1952 | Cleveland Electric Illuminating 3s 1982 | 100.5 | 87.0 |
| | Pacific Power & Light 3⅝s 1982 | 100.4 | 84.0 |
| | International Bank 3⅛s 1975 | 99.7 | 95.0 |
| 1954 | Columbia Gas Systems 3⅜s 1979 | 101.7 | 95.0 |
| | Pacific Power & Light 3⅛s 1984 | 102.6 | 83.0 |
| | Food Fair Stores 3⅝s 1974 | 100.0 | 85.0 |
| 1955 | U.S. Plywood 3.40s 1980 | 100.0 | 86.0 |
| | Average of 41 issues | 101.0 | 87.7 |

TABLE II.—*Proportion of total corporate bonds outstanding in default*

[Dollar amounts in millions]

| | Total outstanding | Outstanding in default | Percent in default | | Total outstanding | Outstanding in default | Percent in default |
|---|---|---|---|---|---|---|---|
| 1900 | $5,935 | $22 | 0.4 | 1923 | $20,310 | $795 | 3.9 |
| 1901 | 6,814 | 46 | .7 | 1924 | 21,035 | 484 | 2.3 |
| 1902 | 7,826 | 41 | .5 | 1925 | 22,104 | 550 | 2.5 |
| 1903 | 8,633 | 33 | .4 | 1926 | 22,902 | 679 | 3.0 |
| 1904 | 9,325 | 28 | .3 | 1927 | 24,449 | 578 | 2.4 |
| 1905 | 10,087 | 29 | .3 | 1928 | 26,476 | 732 | 2.8 |
| 1906 | 10,874 | 38 | .3 | 1929 | 27,026 | 470 | 1.7 |
| 1907 | 11,795 | 51 | .4 | 1930 | 27,104 | 492 | 1.8 |
| 1908 | 12,594 | 56 | .4 | 1931 | 28,555 | 489 | 1.7 |
| 1909 | 13,417 | 230 | 1.7 | 1932 | 29,014 | 1,175 | 4.0 |
| 1910 | 13,967 | 255 | 1.8 | 1933 | 28,007 | 2,139 | 7.6 |
| 1911 | 14,490 | 274 | 1.9 | 1934 | 27,841 | 3,411 | 12.3 |
| 1912 | 15,303 | 266 | 1.7 | 1935 | 27,246 | 3,505 | 12.9 |
| 1913 | 16,073 | 338 | 2.1 | 1936 | 26,518 | 3,945 | 14.8 |
| 1914 | 16,470 | 397 | 2.4 | 1937 | 26,351 | 3,668 | 13.9 |
| 1915 | 16,942 | 960 | 5.7 | 1938 | 25,407 | 3,490 | 13.7 |
| 1916 | 17,227 | 1,057 | 6.1 | 1939 | 25,883 | 3,842 | 14.8 |
| 1917 | 17,474 | 738 | 4.2 | 1940 | 25,300 | 3,887 | 15.3 |
| 1918 | 17,784 | 539 | 3.0 | 1941 | 24,866 | 3,518 | 14.2 |
| 1919 | 17,859 | 734 | 4.1 | 1942 | 24,047 | 3,205 | 13.3 |
| 1920 | 18,085 | 943 | 5.2 | 1943 | 23,733 | 3,084 | 13.0 |
| 1921 | 18,772 | 974 | 5.2 | 1944 | 22,798 | 2,966 | 13.0 |
| 1922 | 19,696 | 932 | 4.7 | | | | |

TABLE III.—*Major declines in common stock prices as reflected by Dow, Jones average of 30 industrial stocks*

| | Drop in stock prices | Low point of decline |
|---|---|---|
| | *Percent* | |
| June 1901 to November 1903 | −46 | 31 |
| January 1906 to November 1907 | −49 | 39 |
| November 1916 to December 1917 | −40 | 66 |
| November 1919 to August 1921 | −47 | 64 |
| September 1929 to November 1929 | −48 | 195 |
| April 1930 to July 1932 | −86 | 41 |
| March 1937 to March 1938 | −49 | 97 |
| October 1939 to April 1942 | −40 | 93 |
| May 1946 to October 1946 | −23 | 160 |
| June 1948 to June 1949 | −17 | 161 |
| January 1953 to September 1953 | −14 | 254 |
| July 1957 to October 1957 | −19 | 419 |

TABLE IV.—*Ratio of capital and surplus*[1] *to assets for companies grouped by size*

MUTUAL COMPANIES

| Total assets | Number of companies | Average of ratios |
|---|---|---|
| | | *Percent* |
| Less than $0.5 billion | 20 | 7.1 |
| $0.5 to $1 billion | 7 | 6.9 |
| $1 to $5 billion | 7 | 6.4 |
| More than $5 billion | 5 | 6.3 |
| All companies | 39 | 6.8 |

STOCK COMPANIES

| Total assets | Number of companies | Average of ratios |
|---|---|---|
| | | *Percent* |
| Less than $0.1 billion | 27 | 23.9 |
| $0.1 to $0.5 billion | 21 | 13.5 |
| $0.5 to $1 billion | 7 | 9.1 |
| More than $1 billion | 4 | 9.5 |
| All companies | 59 | 17.5 |

[1] Surplus as shown on p. 4, lines 27 and 29, of the annual statement.

TABLE V.—*Average interest rates used for reserves in 1957 by member companies of the American Life Convention*

| | *Percent* |
|---|---|
| Stock companies | 2.980 |
| Mutual companies | 2.725 |
| Difference | .255 |

TABLE VI.—*Average of ratios of capital and surplus to reserves for 10 mutual and 7 stock companies in 1928, 1934, 1938, and 1957*

| | 7 stock companies | 10 mutual companies | Excess of stock over mutual averages |
|---|---|---|---|
| | *Percent* | *Percent* | *Percent* |
| Dec. 31, 1928 | 15.9 | 8.4 | 7.5 |
| Dec. 31, 1934 | [1] 10.3 | 5.9 | 4.4 |
| Dec. 31, 1938 | [1] 8.8 | 5.8 | 3.0 |
| Dec. 31, 1957 | 15.4 | 9.0 | 6.4 |

[1] If capital and contributed surplus paid in by stockholders since 1928 were excluded, the Dec. 31, 1934, average ratio would be 8.8 percent, and the Dec. 31, 1938, ratio would be 7.5 percent.

TABLE VII.—*Ratio of nonparticipating premiums to participating premiums, by year of issue*

[Percent]

| | Year of issue | | | |
|---|---|---|---|---|
| | 1958 | 1948 | 1938 | 1921 |
| Ordinary life: | | | | |
| Age 25 | 77 | 80 | 80 | 82 |
| Age 40 | 81 | 83 | 84 | 84 |
| Age 55 | 84 | 86 | 87 | 86 |
| 20-payment life: | | | | |
| Age 25 | 82 | 83 | 83 | 83 |
| Age 40 | 84 | 85 | 86 | 84 |
| Age 55 | 85 | 88 | 88 | 86 |
| 20-year endowment: | | | | |
| Age 25 | 92 | 92 | 90 | 87 |
| Age 40 | 90 | 90 | 89 | 88 |
| Age 55 | 88 | 88 | 88 | 86 |

NOTE.—The Flitcraft compends for the years indicated were used as the source of the data. The number of different companies entering into the averages ranged from 11 nonparticipating companies in 1921 to 61 participating companies in 1948. Where the rate was based on size of policy, $5,000 was used.

TABLE VIII.—*Dividend levels 1930–45 for 5 companies compared with 1929 dividend scale*

RATIOS TO 1929 DIVIDEND SCALE

[Percent]

| Year | Company A | Company B | Company C | Company D | Company E |
|---|---|---|---|---|---|
| 1930 | 100 | 100 | 100 | 100 | 100 |
| 1931 | 100 | 100 | 96 | 100 | 100 |
| 1932 | 75 | 96 | 88 | 98 | 100 |
| 1933 | 72 | 72 | 72 | 86 | 95 |
| 1934 | 69 | 60 | 67 | 85 | 73 |
| 1935 | 34 | 60 | 67 | 83 | 84 |
| 1936 | 38 | 60 | 60 | 75 | 84 |
| 1937 | 38 | 62 | 70 | 76 | 70 |
| 1938 | 49 | 62 | 65 | 76 | 74 |
| 1939 | 55 | 62 | 47 | 77 | 74 |
| 1940 | 55 | 62 | 52 | 76 | 74 |
| 1941 | 55 | 62 | 44 | 77 | 80 |
| 1942 | 46 | 61 | 44 | 60 | 80 |
| 1943 | 46 | 61 | 44 | 60 | 80 |
| 1944 | 46 | 61 | 44 | 60 | 79 |
| 1945 | 46 | 61 | 50 | 60 | 79 |

PRESENT VALUE OF DIVIDEND REDUCTIONS DECEMBER 31, 1929

| Company | Equivalent number of years of dividends on 1929 scale | | Ratio of 1929 dividends to December 1928 reserves | Equivalent percent of Dec. 31, 1929, reserve | |
|---|---|---|---|---|---|
| | Low estimate | High estimate | | Low estimate | High estimate |
| | | | *Percent* | *Percent* | *Percent* |
| A | 2.53 | 2.92 | 3.15 | 8.0 | 9.2 |
| B | 1.91 | 2.86 | 5.29 | 10.1 | 15.1 |
| C | 2.20 | 3.22 | 6.02 | 13.2 | 19.4 |
| D | 1.23 | 3.42 | 5.93 | 7.3 | 20.3 |
| E | 1.15 | 1.99 | 6.09 | 7.0 | 12.1 |
| Average | | | | 9.1 | 15.2 |

Mr. TAYLOR. As a matter of fact it seems to me that phase 2 still does not do full justice in one respect: the limitations upon the deductibility of interest exempt from taxation and upon the intercorporate dividend credit. The reason for these limitations is to prevent double deductions, the theory being that a deduction having been allowed for the policy reserve interest, whether invested in tax-exempt securities or not, deduction under phase 2 would constitute a second deduction. This is a confusing question and probably boils down to a question of interpretation of meanings. So far as tax-exempt interest is concerned, there seems to be a constitutional question involved and I understand others who are competent to discuss such questions will go into that side of the question.

The practical side of the question seems to me this: As H.R. 4245 is written a life insurance company in deciding whether or not to buy tax-exempt securities or stocks instead of taxable securities, faces a different set of figures than a bank or other type corporation. A bank asks itself: Shall we buy a corporate bond which after tax will net us 48 cents on the dollar of interest, or shall we buy a lower yielding municipal bond which will net us 100 cents on the dollar of interest?

The life insurance company, on the other hand, once it has investments that produce interest to the point of its policy reserve interest deduction, asks itself a different question: Shall we buy the corporate bond on which the net return is 48 cents on the dollar, or a lower yielding tax-exempt security when, after taxes, the interest income is reduced to something like 65 cents on the dollar?

Another way of looking at the problem is that there are only so many tax-exempt securities to be had. If these are all bought by individuals or by corporations to whom they are wholly exempt, none of the income produces revenues to the Government. If some are bought by life insurance companies that is not true.

Still another way of looking at the question is to consider whether or not a bank which pays interest on savings deposits is any more entitled to deduct in full its tax-exempt interest than a life insurance company which has policyholders' reserve interest item to be met.

It does not seem to me that the same treatment on tax-exempt interterest and interincorporate dividend credits is given the life insurance business by H.R. 4245 as is given other corporations by other sections of the law, and I respectfully urge that you give it further consideration and grant equality of treatment.

My final point has to do with the very large increase in taxes which will be imposed upon many companies under H.R. 4245 on their 1958 business.

We believe a thrift institution such as ours should be encouraged. We hope you may see fit to reduce somewhat the tax take. Also it would be very helpful if there was a transition period such as is suggested in the letter of the Secretary of the Treasury of April 10, 1958.

Thank you very much for permitting me to express these views.

The CHAIRMAN. Thank you very much.

Senator Frear.

Senator FREAR. No questions.

The CHAIRMAN. Senator Carlson.

Senator Douglas, do you have any questions?

Senator Butler.

Senator BUTLER. Mr. Taylor, I have a comparative table before me which I would like to make a part of the record at this time reflecting the actual figures of the Monumental Life Insurance Co. in Baltimore City, in connection with the question you have raised in your statement.

I would like you to refer to that. I think it very well illustrates your point.

The taxable income of this company which has, I think, 3 or 3.5 percent of its investment portfolio in tax-exempt securities, under the House bill would pay a tax of $1,280,000, and a company having no tax exempts would pay a tax of $1,329,000, and this company actually, with the full allowance of tax-exempt interest and dividend credit, would pay but $1,096,000, which I think emphasises the point you have made.

Mr. TAYLOR. That is exactly the point I was trying to make, and I am delighted you have put it in the form of figures which illustrate the point.

Senator BUTLER. Yes, I think it would be a good illustration of the point you have made, and I would like to put it in the record at this point, if the chairman would permit it.

Mr. TAYLOR. It would be very nice, as far as I am concerned.

The CHAIRMAN. The insertion will be made.

(The tabulation referred to follows:)

*Monumental Life Insurance Co.—Tax computations based on estimates for year 1958*

[In thousands]

| | H.R. 4245 | H.R. 4245 assumption: Company not having tax free bonds or stocks | Assumption: full allowance for tax free and dividend credit |
|---|---|---|---|
| Phase 1: | | | |
| 1. Net investment income | $7,572 | $7,572 | $7,572 |
| Deductions: | | | |
| 2. Tax free interest | 301 | ............ | 301 |
| 3. 85 percent dividend credit | 147 | ............ | 147 |
| Total | 448 | ............ | 448 |
| 4. Adjustment (portion of items 2 and 3 not allowed) | 364 | ............ | ............ |
| Total | 84 | ............ | ............ |
| 5. Small business deduction | 25 | 25 | 25 |
| 6. Interest required (formula) | 6,075 | 6,075 | 6,075 |
| 7. Interest paid | 39 | 39 | 39 |
| Total | 6,223 | 6,139 | 6,587 |
| 8. Taxable investment income | 1,349 | 1,433 | 985 |
| Phase 2: | | | |
| 9. Premiums | 29,827 | 29,827 | 29,827 |
| 10. Net investment income | 7,572 | 7,572 | 7,572 |
| 11. Less tax free and dividend credit | 448 | ............ | 448 |
| Total | 7,124 | ............ | 7,124 |
| 12. Plus adjustment (portion of item 11 not allowed) | 349 | ............ | ............ |
| Subtotal | 7,473 | ............ | ............ |
| Total | 37,300 | 37,399 | 36,951 |
| 13. Less various deductions | 33,700 | 33,700 | 33,700 |
| 14. Gain | 3,600 | 3,699 | 3,251 |
| 15. Less taxable investment income | 1,349 | 1,433 | 985 |
| 16. Total | 2,251 | 2,266 | 2,266 |
| 17. ½ of item 16 | 1,126 | 1,133 | 1,133 |
| 18. Plus taxable investment income | 1,349 | 1,433 | 985 |
| Total | 2,475 | 2,566 | 2,118 |
| Tax | 1,282 | 1,329 | 1,096 |

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Taylor, in your statement you speak of a subject which has troubled me no end. You say, "We must have substantial equality with the mutual companies."

Would you please explain to me what you mean by "substantial equality"?

Mr. TAYLOR. Yes, sir; I will try to.

It seems to me in our type of life insurance, the type of life insurance we sell, the guaranteed cost nonparticipating insurance is to survive that up to a point at least the tax treatment for Federal income taxes of mutual companies and stock companies must be identical, if the latter companies are to survive.

Senator GORE. Must be what?

Mr. TAYLOR. Identical, not in dollars but in the formula applied.

Senator GORE. Now, phase 1 does that, is that correct?

Mr. TAYLOR. Phase 1, as written in this bill, does that.

I think that is point 1 that appears to me as making H.R. 4245 a good bill.

Senator GORE. Although you are suggesting changes?

Mr. TAYLOR. I am suggesting a couple of changes; yes, sir.

Senator GORE. Which would have the effect about which I questioned Mr. Guest?

Mr. TAYLOR. You mean of reducing——

Senataor GORE. Of increasing the deduction.

Mr. TAYLOR. Yes, sir; and while you were questioning Mr. Guest, I was very much afraid you might ask me the same thing. [Laughter.]

Senator GORE. We will just skip over that one.

Mr. TAYLOR. All right; if you don't want to go into it, I won't.

Senator GORE. All right. Let's presume for the sake of our discussion of this phrase you use here that phase 1 does treat mutual and stock companies alike. You say up to a point the taxes should be identical.

Mr. TAYLOR. That is right.

Senator GORE. All right.

Mr. TAYLOR. And that point is phase 1. All the investment income of a mutual company and a stock company is taxed exactly alike under phase 1, and I like it.

Senator GORE. All right.

Will you proceed to explain what you mean beyond that by "substantial equality" up to where you said they are treated equally?

Mr. TAYLOR. Frankly that, so far as I am concerned, answers the question. There are some people who believe that phase 2 gives them a competitive advantage. If there is any, I believe it is so small it can be ignored.

I think phase 1, as written, without any carryback of losses due to the payment of policyholders' dividends, gives the nonparticipating insurance companies the protection they need—phase 1, as written.

Senator GORE. I am sure you mean more than that by this term "substantial equality," and I will ask you——

Mr. TAYLOR. Actually, all we are asking is don't put them in a position where they can underprice us through a tax advantage; that is all we are asking for.

Senator GORE. I want to ask you a question, and I am troubled about it, and I am soliciting help here. I am not trying to be mean with you in any respect whatsoever; I hope I never will be.

I have had the suggestion made to me many times that if stock companies are taxed on their actual net earnings and the mutuals are allowed to make deductions to policyholders the stock companies will not be able to survive. The statement made has not been in those identical words, but that seems to have been the meaning of many statements I have heard.

The thing that has troubled me is this: I don't quite see how taxation on net profits earned puts anybody out of business or could put anybody out of business.

Mr. TAYLOR. I would agree with that, sir, except for the peculiarity of the mutual companies, if you are talking about the investment income.

We, in our premium rates, must pay a 52-percent tax on all or a part of the investment income we earn, and we cannot compete with the mutual companies if they are not also required to pay a tax on that same investment income.

As to expenses and mortality, that is another thing.

Senator GORE. We assume, for the sake of our discussion here, that investment income is treated alike.

Mr. TAYLOR. Yes, sir.

Senator GORE. Now let's go to gains from operations.

Mr. TAYLOR. Yes; other than investment income.

Senator GORE. Other than investment income.

Explain to me what you mean by "substantial equality."

Mr. TAYLOR. Senator, I think you must be quoting somebody else and not me, because the substantial equality I seek is there in phase 1; that is all I am asking for, maintain that.

Senator GORE. I am not sure that is all you mean.

Mr. TAYLOR. Maybe I ought to be asking for more. [Laughter.]

Senator GORE. I am sure that is not all that some of my friends mean.

Mr. TAYLOR. I have told you some of my friends do not agree with my stand on this. And I am speaking for myself.

Senator GORE. I imagine there is wide disagreement among insurance men themselves on this bill.

Mr. TAYLOR. I am sure of that, Senator.

Senator GORE. Do you mean in any way that the stock companies should be permitted to retain as untaxed profits an amount roughly comparable to the premium dividends paid by the mutual companies?

Mr. TAYLOR. Senator, you are right.

Senator GORE. Distributed.

Mr. TAYLOR. I wrote this thing last Sunday, and when I was visiting in Atlanta, Ga., and I believe something was left out here.

I thank you very much. There is a provision——

Senator GORE. Then you do mean something else?

Mr. TAYLOR. Yes, sir. There is a provision in phase 2 which I mentioned for the deduction of 10 percent of the increase in the reserve on nonparticipating business which I do think is quite correct, and it is on that point that this addendum covers the need for that.

I do think in that respect, yes, in phase 2, we do need very definitely different treatment from the mutual companies in that respect.

Senator GORE. I thought you did.

Mr. TAYLOR. I am nervous, Senator. Excuse me for forgetting that.

Senator GORE. I assure you I have no desire whatsoever to create any competitive disadvantage for a privately owned company. In my private life I am a businessman and I try to make ends meet.

Mr. TAYLOR. Yes, sir.

Senator GORE. And thus far I am a little ahead of the hounds. I have no desire whatsoever to create a disadvantage for private stock companies in this case.

But I do not understand why it is necessary to give to a stock company a portion of its profits tax-free because a mutual refunds a corresponding amount to the policyholder. I don't know why it would discriminate unfairly against a stock company to require it to pay tax on its total net profits.

Mr. TAYLOR. Senator, I would agree with you if we knew exactly what those total net profits are. They are very difficult to ascertain in the life insurance business.

Senator GORE. I agree with you.

Mr. TAYLOR. Actuarial calculations are crude at best, and I am an old actuary, but most people think we know exactly what they should be. Actually, we make the crudest sort of estimates.

So all we are asking is that in making those estimates reasonable leeway be left so that we can have about the same thing as the mutual company has in its large premium, the dividend on which can be reduced in times of calamity. We don't have any such thing. We need to have a little money tucked aside for that purpose.

Senator GORE. But, Mr. Taylor, you are asking for more than that.

Mr. TAYLOR. Are we?

Senator GORE. This bill provides for more than that. I agree with you that your liabilities cannot be determined with exactness, and I am willing to permit a liberal reserve. I am willing to provide a reasonable deferral of a portion of the taxes. But I don't know why we should permit a private corporation to expand on tax-free profits in perpetuity.

Mr. TAYLOR. I am not asking for that, sir, I hope.

Senator GORE. You think, then, there should be a reasonable termination date of the deferral?

Mr. TAYLOR. No actual termination date, but we life insurance companies contemplate being in business forever, actually.

Senator GORE. I know you do, and it is contemplated that taxes will be deferred forever on a portion of the net earnings, and I think there should be a termination date.

Mr. TAYLOR. As a practical matter, there may well be. If the life insurance business ever grows up to the point where we stop growing, where our new business written is just enough to cover the old business that goes off the books, where our reserves are no longer increasing, then, of course, there will be no increase in reserves to add to that fund. Such funds as have been set up in past years would still be there as long as we have that same number of policyholders to protect.

So I think there is a practical termination date and, of course, if we do start downhill or liquidate, then the reserve would be taken down.

Senator GORE. Well, you have been very patient and generous, and I thank you.

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

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Mr. Taylor, you have spoken of the difficulty of determining what your future mortality rate will be, and hence the charges as [reserves for] policyholders.

Mr. TAYLOR. Yes, sir.

Senator DOUGLAS. May I ask this question?

Don't you have already a tremendous safety factor and, indeed, a source of gain in the fact that you use a standard mortality table based in the main on the mortality rates of the 1930's?

Mr. TAYLOR. Senator, there is more misunderstanding on that feature than——

Senator DOUGLAS. Let's try to clear up some of the misunderstandings.

Mr. TAYLOR. I will try to go back to my actual mortality——

Senator DOUGLAS. What is the standard mortality table you do use?

Mr. TAYLOR. We are using for reserve purposes the CSO table based on the experience of the life insurance companies in the 1930's, that is for setting up policy reserves.

Senator DOUGLAS. Yes.

Mr. TAYLOR. We stock companies, in calculating our premiums, use our own experience—those of us who are large enough to have that—and in my own company it is a very recent experience. We are using the experiences of the Life Insurance Co. of Virginia from 1950 to 1955 for the computation of our premiums. That is the mortality element in what we charge the public.

Now, when we come to setting up our statement reserves—and it makes far less difference than most people think what mortality table you use—we do use the older table.

Practically, I guess if we used right-up-to-date mortality tables for reserve purposes our reserves would not be decreased; they would be slightly increased. That was the effect the last time we did that.

Senator DOUGLAS. Then you do, for reserve purposes, use the mortality tables of the 1930's?

Mr. TAYLOR. Yes, sir.

Senator DOUGLAS. Is it not true that since 1930 there has been a decrease in the mortality rate and an increase in the average expectation of life?

Mr. TAYLOR. Very definitely; yes, sir.

Senator DOUGLAS. That means your reserves are more than ample.

Mr. TAYLOR. No, sir; no, sir. Actually, as I just said, when we last modernized policy reserve mortality tables the net effect was to increase reserves, not to decrease them. That is a misunderstood subject.

Senator DOUGLAS. I would merely like to have you explain that in more detail, how a decrease in mortality causes you to increase the reserves. This is a mystery to me.

Mr. TAYLOR. Senator, I was a member of the committee back in—close to 20 years ago now—that represented the various States in modernizing the mortality standard for reserve purposes. A report——

Senator DOUGLAS. At that time what mortality table did you use?

Mr. TAYLOR. We brought out this one we are now using, the CSO.

Senator DOUGLAS. What had been the previous mortality table?

Mr. TAYLOR. The old American Experience.

Senator DOUGLAS. What had that been based on?

Mr. TAYLOR. 1860 or——

Senator DOUGLAS. 1867, isn't that true? I congratulate the insurance industry in correcting the 1867 figures and coming up to the 1930's, and the accumulation of a large portion of reserves in insurance companies has been due to that factor, but now you are 20 years behind the times.

Mr. TAYLOR. And they are being modernized again, I think, right now; but I don't think it is going to reduce the amount of reserves.

You see, under the reserve system we use in this country, and it is not like everybody else in the world, we are on what is known at a net level valuation system, net premium valuation system.

The fact that you use a mortality table of much higher death rates, on the one side, our reserve can be looked at as the present value of your life insurance. How much it takes to pay all of your policies, if you get no more premiums, just discount for interest.

On the other hand, you take off the premiums you expect to receive. Under our system you have a reduction on the present value of the insurance side which is quite substantial, but to a large degree there is just as much, and sometimes more, reduction on the other side, of the premiums you expect to receive, and the difference between the two, which constitutes your reserves, goes down more often than it goes up.

If you look at a single premium policy only, all premiums paid, that is not true. The lower the mortality generally the higher the reserve, but on the average when we have modernized reserve tables, company reserves have not been decreased by that factor.

This report that I was referring to, if you would like, sir, I think I have a copy in my office, I will lend it to you, and I believe that explains it better than I can do right here.

Senator DOUGLAS. Mr. Chairman, I do not mean to be sarcastic but I do not understand how this can be true.

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

Mr. TAYLOR. Thank you, gentlemen.

The CHAIRMAN. The next witness is Mr. Edward J. Schmuck, Acacia Mutual Life Insurance Co.

## STATEMENT OF EDWARD J. SCHMUCK, VICE PRESIDENT AND GENERAL COUNSEL, ACACIA MUTUAL LIFE INSURANCE CO.; ACCOMPANIED BY LLOYD K. CRIPPEN, VICE PRESIDENT AND ACTUARY; AND WILLIAM SIMPSON, SECOND VICE PRESIDENT AND ASSOCIATE ACTUARY, ACACIA MUTUAL LIFE INSURANCE CO.

Mr. SCHMUCK. My name is Edward J. Schmuck. I am vice president and general counsel of the Acacia Mutual Life Insurance Co. I would like to associate with myself in this testimony Mr. Lloyd K. Crippen, vice president and actuary of our company, and Mr. William Simpson, second vice president and associate actuary. From the nature of the questions that have been asked, I think technical assistance is going to be indicated.

Acacia supports the basic principles, the structure, and most of the detailed provisions of H.R. 4245. Subject to your committee's possible modification of some specific aspects of the tax formula prescribed, we urge strongly that your committee report H.R. 4245 favorably for adoption by the Senate. With equal vigor, we are opposed to the 1942 formula as the effective method for the taxation of life insurance companies, either permanently or even on a 1-year temporary basis.

In our opinion, H.R. 4245, in general, is a good law. It is not possible in the time allotted by your committee either to discuss each essential element of the bill or to marshal each argument in its support. Nor, in fact, would this appear necessary or perhaps even appropriate in view of the excellent report and analysis on the bill prepared by the Committee on Ways and Means, and the extremely able and informative discussion of the bill by Hon. Wilbur D. Mills, distinguished chairman of the Ways and Means Committee, and a number of his committee colleagues, when the bill was considered by the House of Representatives.

Two sound and desirable basic changes distinguish H.R. 4245 from all formulas for the taxation of life insurance companies which have been effective since 1921:

1. The tax of each company under each phase of the prescribed formula is based essentially on the individual company's own operating experience.

2. Sources of taxable income of life insurance companies have been expanded to include not only taxable investment income but also a substantial portion of the other operating gains of the individual companies. Capital gains are also subject to tax.

In the remainder of the statement we will cover two points, why and how we believe phase 1 should be amended, and why we believe that the 1942 formula should not be, or remain, effective as the tax method even for a single year.

H.R. 4245 is an implementation, to a considerable degree, of the company-by-company approach to the taxation of life insurance companies. In phase 1 it discards the unsound concept of previous formulas which determined taxable investment income of the individual life insurance company on the basis of a uniform average or arbitrary deduction for interest required to maintain policy reserves. Through its basic technique of revaluation of reserves, the proposed phase 1 formula establishes, on the basis of each company's operating experience, a relationship among the company's earned interest rate, reserve interest requirement, and surplus accumulation. While the phase 1 formula still gives some effect to the company's assumed interest rate in that it provides that the company's deduction rate shall be the mean between the company's earned interest rate and its assumed interest rate, the method proposed minimizes appreciably the effect of the individual company's interest rate assumptions.

Further, H.R. 4245 provides that if the company's assumed interest rate is lower than the average assumed rate for the industry, the latter may be substituted in calculating the deduction rate. To this extent, the principle of industrywide averaging is retained in the pending bill. However, because the companies with higher than average assumed interest rates are permitted to use their own required rates in the calculation, the adverse and discriminatory effects upon these companies of the previous averaging methods is materially reduced. Because H.R. 4245 provides for so many improvements over previous tax legislation we are in favor of it, even though some industrywide averaging remains in the bill. Nevertheless, we join in the suggestion to your committee that it would be desirable to entirely eliminate the assumed interest rate from the phase 1 formula.

The original conception of determining the taxable investment income of a life insurance company by revaluing its reserves was based upon using the company's earned interest rate in both the reserve revaluation and the calculation of deductible interest required for reserves. This placed the emphasis upon the company's demonstrated capacity to earn interest to fulfill its contract requirements. The rate of interest which the company, or the industry, elected to assume as the basis of minimum contract guarantees would be entirely subordinated to the actual earned interest rate. Largely, it appears, because direct application of this method would not have produced a desired total amount of tax revenue, the deduction formula in phase 1 of H.R. 4245 was devised, using the mean of the earned interest and assumed interest rates as the deduction rate.

One major effect of this formula is that, according to the latest calculation of Life Insurance Association of America, H.R. 4245 will produce a total amount of taxes in the area of $558 million, substantially in excess of the apparent target of $500 million of tax revenues. This $558 million tax represents an increase of about 90 percent over the total tax payable for the taxable year 1957. It represents an excess of $58 million, more than 10 percent over the amount of tax objective set up by the Treasury and in the proposed budget. Approximately $519 million of this total tax is developed under phase 1 of the bill. Thus phase 1 alone would produce about $19 million more than the total amount of tax which is the apparent objective of the Treasury, and phase 1 alone would provide a tax which would be 77 percent greater than the total tax for 1957. Therefore, we urge an amendment of the phase 1 formula which will take practical account of the apparent demand for aggregate taxes of $500 million to be paid by the industry, and also give maximum weight to the original concept that the revaluation of reserves and calculation of the required interest deduction should be based on each company's earned interest rate. The proposed amendment is that, instead of using the mean of the company's earned rate and assumed rate for the taxable year, each company will adjust its reserves and compute its deduction on the basis of its average earned interest rate for the taxable year and the preceding 4 years. This proposed amendment would be technically simple to make and would have the effect of:

1. Reducing the tax on policyholder savings to a more equitable and more reasonable level.

2. Giving recognition to the supplemental views expressed by members of the Committee on Ways and Means in Report No. 34 on H.R. 4245 in which serious question is raised as to whether the impact of the bill, as it stands, would be too great an economic burden upon the life insurance industry.

3. Determining the tax solely according to the actual investment earnings rate of each company—an ascertainable fact—not influenced by management assumptions or by industry averages.

4. Removing from the law the last vestige of an industry average in determining taxable investment income.

5. Average the company's earnings rate over a 5-year period thus providing a leveling effect and avoiding accidental variations that might occur if a single year's earned rate were used in the formula.

We urge this proposed modification of phase 1 of the formula and respectfully request your committee's careful consideration of it.

We would like to turn to the 1942 law.

Various arguments have been advanced and will be advanced in favor of the 1942 tax formula in preference to the pending bill. The 1942 tax law is a bad law in principle and in result. It should not be resurrected even for 1 year. It failed to produce any income tax in 1947 and 1948 and as a result was abandoned by Congress for the tax year 1949 and later tax years. While technically it has remained on the books, actually it has been superseded year by year by temporary stopgap measures. The 1942 tax law is bad because it is incomplete and inadequate in reaching all sources of income of a life insurance company; it is unfair and discriminatory in the distribution of tax among life insurance companies; it is arbitrary and artificial in its formula.

The 1942 law is incomplete and inadequate because it imposes taxes only on the basis of the investment income of a life insurance company. It does not reach all sources of a company's actual gains from operations. As a result, it is unfair and discriminatory in the distribution of the taxload among life insurance companies. Under this law, we would have, on one hand, the extreme case of some companies being forced to pay income taxes when they actually had losses from operation and, on the other hand, the extreme case of other companies, engaged primarily in short-term business, going off almost scot-free, paying an income tax which would be less in some instances than 1 percent of their total gains from operations.

The 1942 formula is arbitrary and artificial being based partly on the average assumed rate of interest for the whole industry, for the year preceding the taxable year, and partly on an arbitrary and artificially established deduction rate of 3.25 percent which has no connection with actual experience.

Any formula based on averaging and which disregards the individual company's operating results, as does the 1942 formula, is extremely erratic in its impact among the companies. Obviously, under an averaging formula some companies will pay more than they should, others less. Even though the 1955 formula contained a number of improvements over the 1942 formula, being basically an averaging formula, it produced discriminatory results which illustrate the inherent inequity of any averaging formula. In the case of Acacia, Federal income taxes paid under the 1955 formula in the years 1955 through 1957, amounted in the aggregate to 42 percent of the funds available for addition to surplus after dividends to policyholders. The corresponding ratio for the industry, as a whole, for the same period was 25 percent. In the year 1957, 69 percent of Acacia's available net gains were paid in Federal income taxes, whereas for the industry, as a whole, the ratio was only 27 percent. These essential inequities would be increased under the 1942 formula.

It may be argued that H.R. 4245 is discriminatory because it will change the impact of taxation among the companies and because it will substantially increase the taxes of some companies. Obviously, if the starting point of such a comparison, the previous investment income tax formulas based on industry-wide averages, effected a distorted and discriminatory distribution of the tax burden among the companies, as they have, any move in the direction of correcting and enlarging the tax base will change the relative tax impact upon the individual companies. Certainly, the desires of some companies to perpetuate for themselves the highly preferential characteristics of the previous tax formulas is no sound reason for rejecting the substantial improvements in tax method incorporated into H.R. 4245. Furthermore, the fact that H.R. 4245 reaches out to tax gains other than from investment income is realistic even though it will result in some companies paying higher taxes than heretofore. It gives recognition to the marked change in the composition of the life insurance business since the investment income approach was first developed in 1921. During the period between 1921 and the present date there has been a tremendous increase in the sale of term insurance of various kinds, none of which are productive of a substantial amount of investment income. H.R. 4245 reaches the substantial underwriting gains flowing from such term business. To urge that no part of these gains should be taxed is to evade the realities of the securities market, cash and stock dividends paid to the stockholders of stock life insurance companies, stock splits, and the massive accumulations of surplus, a large percentage of which has inured or will inure to the personal benefit of shareholders.

In the words of Congressman Mills:

> The situation demands that the Congress open it eyes to the facts in this industry and assess the ability to pay the tax of the various companies on the basis of their total operations and not on merely a part of the total.

For these and other reasons which time does not permit us to cover, we respectfully submit for the consideration of your committee:

1. That H.R. 4245 basically is a good and sound law.
2. That there is valid reason for amending phase 1 of the bill by substituting the average earned interest rate of each individual company, over the last 5 years, for the mean between that company's earned interest rate and assumed interest rate for that taxable year.
3. That the 1942 formula should not be the effective tax law for life insurance companies, even for the single taxable year 1958.

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

Senator Kerr.

Senator KERR. No questions.

The CHAIRMAN. Senator Butler.

Senator BUTLER. No questions.

The CHAIRMAN. Thank you very much indeed, sir.

The next witness is Mr. Dennis Warters, Bankers Life Co.

Will you proceed, sir.

## STATEMENT OF D. N. WARTERS, PRESIDENT, BANKERS LIFE CO., DES MOINES, IOWA; ACCOMPANIED BY WILLIAM RAE, ACTUARY

Mr. WARTERS. Gentlemen, my name is D. N. Warters, president of the Bankers Life Co. of Des Moines. Bankers Life Co. of Des Moines, Iowa, is a midwestern, middle-of-the-road, mutual legal reserve life insurance company with approximately 1,200,000 policyholders and insureds. While I am a fellow of the Society of Actuaries, I am testifying here from the viewpoint of one working in the broad management area. I am accompanied by one of the actuaries of my company, Mr. William Rae, and I hope you will allow him to help me in answering any questions.

In its present form H.R. 4245 imposes too heavy a burden on the life insurance policyholders and their savings. However, I do support the general pattern of the bill with use of the 5-year average interest rate in phase 1 and some credit for dividends paid participating policyholders in allowing negatives in phase 2. As others are testifying in detail on these points, I will confine my testimony to those parts of the bill affecting insured pension plans. This is an area of paramount importance to the Bankers Life Co. as of our $900 million of assets, approximately $250 million belong to pension funds.

We are very glad that the unfair income tax discrimination against insured pension plans has been recognized in H.R. 4245. Unfortunately, the language in the bill does not entirely accomplish the task which I believe was intended (see table A, sec. 3). Some amendments are necessary in order to place the insured pension plan in an equivalent tax position to the self-insured plan and thus avoid the discrimination which now bears heavily on both employees and employers who insure their plans. A number of letters on this subject from employers and others appear on pages 471 and following in the report of the hearing before the subcommittee of the House Ways and Means Committee in November, 1958.

In my testimony, I will—

(1) summarize the reasons why tax discrimination between insured and self-insured pension plans should be removed;

(2) suggest amendments to H.R. 4245 which will make it more completely accomplish this purpose;

(3) answer some objections.

1. Reasons why income on pension funds in the hands of life insurance companies should be excluded from the taxes imposed under H.R. 4245:

(*a*) Trustee banks and trust companies pay no income tax on the income on the funds of self-insured plans placed with them. In so exempting this income, the Congress wisely recognized the social desirability of private pension plans as a supplement to retirement benefits under the social security law.

(*b*) It has never been your policy to discriminate in favor of one competitor against another. There have been many indications that it was the intention of Congress to exempt from income tax the income on insured pension plans just as it is exempt on self-insured plans. This action has been postponed because it was thought best to make it part of the permanent tax bill for life insurance companies when that could be enacted. Discrimination against the insured pension plan was recognized in 1955 and partly corrected in H.R. 7201 passed by the House at that time. Unfortunately, the inequity was not removed as the Senate eliminated this section of the bill stating that it was without prejudice but due to lack of time for hearings.

(*c*) During the period in which insured plans have operated under this discrimination, it has been amply proved that the insured pension plan cannot compete with the self-insured plan and carry this tax burden. Even under the so-called stopgap law in effect in 1957, the income tax paid by an insurance company on funds of an insured pension plan increased the cost of the insured plan by from 6 to 8 percent (see table A, sec. 1). Banks, trust companies, and others interested in handling the funds for and administering self-insured plans have widely advertised this tax cost differential as an important reason why their services should be preferred. Some of the material they use was included in the testimony of Carrol Shanks, president of the Prudential of New Jersey, before the subcommittee of the Ways and Means Committee in December 1954, and is shown on page 320 of the report of those hearings.

More and more of the pension funds are going into self-insured plans. In 1950, insured and trusteed plans shared the field on roughly a 50–50 basis in terms of total funds held. Today the ratio stands at about 40–60 against the pension plans of life insurance companies. I attach table B giving detailed figures. This shift to trusteed plans did not arise solely because of the establishment of new pension plans. The life insurance companies are today losing a substantial part of their existing business to trusteed operations of banks and trust companies. This is well documented in the statement of Robert L. Hogg, vice chairman of the board of the Equitable Life Assurance Society of the United States, before the subcommittee of the committee on Ways and Means on November 17–20, 1958, and appearing on pages 278 and 279 of the report of those hearings.

(*d*) H.R. 4245 materially increases the tax on life insurance companies. Without the partial relief included in that bill for insured pension plans, the tax on insured pension plans would make those plans cost from 9 to 20 percent more than self-insured plans (see table A, sec. 2). Very evidently, if we have been unable to compete with a 6 to 8 percent differential in cost (see table A, sec. 1), there would be no chance with a 9 to 20 percent differential. The net result of such a differential would be an increasing transfer of funds from insured plans to self-insured plans to avoid the tax.

(*e*) The small businessman is a major sufferer from any tax on insured pension plans as it increases his cost above that of the large employer who can self-insure. John A. Gosnell, of the National Small Businessmen's Association, testified in this regard last November before the subcommittee of the Ways and Means Committee. Self-insurance involves heavy risks and costs for the small business. Under a self-insured plan, the employer is solely responsible for the successful operation of the plan. The small business has neither a sufficient number of lives nor a large enough fund to permit the law of averages to operate. The officers are less likely to have the time and talent available to devote to the management of the self-insured plan. From the point of view of the employees, there is less assurance that the small business will be in existence through all of the years in which pension payments may have to be made.

2. May I suggest amendments to eliminate the remaining discrimination in H.R. 4245 against insured pension plans as compared with self-insured pension plans?

(*a*) In addition to excluding the investment income on pension reserves, in phase 1 of H.R. 4245, exclude the investment income on the other funds of the company insofar as they are a part of pension funds. H.R. 4245 overlooks the fact that pension funds in the hands of insurance companies are represented not only by reserves but by other liability items for pension funds (for example, due and unpaid pension payments, dividend earnings yet to be paid, incurred and unpaid taxes, and so forth, and part of the mandatory security valuation reserve), and that part of the so-called surplus of the company arising out of and held for the protection of pension funds. I included the so-called surplus because the pension reserve held in a life insurance company is calculated on the basis of certain interest, mortality, and expense assumptions and the further assumption that assets will eventually be liquidated for the full value for which they are carried on the books. The so-called surplus is carried as an additional reserve to protect against any experience adverse to the assumptions which have been used and to further insure that the contracts will be fully carried out in the long distant future in accordance with their terms.

Thus, the pension fund in the insurance company is in several parts and income on each part should be excluded from tax. Some may feel that to determine the exact amount of pension funds held by a company in addition to reserves is not justified. In that event I suggest that we use the conservative assumption that of the pension funds held by life insurance companies at least 6 percent represents funds other than reserves.

In most companies, the nonreserve sums in the balance sheet arising from pension funds are much greater than 6 percent. In my company, the figure in 1958 is 8.4 percent. I have not available to me similar figures for the industry as a whole. However, figures that are available show that nonreserve liabilities plus surplus for all lines of business combined (this includes pensions) are 14.6 percent of assets. The industry figure for pensions may be somewhat smaller but certainly well above the 6 percent I am suggesting as an allowance. Others undoubtedly feel much more is fully justified.

(*b*) While H.R. 4245 makes partial provision for the elimination of pension funds in phase 1 (subpart B) that elimination is not carried into phase 2 (subpart C). The result is that even with the amendment I have just suggested in (*a*) above, a large part of the exclusion may be lost to the company through the operation of phase 2. Assuming the amendment I have suggested in phase 1 is accepted the tax base left in phase 2 is the current year's addition to so-called surplus insofar as it arises from pension business. This again results in a discriminatory tax compared to the treatment given a self-insured pension fund and I urge you to eliminate it. This can be done by actually excluding from the tax base in phase 2 any increase in so-called surplus applicable to pension business. Here, again, if it is desired to avoid exact accounting, a conservative estimate from the point of view of the taxing authorities would be that such increase in surplus is 4 percent of the increase in pension reserves for the current year.

(*c*) A similar situation arises in section 802(a)(2), tax in case of capital gains. Here, again, the situation could be remedied by eliminating that portion of any capital gain represented by the ratio of pension reserves, other pension liabilities, and pension surplus to the total company assets.

(*d*) I attach as appendix A some language which I believe could be used in amending the bill to carry out the ideas in (*a*), (*b*), and (*c*) above.

(*e*) The pension business is intensely competitive between self-insured plans handled by banks and trust companies and insured plans handled by mutual life insurance companies and stock life insurance companies. This is perhaps well illustrated by the material appearing in the statement of Robert L. Hogg, vice chairman of the board of the Equitable Life Assurance Society of the United States, to the subcommittee of the Committee on Ways and Means of the House of Representatives last November. Some figures are shown on page 287 of the report of those hearings from the Federal Reserve Bank of New York, which indicate that the pension and profit sharing trusts of the New York City banks in the years 1953, 1954, 1955, and 1956, did not return any profit to the banks but were operated at a loss. With this competition, I doubt that any stock life insurance company will make a big profit out of the pension business. However, any profits that should be made and become available to shareholders could be taxed under phase 3 (subpart D of H. R. 4245).

(*f*) I would expect that the changes I have suggested above would reduce the tax collected under this bill by nothing in 1958, approximately $7 million in 1959, $13 million in 1960, and $20 million in 1961. Of course, the effect on the Government's revenue would only be approximately half these figures. The reduction in tax would be passed on to employers and they in turn would be reducing their deduction claimed for pension contributions in their tax returns.

(*g*) May I also point out that because of the deferral in the relief provided by H.R. 4245 which has, I think, already been mentioned by several of you Senators, insured pension plans compared with self-insured plans will be very heavily penalized for the next few years. Under the 1955–57 stopgap laws an increase in pension contributions of from 6 to 8 percent was required to pay income tax. (See table A, sec. 1.) In 1958 this increased cost under H.R. 4245 as written will be 9 to 20 percent. (See table A, sec. 2.) In 1959 it will be 8 to 16 percent. In 1960 it will be 7 to 12 percent. In 1961, H.R. 4245 as now written takes us back to about the 6 to 8 percent penalty we had under the stopgap laws. (See table A, sec. 3.) The changes I have suggested mend the discrimination other than that existing because of the deferral of the relief. I urge you to give your earnest consideration to this deferral question.

Answers to some objections: While there has been——

Senator GORE. Mr. Chairman, could I ask one question here in view of the lateness of the hour and in view of the fact that I have a luncheon engagement? I would like to interrupt to ask one question.

Mr. WARTERS. Yes.

Senator GORE. In view of the subject matter that you are discussing, I wonder if you would comment on a news story in the New York Times which reports that life insurance companies, lead by Equitable Life, are now asking for a change in the State insurance law to permit insurance companies to act as pension plan trustees, and it lists as one of the benefits from such an action this, "They would also benefit by having their tax bills lowered."

Do you understand that to be the case, that that would be a possibility?

Mr. WARTERS. I have not seen this article.

Senator GORE. I understand; I do not expect you to comment on something you have not seen.

Mr. WARTERS. I think they may mean State taxes, State taxes might be lowered. I do not know what sort of a bill they are introducing there. But as far as I know it has no reference to this bill. State premium taxes, perhaps; I do not know.

Senator GORE. You do not think they refer then to Federal taxes?

Mr. WARTERS. No. I cannot offhand see where it would help our company unless you give us relief in here.

Senator GORE. Thank you, Mr. Chairman.

(Mr. Warters subsequently submitted the following for the record:)

On further investigation I find my answer to this question was incorrect and so advised Senator Gore on the next day. Alarmed by the amount of business being transferred to trust companies, a proposal was made in New York State that companies domiciled there be granted limited trust powers in the pension field. The New York proposal is strongly opposed by banks, trust companies, and others. It lacks the endorsement of the State insurance department and does not have the unanimous support of the life insurance companies. It has been referred for further study. If eventually enacted it might enable some life companies to act as trustees and perhaps avoid the income tax on life insurance company earnings as far as funds so trusteed were concerned.

My company would not be directly affected or helped as we are domiciled in Iowa. That is one of the reasons for my lack of familiarity with the subject.

Mr. WARTERS. Now, answers to some objections.

While there has been no denial of the tax discrimination between insured and self-insured pension plans, there have been a few who oppose tax relief for life insurance companies on insured pension funds for other reasons. A few may be interested in retaining a competitive advantage for self-insured plans. A few life insurance companies may feel that it is your purpose to collect a predetermined amount of money in taxes from the life insurance industry and that eliminating insured pension funds from tax will mean more taxation for other forms of life insurance.

As many of you have told us in this hearing, your decisions are not made in this way, and I never thought they were.

I would also like to point out that some say the elimination of tax on insured pension plans mostly favors a few large companies. I would point out that they are large because they serve many thousands of pension plans and millions of employees. These large numbers of employers and employees should not be penalized because they have chosen to use the services of a large insurance company. In our competitive economy, it is large because it has served well.

I would further like to point out that there are large numbers of small companies which are writing pension plans for the smaller employers.

No tax advantage flows to any mutual life insurance company by reason of the elimination of the tax on insured pension funds. Even were it not the policy of mutual life insurance companies, competition and the desire to preserve business and write new business will result in any tax savings being passed directly to the purchasers of pension plans in the form of dividends or rate credits. The real beneficiaries are small employers who must insure their plans and want to buy a plan at the same cost as their large competitors who do not have to insure their plans.

Small life insurance companies have, and all can, enter the pension field. If they do not now write a proportionate share of the pension business, it is because of the tax discrimination in favor of self-insured plans which has existed in the past or because they believe attention should be given to the more profitable lines.

It is clear from the record before the House Ways and Means Committee that the pension deduction does not in any way affect the discrimination arguments used and the differences of opinion expressed by stock and mutual companies generally. There is strong stock company as well as mutual company support for the pension deduction. On record in this regard are a number of witnesses before House committees and the representations made by spokesmen and in printed material of the Joint Tax Committee of the A.L.C. and the L.I.A.A. over a good many years. The question here is one of discrimination between one way of funding pension business outside the life insurance business and the underwriting of such business by life insurance companies generally. The House of Representatives has given its blessing to the pension deduction on two occasions—once in 1954 and in H.R. 4245. It is reported that the Treasury is sympathetic. While the Senate has never directly passed on the question, I am sure you will not wish the present discrimination continued.

I attach tables here that I think document my testimony.

The CHAIRMAN. The insertions will be made in the record.

(The tables referred to are as follows:)

### TABLE A

[All items refer to pension operations only]

| Rate of investment earnings before tax | Phase 1 tax | Rate of earnings after phase 1 tax | Percentage increase in contributions to offset phase 1 tax | Phase 2 tax (if applicable) | Rate of earnings after phase 1 and 2 taxes | Percentage increase in contributions to offset phase 1 and 2 taxes |
|---|---|---|---|---|---|---|
| SEC. 1. 1955 STOPGAP [Percent] | | | | | | |
| 3.25 | 0.25 | 3.00 | 6.2 | None | 3.00 | 6.2 |
| 3.50 | .27 | 3.23 | 6.7 | None | 3.23 | 6.7 |
| 3.75 | .29 | 3.46 | 7.2 | None | 3.46 | 7.2 |
| 4.00 | .31 | 3.69 | 7.7 | None | 3.69 | 7.7 |
| 4.25 | .33 | 3.92 | 8.2 | None | 3.92 | 8.2 |
| 4.50 | .35 | 4.15 | 8.7 | None | 4.15 | 8.7 |
| SEC. 2. H.R. 4245 WITHOUT THE PENSION ADJUSTMENT WRITTEN THEREIN | | | | | | |
| 3.25 | 0.36 | 2.89 | 9.0 | None | 2.89 | 9.0 |
| 3.50 | .45 | 3.05 | 11.2 | None | 3.05 | 11.2 |
| 3.75 | .54 | 3.21 | 13.5 | None | 3.21 | 13.5 |
| 4.00 | .63 | 3.37 | 15.7 | None | 3.37 | 15.7 |
| 4.25 | .73 | 3.52 | 18.2 | None | 3.52 | 18.2 |
| 4.50 | .82 | 3.68 | 20.5 | None | 3.68 | 20.5 |
| SEC. 3. H.R. 4245 WITH THE PENSION ADJUSTMENT WRITTEN THEREIN | | | | | | |
| 3.25 | 0.13 | 3.12 | 3.2 | 0.10 | 3.02 | 5.7 |
| 3.50 | .14 | 3.36 | 3.5 | .11 | 3.25 | 6.2 |
| 3.75 | .15 | 3.60 | 3.7 | .12 | 3.48 | 6.7 |
| 4.00 | .16 | 3.84 | 4.0 | .13 | 3.71 | 7.2 |
| 4.25 | .17 | 4.08 | 4.2 | .14 | 3.94 | 7.7 |
| 4.50 | .18 | 4.32 | 4.5 | .15 | 4.17 | 8.2 |

Assumptions:
(i) Surplus and nonreserve items equal to 7.5 percent of assets.
(ii) Valuation interest rate of 2.5 percent.
(iii) Operating gains after policyholder dividends and before Federal tax equal to 20 percent of investment income before Federal tax.
(iv) One percent reduction in rate of interest increases contributions by 25 percent.

Support for assumptions:
(i) 1957 industry percentage for all business is 14.6 percent; 1957 industry percentage for pension business is not available; 1958 Bankers Life percentage for all business is 11.6 percent; 1958 Bankers Life percentage for pension business is 8.4 percent.
(ii) 1957 industry group annuity percentage is 2.45 percent; 1958 Bankers Life percentage is 2.51 percent.
(iii) 1957 industry group annuity percentage is 24.0 percent; 1958 Bankers Life percentage is 25.2 percent.
(iv) This is the generally recognized rule-of-thumb for typical pension plans.

Source: Spectator Yearbook, annual statements of representative companies, annual statement and supporting worksheets of Bankers Life.

TABLE B.—*Insured reserves and trust funds of private pension plans*

[In millions]

| End of year | Insured reserves (1) | Trust funds (2) | Total (1)+(2) (3) | Proportion | |
|---|---|---|---|---|---|
| | | | | Insured (4) | Trusted (5) |
| | | | | *Percent* | *Percent* |
| 1950 | $5,575 | $5,750 | $11,325 | 49.23 | 50.77 |
| 1951 | 6,550 | 7,300 | 13,850 | 47.29 | 52.71 |
| 1952 | 7,675 | 9,000 | 16,675 | 46.03 | 53.97 |
| 1953 | 8,775 | 10,675 | 19,450 | 45.12 | 54.88 |
| 1954 | 9,950 | 12,900 | 22,850 | 43.54 | 56.46 |
| 1955 | 11,250 | 15,125 | 26,375 | 42.65 | 57.35 |
| 1956 | 12,450 | 17,625 | 30,075 | 41.40 | 58.60 |
| 1957 | 14,025 | [1] 20,319 | 34,344 | 40.84 | 59.16 |

[1] Estimated.

Sources: Insured Reserves, Institute of Life Insurance (includes both group annuity and individual policy); Trust Funds, Securities and Exchange Commission and Social Security Administration (includes multiemployer plans and plans of exempt organizations).

## APPENDIX A

### SUGGESTED PENSION CHANGES IN H.R. 4245

(As reported to the House)

Page 17, line 14. Change section 805(c) (1) (b) (ii) to read: "the mean of 94 percent of the taxpayer's assets * * *."

Page 24, line 8. Section 809(d). Insert a new paragraph between (6) and (7):

"(6.5) RESERVES FOR PENSION PLAN.—An amount equal to 4 percent of the increase in pension plan reserves, excluding any increase in reserves for which a deduction is allowed under paragraph (6) of this subsection."

Page 6, line 19. Delete the period at end of section 802(a) (2) and add: "less said amount multiplied by the ratio of the mean of the taxpayer's pension plan reserves at the beginning and end of the taxable year to the mean of 94 percent of the taxpayer's assets at such times."

(The preceding amendments were also referred to by Mr. Slater on p. 383.)

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

The committee will recess until 2:30.

(Thereupon, at 1 p.m., the committee recessed to reconvene at 2:45 p.m., of the same day.)

### AFTERNOON SESSION

Present: Senators Byrd (presiding), Kerr, Frear, Long, Douglas, Gore, Talmadge, McCarthy, Williams, Carlson, Bennett, Butler, and Curtis.

The CHAIRMAN. The committee will come to order.

The next witness is Mr. H. Lewis Rietz, executive vice president, Great Southern Life Insurance Co.

## STATEMENT OF H. LEWIS RIETZ, EXECUTIVE VICE PRESIDENT, GREAT SOUTHERN LIFE INSURANCE CO.

Mr. RIETZ. My name is H. Lewis Rietz. I am executive vice president of the Great Southern Life Insurance Co., of Houston, Tex. Our company is a stock life insurance company but sells both participating and nonparticipating business.

My appearance here today is essentially in support of H.R. 4245. I regret the magnitude of the tax to be imposed which must ultimately be borne by policyholders. But if a tax of this magnitude is deemed necessary, and the determination has been made to tax on a broader base than free investment income then the basic structure of the present bill is as fair and equitable as has been conceived to date. Some technical amendments are desirable. I support the suggested 5-year individual company average interest rate amendment in phase 1 and the full deduction of tax exempt interest in phase 2.

The bill properly, and in my opinion, adequately recognizes the long-term nature of the life insurance business in the specific provision for creation in stock companies of a policyholders surplus account free of tax so long as it is held for the protection of policyholders. It is demonstrable that, over the years, sharp fluctuations have occurred in mortality, in interest rates, and in market value of assets, and that substantial capital losses have been sustained in some cycles which make a policyholder surplus essential to assure fulfillment of policy obligations.

Not only does H.R. 4245 provide for the maintenance of a policyholders surplus fund but it imposes specific limits on this fund, these limits being the greater of (a) 25 percent of life insurance reserves or (b) 60 percent of the sum of the net premiums for the taxable year. Thus the amount of policyholders surplus that may be accumulated and retained tax free for the protection of policyholders is specifically limited. These limits seem to me to be fair and reasonable.

There is a priority of interests in the policyholders surplus account. First, the policyholders must be protected, then the Government has a tax lien on the fund and, only after that do the stockholders have any interest. In other words, if funds in the policyholders surplus account are no longer needed for the protection of policyholders, stockholder dividends may be paid, but only after the interest of the Government has been satisfied through the payment of a tax.

H.R. 4245 also provides for a priority of stockholder dividend payments from the various surplus accounts. First, dividends may be paid freely from the shareholders surplus account inasmuch as taxes will have been paid under the proposed bill. Second, if the company no longer needs the full amount in the policyholder surplus funds to protect the policyholders and wishes to use some of it for dividends to stockholders, it may do so, but must first pay the income tax on the funds used. Third, if the company exhausts the policyholders surplus account, paying a tax on any amounts transferred to the stockholders surplus account, it may then pay dividends from the surplus which existed at the time this law became effective. Since these funds were accumulated after payment of taxes under previous tax laws, the bill recognizes that taxes have been paid and permits the payment of such amounts to stockholders without further taxation.

It is to this specific order of distribution that I desire to direct your attention. This provision in effect freezes present surplus funds whether contributed by stockholders or arising from previous earnings already taxed under prior laws and voluntarily retained for the protection of policyholders. The management of established stock companies have properly retained surplus funds to guarantee fulfillment of policy obligations at a considerably higher level than has prevailed in mutual companies where dividend reductions can and have absorbed the shock of adverse experiences, whether from mortality, interest, investments or expenses. Thus for established companies, capital and surplus ratios in stock companies generally exceed 10 percent of contractual liabilities—in many cases they exceed 10 percent by a substantial margin—while they seldom exceed 10 percent in established mutual companies.

Furthermore, any capital funds contributed by stockholders should be available for repayment to them without any prior tax obligation when such stockholder contributed surplus is no longer deemed necessary for the protection of policyholders.

Present surplus funds have been taxed on the varying standards applicable over the years. To the extent they are not needed to protect policyholders, they should be available to stockholders without incurrence of further tax obligations on subsequently accumulated policyholder surplus funds.

This the bill recognizes, but the priority of stockholder dividend payment provisions in effect makes these existing surpluses unavailable even after they are no longer needed to protect present policyholders except through the prior payment of tax and disbursement of future earnings which are being accumulated to protect future policyholders. For practical purposes, this freezes the already taxed present surplus funds in most companies.

Admittedly, nonparticipating premiums of stock companies contain a margin for contingencies. Each generation of policyholders should contribute contingency funds which with the company's existing capital will be sufficient to guarantee fulfillment of contractual obligations under any foreseeable set of circumstances. It is only after the contractual obligations of each generation of policyholders expire by death, maturity, lapse, surrender, or other contractual fulfillment that this contingency fund properly reverts to stockholders.

Our existing surplus funds of substantial amount and voluntarily retained to assure contractual fulfillment have already been subject to tax. At present policies terminate by death, maturity, or surrender and these surplus funds are no longer needed to protect this generation of policyholders, the existing surplus should be available to stockholders without it first exhausting the surplus retained to protect policyholders arising from experience of present policyholders after January 1, 1959, and by the company's experience with future generations of policyholders.

The basic purpose of phase 3 is to subject to tax all life insurance company earnings arising from any source after the effective date of this bill, which ultimately revert to stockholders.

From a practical standpoint we recognize that a blanket, immediate transfer of all existing capital and surplus to the shareholders account would defeat the major purpose of phase 3 of the bill, but we urge that some relief is justified as present surplus funds are no longer needed to protect policyholders who contributed such funds.

It is proposed that a gradual payout of existing surplus be accomplished by transferring a small percentage of the existing surplus to the shareholders surplus account each year. Specifically, we recommend that this be accomplished by adding a paragraph immediately after section 815(b)(iv) to provide that each year 2 percent of the company's paid-up capital, special surplus funds, unassigned surplus, mandatory securities valuation reserve, contingency reserves, and any amounts set aside from surplus to increase actuarial reserves, all computed as of December 31, 1958, be added to the shareholders surplus account. After 50 years, the existing surplus and special reserve funds would then have been completely transferred to the shareholders' account. And I might say parenthetically, as an aside, within 50 years the vast majority of the liabilities with respect to our present policyholders will have terminated. There will be some left.

We believe this treatment is somewhat similar to the handling of terminal dividends under participating policies. A number of mutual companies operate on the philosophy that each policyholder should contribute toward the company's surplus, but that when a policy terminates, all or a part of the surplus contributed by that policyholder will be returned to him. Thus, any surplus now being held by such a mutual company would be returned to the owners, that is, the policyholders of the company, when their policies terminate. In the meantime, new policies would be issued and those policyholders would contribute to a surplus account for their own protection.

There is another point involved. Occasionally it is deemed desirable to increase the surplus of a company by obtaining contributions from stockholders as cash contributions to surplus. This is usually done at a time when the ratio of surplus to reserves falls below the point considered safe by the management either because business is expanding rapidly or because there have been heavy losses from mortality or investments. Under H.R. 4245, if such funds are contributed, the proposed bill does not provide that they will be placed in the shareholders surplus account. Consequently, amounts in the policyholders surplus account must be transferred to the shareholders surplus account and a tax paid before the stockholders would be entitled to a repayment of their contributed surplus. This seems totally unfair and contrary to the general philosophy of taxation with respect to other corporations.

Frequently these additional funds—and in that I mean contributed surplus—may be needed for only a temporary period of time. For example, during the influenza epidemic in 1918, come companies called upon their stockholders for additional surplus contributions, but felt it was reasonable to repay these contributions a few years later when the emergency was over.

A similar situation exists with respect to new companies. When a company begins business, it has expenses of organization, and usually surplus is depleted during the early years while business is being placed on the books fairly slowly. Not only are overhead expenses high in proportion to the premiums collected, but the company has the strain of paying first-year commissions, medical fees, expenses of underwriting and issuing the policies and setting up records, and first-year death claims, and in addition setting up a reserve at the end of the year. Usually there is a loss from operations during the first policy year which is recouped over a period of renewal years.

Under H.R. 4245 there is no provision either for paying any of the contributed surplus back to the stockholders or even for making whole the original surplus without first paying a tax on future earnings.

For example, if a new company starts out with $100,000 of surplus and spends half of it in getting established, any net gains from operations which accrue thereafter must be taxed although the first $50,000 is clearly a return of capital funds invested in the business.

The bill does make some attempt to correct this situation through the 5-year carryover provision. However, this is not adequate as many of these companies are still losing money at the end of 5 years. Others may not longer be losing money but it would be rare indeed for a young company to have recouped its initial loss in a 5-year carryover period. A longer carryover provisions, such as 15 years, would alleviate this situation somewhat although it would not completely correct it.

I propose that any amounts contributed by shareholders, either as capital or surplus, whether at the time of the formation of a company or during a later period, should be added to the shareholders surplus account. This may easily be handled by providing for the addition of such funds to the shareholders surplus account immediately after section 815(b)(iv).

Thank you.

Senator KERR. Thank you, Mr. Rietz. I will ask you one or two questions.

You say:

> This the bill recognizes, but the priority of stockholder dividend payment provision in effect makes these existing surpluses unavailable even after they are not longer needed to protect present policyholders except through the prior payment of tax and disbursement of future earnings being accumulated to protect future policyholders. For practical purposes, this freezes the already taxed present surplus funds in most companies.

Now, you suggest an amendment, as I understand it, which would make the distribution of the already taxed present surplus fund possible to stockholders without payment of any further tax insofar as that amount of money is concerned.

Mr. RIETZ. Yes, sir.

Senator KERR. Now, have you given any thought to the putting of phase 3 of the bill into effect gradually rather than making it 100 percent immediately?

Mr. RIETZ. I have not thought at all of making it effective gradually. As I indicated in my statement, I look upon phase 3, and I think most of the people in the stock companies look upon phase 3, as being a means to assure that any future earnings that are not previously taxed under phases 1 and 2 and which ultimately revert to the stockholders of the company will be subject to a Federal income tax at the time that they revert to the stockholders. Now——

Senator KERR. Now, that provision with reference to earnings is not now in the law with reference to 1958, is it?

Mr. RIETZ. Not in the law that would be applicable if this bill is not passed; no, sir.

Senator KERR. Then it is not now in the tax law with reference to insurance companies.

Mr. RIETZ. That is correct.

Senator KERR. And if that provision of H.R. 4245 were to be made applicable to 1958, would it not to that extent be imposing a tax retroactively?

Mr. RIETZ. Senator Kerr, I don't believe the way the bill is drafted it would ever be applicable to 1958, the past year, because under the definition of the bill, the shareholders' surplus account is zero on January 1, 1959,

Senator KERR. 1959.

Mr. RIETZ. The policyholders' surplus account is zero on January 1, 1959, and as I interpret the bill——

Senator KERR. Phase 3 does not apply to earnings of 1958?

Mr. RIETZ. That is right.

Senator KERR. Now, is there any other provision in the bill which would trigger the effectiveness of this tax against those funds which you referred to as already taxed present surplus funds, or accumulations which would be free of the tax with reference to half of them under phase 3?

That is, is there any provision in this bill whereby the use of money under the bill, or by a company other than the payment of dividends would make it necessary for the company to pay this tax?

Mr. RIETZ. Not under phase 3. The trigger mechanism is built in and depends entirely on the company deciding that they are in a position and justified in paying stockholder cash dividends in excess of the amount then in their shareholders' account.

Senator KERR. And that is the only thing under the language of the bill that would trigger the operation of collecting tax on those untaxed funds.

Mr. RIETZ. On policyholder surplus funds?

Senator KERR. Yes.

Mr. RIETZ. Under the present bill you must pay that tax and exhaust those funds, all of which will be accumulated for the protection of policyholders in the future, before you can touch your existing surplus even though the liabilities with respect to which you are maintaining your existing surplus no longer exists.

Senator KERR. No longer exists.

Senator CARLSON. No.

Senator KERR. Senator Douglas?

Senator DOUGLAS. Mr. Rietz, may I ask if you believe more encouragement should be given by the tax laws for the accumulation of added reserves?

Mr. RIETZ. As reserve liabilities?

Senator DOUGLAS. Well, as reserve against policies.

Mr. RIETZ. Well, as liabilities my answer would be "No." Now, in a time of stress a liability is of no value to you. I mean, your reserve liability should be adequate and it should be fair, but there is no point in strengthening your liability in my opinion on a redundant basis because in times of contingencies when your market goes to pieces, or your mortality goes bad, it is not liabilities you need to protect your policyholders and the company, it is surplus funds.

Senator DOUGLAS. Were you here this morning when Mr. Taylor testified?

Mr. RIETZ. Yes, sir.

Senator DOUGLAS. Do you remember my question to Mr. Taylor on this point?

Mr. RIETZ. I don't remember how it was worded, sir. I'm sorry.

Senator DOUGLAS. Well, on what basis do you and your company accumulate your reserves or set aside your reserves? Do you use the same mortality tables, the average mortality of the 1930's?

Mr. RIETZ. Yes, sir.

Senator DOUGLAS. Which would be roughly the mortality of 1935. Roughly.

Mr. RIETZ. Yes, because it is prescribed by statute.

Senator DOUGLAS. Pardon?

Mr. RIETZ. It is prescribed by statute in various States. We do not control that.

Senator DOUGLAS. I understand that. Now, in these last 25 years there has, of course, been a great reduction in the death rate and a corresponding increase in the expectation, the average expectation of life. Now, wouldn't this instead of requiring the accumulation of added reserves, as I understood Mr. Taylor's reply this morning, mean that your existing reserves would be even more adequate than they had been in 1910?

Mr. RIETZ. You are asking a very highly technical question.

Senator DOUGLAS. Well, it is a very important one.

Mr. RIETZ. I will attempt to answer it for you and see if I can get across a point here.

If the rate of mortality in every year of life were uniform, in other words, if people died at the rate of 10 per thousand per year, you would have level premium life insurance without having a reserve at the end of any policy year because you would collect your $10 for your average claim; you would collect your loading for your expenses and taxes; you would pay out your $10 in claims during the year and the next year would again stand on its own feet.

The reason that you have a reserve is because you have an increasing risk. The death rate increases year by year.

Senator DOUGLAS. Just a minute. The death rate has not been increasing year by year.

Mr. RIETZ. Well, age by age.

Senator DOUGLAS. It has been falling year by year.

Mr. RIETZ. We are talking about two different things. You are talking about calendar years and I am talking about years of age. But from 41 to 42 to 43, on up to 50, the death rate does increase. The level of your reserves is determined not by the level of the rate of mortality but by the rate of increase in the rate of mortality by age, and when the CSO mortality table, the 1930–39 table, was substituted for the American experience table——

Senator DOUGLAS. Substituted for 1867.

Mr. RIETZ. Yes. Your reserves were increased. Your required reserves on most plans of insurance were increased. The reason they were increased was that the mortality rates at ages, say, of 65 and over had not improved as compared to those of the 1860's. But the mortality rates in ages in the twenties and the thirties and forties had improved so that you flattened the mortality curve at these ages, and then you got into the very steep curve to reach the high-age mortality rates and that required higher reserves although the level of mortality was lower at the younger and middle ages.

Senator DOUGLAS. Of course, very few people take out insurance after they are 65. The insurable ages are——

Mr. RIETZ. No, sir.

Senator DOUGLAS. Are the twenties and thirties and forties, just as you mentioned. Now, the average expectation of life for people of those ages has lengthened. The death rate for those ages has fallen. Isn't that true?

Mr. RIETZ. That is true.

Senator DOUGLAS. Doesn't that mean reserves which were needed in 1940 on the basis of the experience are not needed now to the same degree?

Mr. RIETZ. No, sir. In those——

Senator DOUGLAS. That is very interesting.

Mr. RIETZ. You get into this peculiar position. Now, the CSO table produced lower premiums. Forgetting about the expenses, the pure claim premium on the CSO table was lower than on the American experience table, but on plans of insurance which carried the protection into these high ages, the reserves were higher. In other words, you had to put away a little more in the early years in order to provide for that high mortality out in the late——

Senator DOUGLAS. When do people take out insurance? How many take out insurance at age 60 or 65?

Mr. RIETZ. A very small percentage.

Senator DOUGLAS. Yes. Don't they take out insurance in the late twenties and thirties and forties?

Mr. RIETZ. Correct.

Senator DOUGLAS. Is it not true that the expectation of life for people in those age groups has lengthened?

Mr. RIETZ. That is right.

Senator DOUGLAS. The death rate has fallen.

Mr. RIETZ. That is right.

Senator DOUGLAS. Therefore you do not have as large a proportion of losses in any one year as you would have had in the thirties?

Mr. RIETZ. That is correct.

Senator DOUGLAS. Then I should think it would follow as the night the day that you wouldn't need as large reserves, and yet you say you need more reserves.

Mr. RIETZ. It depends upon the rate of increase in mortality by increasing age of the individual, for those persons whose insurance extends into the ages of the high mortality rather than on the rate of mortality.

Senator DOUGLAS. You just said the preponderance of this group is in the lower age groups, in the twenties, thirties, and forties, rather than in the——

Mr. RIETZ. Yes, but our reserve that we establish with respect to the man who is now age 30 and who bought insurance 5 years ago at age 25 on the ordinary life plan which will be paid some day, if he keeps the policy in force, whether he dies at 60, 70, 80, or 90, contemplates provision for paying those claims at those high ages.

Senator DOUGLAS. Let me say this. I can understand how in the case of annuities the prolongation of life would work against the insurance companies, but in the case of death benefits on life insurance, it would seem to me that it works all in your favor.

I must say without wishing to be sarcastic, Mr. Chairman, I have learned a lot here. I learned a reduction in the death rate requires the accumulation of more reserves, and I would hate to see the insurance industry repeatedly take that position. I would like to submit it to any group of unprejudiced actuaries in the world.

Senator KERR. You wouldn't want to in any way discourage the lengthening of life. [Laughter.]

Is that all, Senator?

Senator DOUGLAS. That is all.

Senator KERR. Senator Gore?

Senator GORE. In your statement you referred to the policyholders' surplus. What interest does a policyholder have in the surplus to which you refer?

Mr. RIETZ. It is merely language, I assume, that was adopted by the drafters of this bill in distinguishing between what to me will amount to two memorandum tax accounts. At the end of the tax year——

Senator GORE. It is a name rather than——

Mr. RIETZ. A name.

Senator KERR. And the source of it is the bill, not your statement?

Mr. RIETZ. That is right.

Senator GORE. You claim no credit for naming it?

Mr. RIETZ. None whatsoever.

Mr. GORE. It is a misnomer, if I understand the term.

Now, you say:

> This amount of policyholder surplus that may be accumulated and retained tax free for the protection of policyholders is specifically limited.

And you say further that the Government has a tax lien on it. Just what kind of lien does the Government have?

Mr. RIETZ. Well, let me go back to phase 2 for one minute. The policyholders' surplus arises from an accounting memorandum standpoint. Your policyholder surplus arises from the half of the underwriting gains in phase 2 which are not currently taxed.

There is a definite recognition there that the protection against contingencies in a long-term business is important and in fact essential.

Senator GORE. And because of that recognition, the tax liability is deferred.

Mr. RIETZ. The tax liability is deferred.

Senator GORE. Now, that is the lien to which you referred?

Mr. RIETZ. That is right. Now, the tax liability comes into being when any of that money is taken for the stockholders' account rather than being held purely for protection of policyholders and to guarantee fulfillment of their contracts.

Senator GORE. Now, it seems to me that the burden of your statement is that this tax-free accumulation is, as you say, "for the protection of the policyholders."

Now, if it is for the protection of the policyholders and if tax exemption is given by the Congress on this amount of profits for the benefit of policyholders, should not the tax liability accrue, as I understood Mr. Taylor to indicate was his belief this morning, at such time as it is no longer needed to preserve the liquidity and solvency of the company, which is the basis upon which it is provided for the policy benefits?

Mr. RIETZ. I think you are entirely right. Now, you have fixed within the statute two limits which will automatically make that fund, rather any excess of that fund, immediately subject to tax.

The only limit is the 25 percent of the life insurance reserve.

Senator GORE. Which in practical effect is no limit at all in the ordinary operation of life insurance companies.

Mr. RIETZ. Well, you have companies today who without any tax considerations voluntarily retain surplus funds in substantial amount even approaching capital and surplus of 25 percent.

I think you will find in the paper that I believe was attached to Mr. Taylor's statement this morning—it was a document prepared by Mr. Rood of the Lincoln National—some comparisons of surplus ratios through the cycle of the depression, the thirties.

My recollection is that the group of stock companies in 1928 had surplus ratios of approximately 16 percent, that by 1938 they were down to 7½ percent because of the losses in assets, the high mortality on large amount policies, and other adverse factors of the depression years.

The mutual companies I think had surpluses initially in 1928 of a fraction over 8 percent and dropped down to about 5½ percent, but between 1928 and 1938 they had offset some of their losses by substantial reductions in dividends, I believe.

So the loss in surplus in the stock companies that were on a fixed and guaranteed premium basis, the loss of surplus between 1928 and 1938 was much more substantial relatively than it was in mutual companies who had the higher premiums and had the right to change their dividend patterns on all business.

Senator GORE. Well, I share your sentiment that a stock company must have surplus and reserves to keep its solvency unquestioned, and I am glad to know that you agree with me that when this so-called policyholders' surplus is no longer needed for that purpose, then it should become subject to the corporate tax rate.

Mr. RIETZ. As so provided in the bill.

Senator GORE. Well, I think we might disagree a bit as to just how and when, if ever, it is provided. But so long as we agree on the principle, then we will examine the bill for the technicalities.

I notice in the life insurance reports that part of your corporation is owned by the Greenwood Corp. I should know the identity, but I don't.

Mr. RIETZ. It is a family holding corporation of the Greenwood family. Mr. Pat Greenwood is president of the Great Southern at this time. His father was president some years ago.

Senator GORE. Is this its principal business?

Mr. RIETZ. It is its only business.

Senator GORE. According to this, your company was established in 1909 with authorized capital of $500,000. Is that correct?

Mr. RIETZ. I am sure that is correct.

Senator GORE. And since then you have paid out cash dividends of $16,015,000.

Mr. RIETZ. That is correct.

Senator GORE. And stock dividends of $3,200,000. Is that correct?

Mr. RIETZ. That is correct.

Senator GORE. And as of now what is the book value of the company?

Mr. RIETZ. Well, 540,000 shares of stock and $27 million in capital and surplus funds—roughly $50 million. Now, our paid-in capital over the years—that original capital is not representative of the actual dollars that were put in the Great Southern Life Insurance Co.

Senator GORE. Will you please supply that?

Mr. RIETZ. I can give it to you—I cannot give you the dates at this time as to when the stock was sold. I think the last of it was as late as 1928, but the capital that was paid in was $2,200,000. The contributed surplus totals $3,874,000 over the years, as I recall the figures, so that there has been approximately $6 million up to date put into the Great Southern Life Insurance Co. by stockholders.

Senator GORE. I am not suggesting there is anything wrong in the very profitable operations you have had. It would indicate that there has been a little room for tax liability heretofore which the Congress has not levied. I am glad to see we are finally coming around to requiring a very profitable institution like yours to bear its share, if not proper, at least a part of the share of the cost of national defense and Government of the country.

I notice you place great emphasis on the distribution of surplus. I am not prepared to question you as I should be prepared on that. Is that a problem peculiar to your company or is that one peculiar to companies that have been operated, for want of a better phrase, conservatively? Will you fully identify that problem and how it relates to this bill? I am asking for information. I am unprepared on it.

Mr. RIETZ. You are talking about distribution of surplus to stockholders?

Senator GORE. Yes. It seems to me as you made your statement you were placing emphasis on the need to distribute surplus that had been accumulated heretofore.

Mr. RIETZ. Well, we look upon our policyholders' surplus as not a fixed fund but, rather, as a revolving fund. Now, from time to time as conditions change, we change our premiums. We may increase—in recent years we have been increasing—our interest assumptions in our premium rates, but every premium structure, every set of premium rates, we have has added in their computation a margin for contingencies, and I believe every other company in the business, whether they are stock or mutual, has a margin for contingencies. That generation of policyholders who buy insurance at those rates pay a premium that contains a margin for contingencies, to guarantee the fulfillment of their policy contracts. That money that is paid by this generation of policyholders should in effect be put aside and to the extent your assumptions in your premium structures produce that flow of funds for contingencies for this group, it should be retained——

Senator GORE. Do you think this should accumulate irrespective of the size of the surplus as it might be as of now?

Mr. RIETZ. I think the surplus then should be taken down. That which is not needed for contingencies should be taken down and revert to shareholders as the liabilities with respect to those policies from which these particular dollars were accumulated expire. In other words, if I took my business of 1940, I would have accumulated surplus funds with respect to that block of business, a part of which was intentional accumulation because I put a feature in my premium structure to allow for contingencies that I couldn't estimate. As I think Charlie Taylor said this morning, the actuaries are given credit for being very precise about these things, but our estimates are very rough, and I happen to be an actuary myself. But I put a contingency factor in my premium. I retain those funds. If I do not need those funds that this group of policyholders contributed during the time these policies were in force, then it reverts to the stockholders, but only at that point does it revert in my opinion to the stockholders. My own feeling is quite strong that it is only after you have fully satisfied your policy liabilities are the stockholders entitled to anything out of the Great Southern Life Insurance Co., and I believe practically out of any life insurance company.

Senator GORE. Now, I have one other question. You said that this policyholders' surplus should be tax free and accumulate so long but only so long as it is needed for the protection of the policyholders, and that each additional policy you sell has a percentage of the premium allocated to this contingency.

Now, does that mean that, in your opinion, none of this so-called policyholders' surplus should be subject to taxation, beginning from the date of the enactment of this bill, until all of the present surplus has been distributed to stockholders?

Mr. RIETZ. No, sir.

Senator GORE. It doesn't mean that?

Mr. RIETZ. Not necessarily.

Senator GORE. Well, I mean could it mean that?

Mr. RIETZ. It could have that effect, I think, in some situations.

Senator KERR. Let me see if I can make a contribution to this conversation.

Senator GORE. I wish you would. I am sure you can.

Senator KERR. If I understand it, your position is that the surpluses which have been accumulated and will be in being when this bill goes into effect will be sums of money retained from earnings after taxes have been paid currently on the operations of the company while they were being accumulated?

Mr. RIETZ. Yes, sir.

Senator KERR. And since the taxes currently have been paid on that money and since that money is there for the protection of the existing policyholders and the liability which their policies represent, that when the time comes that the liability has been terminated, either by payment or cancellation or whatever manner is provided that it can be terminated, then those funds having been accumulated in periods when the taxes were being paid, at the time the company is ready to distribute those funds to the stockholders in the form of dividends they should be permitted to do so without their becoming subject to this law now being passed?

Mr. RIETZ. That is right. As a matter of order, this law now provides that if you first pay out the funds contributed by future generations of policyholders and pay the tax on them, you can then go on and pay in stockholder dividends the existing surplus funds without payment of tax.

Senator KERR. Because your position is that the tax having been paid on the earnings when these funds were being accumulated, if they are subjected to a further tax before they could be paid to the stockholders as dividends, it would be in effect making them subject to double taxation.

Mr. RIETZ. Well, it certainly would if that were the effect.

Senator KERR. Both with reference to the years they were accumulated and then with reference to the time when they are paid out.

Mr. RIETZ. As far as we are concerned, we look upon our present surplus, which is a fairly large surplus figure, as something that has been retained voluntarily so that we can be very sure with a fairly competitive low nonparticipating premium scale to fulfill our contractual obligation.

Senator KERR. But whether the tax rate were high or low when you were accumulating it, you didn't fix it?

Mr. RIETZ. That is right.

Senator KERR. But you did pay it on the basis of your tax liability while these funds were being accumulated.

Mr. RIETZ. That is correct.

Senator KERR. And when the contingency for which they were accumulated no longer exists, and with reference to them your company desires to pass them along to your stockholders——

Mr. RIETZ. We believe that——

Senator KERR. So they can pay Federal taxes on them and have the benefit of what is left, you don't want to be in the posture of having to again pay the Federal Government 52 percent of it out in the form of taxes before you can distribute the rest of it to the stockholders so they can pay 70 percent of what they get to the Federal Government in taxes?

Mr. RIETZ. That is right.

Senator KERR. Is that about it?

Mr. RIETZ. That is right.

Senator KERR. I hope I made some contribution.

Senator GORE. Well, I think you mean in a way how this so-called policyholders' surplus may never become subject to taxation.

Senator KERR. It was subject to taxation when it was accumulated, according to the witness.

Mr. RIETZ. He is talking about this future policyholders' surplus.

Senator GORE. I am talking about the policyholders' surplus as provided in the pending bill. Is that the way it is described? You call it—well, I mean the bill calls it policyholders' surplus. Now, is not the insurance in force greater every year, if you have an expanding company?

Mr. RIETZ. We hope that it will be.

Senator GORE. Hasn't that been your experience?

Mr. RIETZ. It has been our experience to date.

Senator GORE. Well, if at the end of 1958 you needed a certain amount of surplus, and during 1959 you grow as you anticipate and hope, will you not need a great amount for the next year when there is a greater amount of insurance in force?

Mr. RIETZ. Possibly we will. If we continue to grow, both insurancewise and assetwise, I believe we will need increments to our surplus fund, merely to maintain our present ratios which we don't think at the end of a cycle where everything has been favorable—mortality has been good, interest has been good—the only thing we have had adverse of any magnitude industrywise in the last 10 years has been the inflationary cost of rising salaries and costs and we have succeeded to some degree in controlling that by improving our efficiency.

Senator GORE. Then——

Mr. RIETZ. But we are at the end of a good cycle where we should have high surplus. If we are at the end of a cycle such as you had with the influenza epidemic of 1918 or the depression of the thirties, because of the losses you will have sustained, the surplus will be very much reduced.

Now, we shouldn't maintain a terminal depression surplus at the end of or during a part of a very favorable cycle, and this has been a favorable cycle.

Senator GORE. If we accept the affirmative answers which you have given me to the questions I have asked you, how then can you say that the surplus earned from expired policies should be distributed without saying that the policyholders' surplus should accumulate tax free in perpetuity in so long as you are a growing and expanding company?

Mr. RIETZ. Well, you put limitations on the policyholders' surplus. Now, those limitations—they are 25 percent of the reserves and 60 percent of the net premiums. They may never be reached in a rapidly expanding company.

Senator GORE. All right. That is what I am trying to say.

Mr. RIETZ. As one of the other witnesses indicated this morning, if this industry stabilized at a given volume of business, became mature, so that we were just replacing each year for practical purposes what terminated by death and maturity, you would find a very different pattern in what would happen to the various funds and what would happen to insurance company earnings.

Senator GORE. I appreciate your candor and your knowledge, and your willingness to answer questions in a forthright way. I am trying to find loopholes in the bill as it is presented, and it seems to me this may be one.

Here is 50 percent of your tax liability deferred under phase 3. Under conditions which we have discussed, and most any which I have been able to imagine, it may be deferred permanently. Certainly so if you are a growing and expanding company, which I like to assume.

Mr. RIETZ. I do, too.

Senator GORE. Now, if that be true and if you and I are correct in the agreement we have reached that when it ceases to be necessary as a protection for the policyholder, it should become subject to tax, then we must provide some termini.

We must provide some reasonable way by which we can reasonably expect that some day, somehow, it will become subject to taxation.

Mr. RIETZ. Well, it seemed to me that the bill had provided for such a thing by precluding any company from accumulating a highly redundant amount in setting these limits that are prescribed in the bill, because as soon as their policyholders' surplus as defined in the law arising from untaxed operating gains under phase 2 exceeds either of these two limits, they must immediately pay the tax on the excess, and in effect transfer the balance after the tax into the shareholders' account.

Senator GORE. But have you not said that before such limits apply, if they ever do, all presently earned and all previously earned surplus should be distributed, and the accumulations for all future surplus should, by terms of this bill, receive a deferral of tax liability?

Isn't that——

Mr. RIETZ. Only by taking down your existing surplus very gradually as these present contractual liabilities expire. Now, as a stockholder in a——

Senator GORE. You say only gradually. Then your answer must be in the affirmative. But you would do it gradually?

Mr. RIETZ. Well, remember that phase 3 of this bill——

Senator GORE. And I would agree thoroughly if it should be done, it could only be done gradually unless you have a whale of a big year next year.

Mr. RIETZ. Remember this, that I think phase 3 of this law was never conceived—at least it is my understanding that it was not conceived as a basic revenue-raising part of the taxation law for life insurance companies.

Rather, it was conceived as a means of precluding any funds reverting to stockholders which would go untaxed at the corporate rate. It was conceived to permit a stock company to have adequate funds and the means of providing adequate funds to thoroughly protect the fulfillment of their contractual liabilities in times such as influenza epidemics and depressions, and so forth.

Senator GORE. I think I agree with you, at least from what I know of its attraction, and would you likewise agree with me it does not have the objective of providing any period, any time, or any conditions under which the surplus would be distributed and thereby become taxable?

Mr. RIETZ. Well, I think if you take individual company situations, it might reach that point. A company that becomes kind of dormant—we have had them in the business—that showed progress for a number of years and then kind of leveled off, new production dropped. I think if you had them to the place where you had almost a closed block of business with very little new business coming in, the tendency would be to increase underwrite gains very rapidly and build that up to these limits, but in a very aggressive, growing company I think I would have to admit to you that it is not probable that this would be triggered to pay Federal taxes, and yet I don't think in a very aggressive, growing company these surplus ratios are going to reach levels which you would not agree are essential to the protection of policyholders.

Senator GORE. Well, I find that you and I are in wide agreement. It may be that we would disagree on whether this aggressive and growing concern should grow on tax-exempt profits or whether it should grow on equity capital. I am perfectly willing to defer taxes to provide the surplus necessary to protect the solvency of the company, but I cannot find myself willing to allow a large portion of the net profits of a corporation to go untaxed in perpetuity.

Mr. RIETZ. I don't think you will be doing that in perpetuity.

Senator GORE. Is it your personal view, or is it not, that private insurance companies should grow and expand on tax-exempt profits or on equity capital?

Mr. RIETZ. I think they have to have equity capital to get started, but it seems to me that any——

Senator GORE. I wasn't speaking of getting started.

Mr. RIETZ. Let me complete my statement. It seems to me that any business enterprise, by deducting the expenses of the development of the business, is always expanding to some degree on money that might otherwise be taxable. Suppose that I am in the drug business and that if I made no effort to expand my sales, my profits would be $1 million, but in this particular year I spend a quarter of a million dollars on advertising and another quarter of a million dollars on other sales promotion. My net profit comes out to be a half of a million dollars.

Now, I hope by spending that quarter of a million on advertising and a quarter of a million on other forms of sales promotion that in ensuing years I will make more money. Otherwise I wouldn't spend the money.

Senator GORE. But that is an operating expense. And you have a similar operating expense in the establishment of new debits, of new accounts, new sales, opening up new territory for your company.

Mr. RIETZ. I thought that was what you are talking about, expanding on tax-free money. Apparently I have misunderstood your question completely.

Senator GORE. I was speaking of the accumulation of surplus on which tax is deferred not only to the extent that it provides a real protection for the policyholders, preserving solvency of the company; but beyond that, it may never be distributed to the stockholders and thereby never become taxable to the corporation. And then there is this second provision which is an all-phase tax exemption of 10 percent. Do you believe in that?

Mr. RIETZ. I think it is essential in a nonpar company.

Senator GORE. It is what?

Mr. RIETZ. I think it is essential in a nonparticipating company.

Senator GORE. In other words, you think it is essential for the Congress of the United States to give complete tax exemption for an amount of profits earned by stock companies roughly comparable in amount to the dividends paid out by the mutual companies.

Mr. RIETZ. I am sorry, but I can't follow that those things are roughly comparable. I think they arise from two entirely different reasons.

Senator GORE. Well, the reason I said roughly comparable, and that may not be an accurate description and I apologize if it isn't, the Ways and Means Committee report refers to this as a tax exemption to compensate the stock companies. You recognize what I am talking about?

Mr. RIETZ. I can't identify that language, although I have——

Senator GORE. You can't identify the word "compensate"? I would like them to ask Mr. Stam's assistant, what is the language of the report?

Mr. WOODWORTH. The report refers to the 10-percent deduction as an allowance which is intended to compensate stock companies for the allowance of the deduction for policyholder dividends to mutual companies.

Senator GORE. That is what—do you recognize that now?

Mr. RIETZ. I recognize it, but I don't understand the statement.

Senator GORE. You mean my statement or his?

Mr. RIETZ. I don't understand the statement in the House Ways and Means Committee report. In other words, I have never seen it demonstrated that there was any correlation between the two factors.

Senator KERR. What the witness thinks is it is rough but not comparable. [Laughter.]

Senator GORE. I guess that is more accurate. You do think that tax exemption should be provided to that extent, or do you?

Mr. RIETZ. I think some reasonable amount of contingency funds should not be subject to tax until it is determined whether they are needed to fulfill those contractual obligations, because we can't draw a line through our statement on December 31, 1958, or any other date and say that this is the end of this business and the experience with this group of customers.

Senator GORE. Again you use the clause "until it is determined that they are not needed, for the protection of the solvency of the company." But that is a provision which is not, in my opinion, spelled out in the bill before us.

Mr. RIETZ. Well, I would take it from your line of questioning, Senator Gore, that you do not agree with the 25 percent and the 60 percent, that is the trigger mechanism, since whenever it accumulates to an amount greater than that, it will be immediately subject to tax.

Now, there are two ways to become subject to tax: One is when the decision is made to transfer it to the shareholder's account and pay stockholder dividend; the other is by its merely reaching a level where it first exceeds those amounts.

I would judge that you feel the trigger mechanism based on the limits of the 25 percent and the 60 percent is not effective enough.

Senator GORE. I think the 25 percent is utterly unrealistic.

Mr. RIETZ. And yet we had a situation where in 1928, I think you can find these figures in Mr. Roods' testimony, you had about 16 surplus percent ratios and they dropped to 7.5 percent by 1938, because of the losess during the depression years, in nonpar companies.

Actually I should amend that statement because they never got to 7.5 percent. The reason they never got to 7.5 percent is because a number of companies asked their stockholders for contributory surplus. But you get down to 8 percent and if you eliminate the surplus contributed by some companies who were in a very narrow position, then the washout was about from 16 percent down to near 7 percent.

Senator GORE. Let's come to this 10-percent deduction. I would like to read a sentence from the Ways and Means Committee report:

> This 10-percent deduction is designed to compensate stock insurance companies for the fact that since they do not have the cushion of redundant premiums which, if the business does not go well a mutual company can use to offset losses that otherwise are subsequently paid back as policyholder dividend, they must have larger capital or surplus.

Now, it seems to me that is saying that because the stock companies are in competition with the mutual companies, they must be given a 10-percent, tax-free deduction. And if that be true, then what about the feed manufacturer, a private corporation, whose principal competitor is a farm co-op across the street? Shouldn't you give the feed manufacturer a deduction, too, and shouldn't you give a commercial bank a deduction because it is, in a way, in competition with a mutual savings bank, or a building and loan association?

Mr. RIETZ. I think the main point of distinction, at least to me—and this is something I haven't given a great deal of thought to, actually—but I think——

Senator GORE. I am sure I have not given enough, because I find it very troublesome.

Mr. RIETZ. I think the main point of distinction is this. Because of the very long-term nature of this business that we are talking about, you don't determine when a profit arises with respect to any given block of your business at the end of any one year——

Senator GORE. Well, now, we have already talked about deferral. This is a complete exemption. This is not triggered by anything. It is an exemption in perpetuity. Isn't that right?

Mr. RIETZ. I think it works that way, as one example.

Senator GORE. Thank you, Mr. Chairman.

Senator KERR (presiding). Senator Curtis.

Senator CURTIS. Do you write group insurance, too?

Mr. RIETZ. Yes; we write a small volume of group insurance. Had been inactive in the business until about 3 years ago and have attempted to reactivate a group department.

Senator CURTIS. Is it one of your major departments?

Mr. RIETZ. We have got about $100 million of $950 million of business in the group life department.

Senator CURTIS. What does that 2-percent deduction for group premiums amount to under the figures for 1958?

Mr. RIETZ. In our company?

Senator CURTIS. Yes.

Mr. RIETZ. I would rather furnish you the figure. If I had to guess, I would say that our group premium income was roughly $1.5 million, and 2 percent of it would amount to $30,000.

Correction. Our group life and accident and health premium income was $2,067,395, so the 2-percent contingency reserve required by some States would be $41,348.

Senator CURTIS. Do you write annuities?

Mr. RIETZ. Very few individual annuities, and would offer group annuities.

Senator CURTIS. Have you gone into the new idea of variable annuities?

Mr. RIETZ. No, sir. In fact, I don't think we can legally under the laws under which we operate. I am sure we cannot.

Senator CURTIS. That is all, Mr. Chairman.

Senator KERR. Senator Talmadge.

Senator TALMADGE. Mr. Rietz, is it possible that any stockholders receive any dividend under the terms of this bill without the corporation first paying either 30 percent or 52 percent income tax?

Mr. RIETZ. I don't think it is possible at all. I think that is just what phase 3 was designed to preclude.

Senator TALMADGE. That is what I was trying to clear up. I listened to Senator Gore's questions with interest about the deferral of taxes. Ultimately, it seems to me, the stockholders want some dividends for their equity capital that they have invested.

Now, in any phase of this bill, could any stockholder ever get a dividend without paying the regular corporate rate, whether it be 30 percent or 52 percent?

Mr. RIETZ. He could never get a dividend from earnings in the future.

Under this bill, under some circumstances he could get the existing surplus which was accumulated under other tax laws.

Senator TALMADGE. That is prior to the passage of this act?

Mr. RIETZ. Prior to the passage of this without their paying a second tax on that. But he could never get, as I interpret the law and believe it applies, any dividend from future earnings without the Federal Government first having gotten the tax at normal corporate rates.

Senator TALMADGE. Thank you, sir.

Senator KERR. Senator McCarthy.

Senator MCCARTHY. I have no questions.

Senator KERR. Thank you very much, Mr. Rietz.

Mr. RIETZ. Thank you.

Senator KERR. Mr. John A. Lloyd, Union Central Life Insurance Co.

Come around, Mr. Lloyd, and identify yourself and your associates for the record.

## STATEMENT OF JOHN A. LLOYD, PRESIDENT, THE UNION CENTRAL LIFE INSURANCE CO., CINCINNATI, OHIO, ACCOMPANIED BY CARL DeBUCK, EXECUTIVE VICE PRESIDENT; AND W. LEE SHIELD, VICE PRESIDENT

Senator KERR. Mr. Lloyd, is your position there with the sun beating down upon you uncomfortable?

Mr. LLOYD. It has been uncomfortable for some time, Senator, and it has been suggested in the room that with some of the excess money the Government is going to get from this tax bill they buy some blinds. [Laughter.]

Senator KERR. We will try to have them for the 1961 hearings. [Laughter.]

Mr. LLOYD. If this hearing lasts that long, I hope I am not on the stand that long. [Laughter.]

Senator KERR. Well, I was going to suggest if it would be to your comfort you come up here and sit in one of these chairs.

Mr. LLOYD. Thank you, sir, that would be too exalted for me. I can handle this very well.

Senator KERR. You mean that would be even more uncomfortable? You would be surprised how good that audience looks out there.

Mr. LLOYD. Well, they are all friends of mine, and I am not afraid to have my back to them. [Laughter.]

My name is John A. Lloyd. I am president of the Union Central Life Insurance Co. of Cincinnati, a mutual company. Organized in 1867, our company is licensed to transact business in all 49 States, in the Territory of Hawaii, and in the District of Columbia.

Associated with me today in this testimony is Mr. Carl DeBuck, executive vice president of our company, and Mr. W. Lee Shield, vice president of our company, who also curently is associate general counsel of the American Life Convention.

In the first part of this testimony I am representing only the company which employs me and my own personal views, althought I know there are many companies which share all or part of the opinions which shall be expressed herein.

In the latter part of this statement I shall represent the American Life Convention, the largest trade organization in the life insurance industry. I shall make it clear to the committee where this testimony changes its emphasis from that representing the Union Central to that representing the views of the American Life Convention.

It is the opinion of the Union Central that H.R. 4245 is the best approach which has yet been developed in the form of legislation for the taxation of life insurance companies and we strongly recommend that it be enacted into law, granting that serious consideration should be given to some one or two of the amendments which will be proposed during these hearings.

Notable among the proposals which we believe worthy of your consideration is that which suggests the use of a 5-year intracompany average in computing investment income under phase 1. This has the effect of putting each company completely on its own experience, without any consideration whatever of the results of the operations of its competitors and this we believe to be desirable.

In previous testimony before the Senate Finance Committee I have counseled against any of the several forms of taxation which have used industrywide reserve interest factors in their formula.

The most glaring example of the inequities which such formulas produce is the 1942 act. Here we have a statute which, because of what I believe to be an indefensible averaging factor, in some years developed no taxable income at all from most companies and thus practically no revenue for the Government from the institution of life insurance; and in other years would have resulted in companies with very large investment income paying much less than 52 percent of such net income in taxes while many would have paid much more than 52 percent and some, including our own company, would have paid as much as 75 percent and even more of their taxable net investment income in taxes.

In our company because of the averaging methods in all of the tax laws in effect from 1942 on, year after year after year we have paid more than our share of taxes while many other companies have, we believe, paid less than their share. Still other companies have borne with us this unjust burden of taxation.

So far as I know, no other business has been so taxed that it pays on the operational results of its competitors and yet that is exactly what the 1942 and intervening tax laws have done to the life insurance business.

In H.R. 4245 this injustice is greatly alleviated and if you would adopt the proposed 5-year average plan for phase 1, it would be eliminated completely.

If the 1942 act were to remain on the books our company would pay in Federal income taxes 79 percent of its net investment income after deducting its reserve interest requirements, while some of our competitors would pay less than 40 percent. Surely your committee does not wish such an unfair situation to obtain.

It is, I am sure, obvious to this committee, as it is to the Treasury and to the Ways and Means Committee, that the 1942 law is unjust in method, operation, and impact upon the companies. We believe it should be repealed and H.R. 4245 enacted in its place.

While there is much which could be said critically about the philosophy of H.R. 4245, like all legislation in a democracy it represents a compromise of many proposals and it is an improvement, in our opinion, over the 1942 act, the 1950 act, and the other intervening statutes enacted as stopgap laws in successive years.

It has the effect of laying its weight across the industry upon the basis of ability to pay. It compromises the philosophical argument of taxation upon the premium deposits made by the holders of participating policies and while those who propose such taxation may not be satisfied and those of us who opposed it likewise could complain, we are all in the position of finding half a loaf better than none.

One of the dangers which some of us saw in those proposals treating participating premium deposits as income, a fallacy, we verily believe, was that the smaller companies, both mutual and stock, could be put at a very serious competitive disadvantage by the huge mutuals with large surpluses and low reserve interest requirements, in that by the payment of larger so-called dividends to policyholders such companies could, in effect, dividend us out of the competitive market.

Your committee will recall that these so-called participating dividends are, for the most part, not dividends at all but a return of an unused portion of the premium deposit.

The concern of many of us smaller mutual companies that such so-called dividends could injure us competitively under certain types of taxation is alleviated considerably by the operation of phase 2 as it now appears in the bill.

There is a movement among some mutual companies to seek additional deductions for policyholder dividends. This we believe to be a most dangerous proposal and we oppose it most vigorously.

The suggestion that some of the big mutuals propose, under which they ask for credit of one-half the difference between the taxable income developed under phase 1 and that developed under phase 2, is the very heart of this dividend controversy.

For all of the more than 1,300 companies in the United States, whether they be stock or mutual, the competition is with the big mutuals. They are so large and they dominate the nationwide market to such an extent that they are the universal competitors. Our problem—that of the rest of us, both mutual and stock—is to meet their estimated dividend scales. This is the focal point of all competition in the life insurance business. To the extent that these estimated dividend scales are determined by mortality costs and expenses of operation, we ask no quarter. But if mutual companies ever can deduct the extra percentage of policyholder dividends which some now seek, they can further use Government tax dollars to sweeten such dividends. This we fear and against it we ask the protection of law by opposing the amendment which some of the big mutuals are seeking on this subject of dividends.

A study of the 1957 operations of six of the largest mutuals reveals that some of them had as much as 45 percent of their investment earnings free of taxes to distribute in dividends to policyholders. This is true because the present tax laws give favorable treatment to these big mutuals. In the same year there were also companies which had nothing from investment income to distribute to policyholders. This matter of the destructive power of competitive dividends is so important that we urge that your committee permit no change in the bill as it relates in any way to this vital factor.

The surpluses which all companies must develop as protection to policyholders are held for emergency contingencies and to ask a dividend tax deduction to avoid using these surplus funds when they should be used is to us unthinkable and wholly unjustified.

For this means that they would be charged with only one-half of any deficit developed even though such a deficit were produced by policyholder dividends and they have complete control over how much they pay out in dividends.

If you should adopt this fantastic proposal two very important enterprises which have a right to look to you for protection will be affected very adversely:

First, the smaller companies will be at the mercy of the giants in any competitive war which starts—and all of the ingredients of such a competition are already present in our business. This proposal could well supply the catalytic agent; and

Second, the U.S. Government will find that instead of getting upward of from $515 million to $560 million out of this bill, it will lose millions upon millions in taxes, for it will put into the hand of the taxpayer the knife with which he can prune his own tax liability. He can write his own tax ticket.

There has been much said about postponing final consideration on H.R. 4245 and the possibility of granting an extension of time to file final returns and pay taxes in 1959 on 1958 business.

Our own American Life convention has indicated that it thinks the committee might wish to take such a step. Much as I regret to part company with the convention, I must do so on this issue.

I can find no valid reason for any long postponement. Delay on a permanent form of taxation has been criticized, and properly so, for many years. I sat in this committee's room just about a year ago and hear Senator Byrd tell a representative from the Treasury to get a proposal to tax life insurance companies in by April 7, 1958; that it had been saying for years that it would make its suggestions and that your committee would not countenance further delay.

Since then the Treasury proposal has been brought forth. The Ways and Means Committee held protracted hearings, adopted the principles of the Treasury proposal, wrote a bill which the House passed overwhelmingly and which is now before you.

Some of the advocacy of delay is sincere, I am sure, but I suspect that some of it comes from sources which would use delay as a parliamentary tactic to scuttle H.R. 4245.

I urge you not to delay, but to act promptly.

To sum up, we favor the enactment of H.R. 4245. We would prefer the proposal to change phase 1 to allow the 5-year average and recommend it to you as being a better method than the one now in the bill. We urge that there be no delay; that this bill be dealt with promptly; that the unjust 1942 law be repealed. Further, we suggest that all proposed amendments be treated with the philosophy which Novelist Winston Churchill credited to Abraham Lincoln who, in refusing to adopt immediately an idea enthusiastically presented to him by one not entirely devoid of self-interest, is alleged to have said he would have to look it over very carefully because "I always shuck an ear of corn before I buy it."

Now I have completed testimony in my capacity as president of a mutual life insurance company, and from here on in this statement I speak for the American Life Convention by direction of its president and shall confine my remarks to an earnest argument for more equitable relief for small companies, a matter in which our organization is vitally interested.

In the past decade some 600 life insurance companies have been organized in the United States. In our opinion, it is generally a good thing that new companies are being formed. I am not pleading the case of the seekers of tax shelter or of any other type of company which has merited criticism, but of the hundreds of bona fide companies which are trying to get a start. It means new venture capital coming in to the economy, new enterprises being developed which, in turn, will provide greater carrying power for the risk load of American life insurance and new and additional investable funds available for the development of the American economy. It also is important to remember that these small companies are investing their funds in their home localities and thus are a very important factor in the development of our country.

The 1942 law makes no provision for the relief of new and small companies. The stopgap measures did make such provision and H.R. 4245 recognizes what we know as a small company deduction, permitting a deduction equal to 5 percent of the net investment income with a ceiling of $25,000.

Working from what reports are available to us, we have developed the following figures, and I think they are very interesting: 254 life insurance companies have assets of less than $500,000; 144 have assets of between $500,000 and $1 million; 243 have assets of between $1 million and $5 million.

Now to me $5 million is a lot of money but I submit to you that in the parlance of life insurance companies if total assets are at that figure you have a pretty small company.

When today's large companies were getting started, from 75 years to more than a century ago, there were no income taxes whatever and very little of any other kind of taxes. What we propose is that today's beginners be given something of a break in their formative years so that they, too, may have their chance to develop.

In the interest of the development of small companies, the American Life convention urges that the small company deduction in the bill be increased substantially from the present 5 percent with a $25,000 ceiling. We suggest that the ceiling be maintained at $25,000; that the percentage within the ceiling be increased. It has been suggested that the increase be from 5 percent to 25 percent and I can see much merit in this proposal. It is a large increase percentagewise, but it means but little dollarwise, to the Government. Our estimate is that to raise the percentage to 25 percent would reduce the tax "take" under this bill by but $4 million, and rechecking that figure our actuaries in the convention tell me that they have used the outside figures in every instance, and that $2.5 million would probably be more nearly accurate than $4 million.

Any lower percentage than 25 percent which your committee might use would reduce that amount of reduction in the "take."

We are not here to argue for any specific figure; we suggest 25 percent; we do heartily endorse the idea that there should be an increase in the deduction.

Most of the companies which would benefit belong to no organization and no concerted voice of their own creation will be heard for them. But their cause is important to our economy and we urge you as earnestly as we know how to grant this one deduction for small companies.

Thank you, Mr. Chairman, very much.

The CHAIRMAN. Thank you.

Senator Kerr?

Senator KERR. No questions.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Frear?

Senator FREAR. I assume that the 5 percent and the $25,000 have been made known to the rest of the companies as to just what that does.

Mr. LLOYD. I do not understand the question.

Senator FREAR. What is the 5 percent and what is the $25,000? Does it pertain to every insurance company?

Mr. LLOYD. Each company gets a deduction of $25,000.

Senator FREAR. I am sorry about the sun hitting you in the face. We are going to get those drapes up here one of these days, but we are a little short of money, and this tax bill will help us on that.

Mr. LLOYD. We are taking care of that. [Laughter.]

Senator FREAR. But every company gets a deduction of $25,000?

Mr. LLOYD. Every company gets the deduction of $25,000.

The 5 percent proviso would give every company a deduction of 5 percent of its investment income, with a ceiling of $25,000. Nobody would get more than that $25,000. It applies to all companies. But the number of them which are small is sufficient so that the reduction in the take by increasing the percentage would not be above, we estimate, $2½ million.

We put in my statement $4 million, and that is an overstatement.

Senator FREAR. But the 5 percent would have a maximum dollar value of $25,000?

Mr. LLOYD. That is right.

Senator FREAR. Thank you.

Mr. LLOYD. That is right.

Mr. CHAIRMAN. Senator Carlson?

Senator CARLSON. Mr. Lloyd, I appreciate very much your comments on the need for some additional relief for the smaller companies.

I noticed that 254 life insurance companies have assets of less than $500,000.

I may be in error, but I believe that in the State of Kansas, where we have a number of these small companies, I think we have 13 companies with less than $500,000.

I notice you make this statement as a representative of the American Life Convention, while in the earlier part of your statement was on behalf of your own company.

Does this also express your own personal views?

Mr. LLOYD. Definitely; yes.

Senator CARLSON. Yes.

Mr. LLOYD. I strongly urge this personally for the small company improvement, definitely.

I did not mean to divorce myself from it, but the first part of my statement is pretty controversial in the life insurance business, and the American Life Convention does not necessarily or probably does not at all agree with me, so I am trying to put my pins in a row here.

Senator CARLSON. I wonder if you do not have in your company in Cincinnati, Ohio, a very outstanding insurance man from Kansas, Judd Benson?

Mr. LLOYD. We certainly do, and we are very proud of him.

Senator CARLSON. I want to state for the record that during my service in the House, and while on the House Ways and Means Committee he used to come in and testify before the committee on this problem, and he made a very good witness for your company.

That is all, Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Has your company always been a mutual?

Mr. LLOYD. No, Senator. It was organized as a stock company.

Senator CURTIS. When did it change to a mutual?

Mr. LLOYD. It began mutualization in 1941, and completed it in 1954.

Senator CURTIS. In reference to the first part of your testimony where you opposed this feature referred to by some as the negative offset, you stated that it supported and would help the very large mutuals.

Are there not a number of small- and medium-sized mutuals that favor and would be helped by it, too?

Mr. LLOYD. That is possible, Senator; they might favor it. Whether they would be helped by it would be at a point where I might disagree with them, but I cannot accurately answer your question because I have not discussed it too much among the companies.

Senator CURTIS. You would not suggest that your view on it was the majority view?

Senator KERR. He means that that part of his testimony was his own view, and that was his view with respect to his own company.

Senator CURTIS. I understand it was. I was asking whether it was the majority view.

Mr. LLOYD. I would not suggest it was the majority view, but I would certainly not concede that it was not until I had talked to the other companies.

I would imagine that a great many of the companies would agree with me, particularly a great many of the stock companies, and I know some of the mutuals would, but I have not polled them, and I cannot tell you.

Senator CURTIS. But there would be some that would disagree?

Mr. LLOYD. Some that would disagree? Very definitely. There are some who have testified here thus far, yes.

Senator CURTIS. I was speaking primarily of the small and, perhaps, middle sized; I realize that is a relative term.

Mr. LLOYD. Yes.

Well, I have not polled them, and I cannot answer your question accurately. I would not attempt to speak for them.

Senator CURTIS. Would you mind stating what situation faced by your company that caused you to pay the inequitable portion of taxes in the past that you referred to in your statement? What set of circumstances brought that about?

Mr. LLOYD. Well, I will. Reserve interest requirements were a great deal higher than the average required under the Secretary's ratio or under the fixed average in the Mills bill, and thus we paid a higher percentage than companies that were nearer the average or on the underside of the average.

Senator CURTIS. You were facing a situation where you were building up your reserves and thus going beyond the industry average to which the previous laws have entitled you to; is that right?

Mr. LLOYD. We had a lot, and still have a lot, of 3½-percent reserve policies on our books.

We are writing at 2¼ percent. Our earning rate is improving. The two factors were closing in, but it takes a long time, and the bill worked—all of these bills have worked—always against any company that is in such a situation as ours.

I gave to Mr. Mills, in the Ways and Means Committee, a list of some 30 companies that were in our situation when this bill was under consideration or when the problem was under consideration over there. It is not exactly unique with our company. We have plenty of company.

Senator CURTIS. There were 30 of them?

Mr. LLOYD. Thirty of them, as I remember; yes.

Senator CURTIS. That is all.

Senator KERR. Mr. Chairman, I want to ask one question.

Was there some law passed in Ohio that in anyway contributed to your company going from the status of a stock company to a mutual company?

Mr. LLOYD. A law passed in Ohio?

Senator KERR. You are from Ohio?

Mr. LLOYD. Yes.

Senator KERR. Yes, sir.

Mr. LLOYD. Well, the Ohio Legislature passed a statute back in the early thirties permitting stock companies to mutualize—I do not know whether that is what you have in mind or not—but we did not mutualize because of the compulsion of law.

Senator KERR. I did not contemplate that you did.

Mr. LLOYD. It was not a shotgun marriage. [Laughter.]

Senator KERR. I was under the impression that the Ohio Legislature passed a law making it possible for a stock company to mutualize, and the controlling stockholders continued more or less in control of the mutualized company.

Was there anything in the bill in that direction or that included anything that would form the basis for that impression?

Mr. LLOYD. Well, the Ohio mutualization law is almost an exact copy of the New York law.

Senator KERR. Well, now, can you tell me what it is without my having to look up the New York law to find out what the Ohio law is?

Mr. LLOYD. The statute provides that when a company is in process of being mutualized, the superintendent of insurance appoints trustees who act for the policyholders, and at the time of mutualization those trustees elect directors.

I have never known them to fail to reelect the old directors in the mutualizations that I know about.

In the mutualizattions that I know about the old control has, after the passage of a few years been diluted very drastically.

Senator KERR. Due to no act of their own. I mean the passage of time eventually brings about, as Senator McCarthy remarked on the side here a while ago during the conversation between Senator Douglas and one of the witnesses about the mortality rate, he remarked that it eventually is a hundred percent. [Laughter.]

I presume that the passage of time would make that dilution necessary even if not by willing act of one of the old directors.

Mr. LLOYD. I can only speak for our own company, and there has been a rather dramatic change over the period from 1954 on in the management of our company; that is, if you called the roll of the management as of 1954 and now you would find that what you call mortality has been pretty heavy.

Senator KERR. In other words, even they have proven mortal. [Laughter.]

Mr. LLOYD. Yes, sir.

Senator KERR. I was not finding any fault with that. I had just been under that impression, and I thought it was a matter of considerable interest to you, and I knew that you would know, and you have proven yourself very articulate, and I thought I would give you the opportunity to advise me.

Mr. LLOYD. May I be a little more articulate to make this one observation?

Senator KERR. I certainly would not want to discourage it in any way.

Mr. LLOYD. I would like to make this one observattion about it: that it does not appear to be practicable or sensible certainly to have a mutualization law which would force out the entire management of a company just because it had been mutualized; that does not seem to me to be sensible. I do not know why anybody would want to do that.

Senator KERR. I do not either, and I think one very available alternative would be to fix it so that the management of the stock company would continue to manage the mutualized successor.

Mr. LLOYD. It might be a very good thing; yes, sir.

The CHAIRMAN. Are there any further questions?

Thank you very much, Mr. Lloyd.

Mr. LLOYD. Thank you.

The CHAIRMAN. Senator Kerr will present the next witness.

Senator KERR. Mr. Chairman and members of the committee, the next witness is Mr. Johnson D. Hill, Jr., of the Atlas Life Insurance Co. of Oklahoma, a great Oklahoma insurance company, and it has been operated for many years by the distinguished father of this witness, who was, at one time, speaker of the house of representatives of the Oklahoma Legislature.

I want to say it is a great pleasure to me to have the opportunity to present Mr. Hill to this committee.

He is aware of the fact that in a little while I am to introduce a member of the Oklahoma Supreme Court over here who is going to pay tribute to a former Vice President, Mr. Curtis, with reference to whom they are having a ceremony in honor of him over at the Capitol, and I may have to leave while your testimony is being given or while you are being questioned.

But I just wanted to say to the committee that there is no one before this committee or will be no one before this committee who would be more sincere or present his case in a more worthy manner than Mr. Hill.

Senator CARLSON. Mr. Chairman, I would like to say that we in Kansas appreciate the great honor being bestowed on a great citizen of our State, Mr. Charles Curtis.

Senator KERR. You would be amazed as to how little consideration that is being given because of the fact that that was in his record. [Laughter.]

## STATEMENT OF JOHNSON D. HILL, JR., EXECUTIVE VICE PRESIDENT, ATLAS LIFE INSURANCE CO., ACCOMPANIED BY C. H. MENGE, VICE PRESIDENT AND ACTUARY

Mr. HILL. Thank you very much, Senator.

My name is Johnson D. Hill, Jr., I am executive vice president of the Atlas Life Insurance Co., of Tulsa, Okla. With me is Mr. C. H. Menge, vice president and actuary of our company.

Atlas Life is a stock company, issuing nonparticipating ordinary and the usual forms of group and accident and health insurance, as well as annuities. We are in our 41st year of business, and as of last December 31 we had insurance in force in excess of $291 million, with assets amounting to $26.7 million. As life companies generally are classified, we would be numbered among the small ones.

My appearance here today represents quite a departure from the custom we have followed for many years. Like most companies of our size, Atlas Life traditionally has been represented, in matters pertaining to Federal legislation, by the able spokesman for various industry organizations of which we are members. The pending question, however, is one on which there is such wide difference of opinion among various segments of our business that we felt it was essential for us to express our views independently. We appreciate very much the opportunity of doing so.

We are unalterably opposed to House bill 4245 in its present form, and, in the absence of any substantial changes in it, we strongly urge that the bill be defeated. The members of this committee are familiar with the long and involved history of life insurance company tax legislation, and I shall not go through a recitation of it. Suffice to say, the life insurance business has been taxed for the last several years under a series of so-called stopgap measures. A year ago, when the last such measure was enacted, Members of both Houses of Congress were outspoken in their statements that it would be the last "temporary" tax bill and that a permanent method of taxing life companies must be developed. It is almost incredible to think that our business is confronted with the possibility of having this bill as the permanent basis of our Federal taxes in the years ahead.

Our opposition to the bill is twofold. First, we consider the estimated tax liability under the bill to be excessive and unrealistic for the life insurance companies as a whole and for our own company in particular. Atlas Life paid Federal income taxes amounting to $59,251 on 1957 operations. Our tax on 1958 operations would be approximately $107,000 under House bill 4245, an increase of almost 80 percent. I have been told that the tax burden on other companies would increase to an even greater degree—more than double in some cases.

We share the feeling of our industry generally that if the increasing cost of government necessitates additional revenues, we are willing to do our part. But where is there a precedent for imposing on a single industry—in the period of a single year—an overall 70 percent increase in the tax burden through adjustment of the tax base? For that matter, how often—in a proposal of this magnitude—has Congress been asked to write a tax law which will conform to a revenue goal arbitrarily predetermined by the Treasury? Isn't that a reversal of the normal procedure?

I was most interested in reading in the Congressional Record the floor debate on this bill in the House of Representatives. Mr. Curtis of Missouri made two observations which I believe are worthy of particular note. After commenting on the fact that the Federal Government, through the social security program, has entered the field of retirement benefits and protection of our people, Mr. Curtis said, and I quote:

> Pressures are constantly exerted to push the Federal Government more and more into this field. There is no question about it. If by accident or otherwise, if in this bill we are taking too much out of this life insurance sector of our private economy, we are going to have the needs taken care of through the governmental sector. It is that point that has not been considered in the studies of the Ways and Means Committee, nor were those considerations studied by the Treasury Department.

At another point in his remarks Mr. Curtis observed that the Ways and Means Committee, which drafted the bill, had made no "adequate" study, as he termed it, of its economic impact upon the life insurance industry.

It would seem to me, Mr. Chairman and members of the committee, that in the preparation of any tax bill involving anticipated yields sharply higher than those which might be expected as the result of existing taxes on normal business growth, serious consideration should be given to a gradual application of the new tax so that the impact would be lessened.

I know this committee is cognizant of the fact that life companies bear a heavy tax burden at the State level in the form of premium taxes. But I would like to acquaint you with the manner in which this situation affects my own company.

Oklahoma has the highest premium tax of any State in the Union—4 percent. It is true that companies domiciled in Oklahoma do not pay this tax on business written in the State, and it also is true that the effective tax rate can be reduced by out-of-State companies which maintain favorable ratios of investments in Oklahoma. I would point out, however, that more and more States are enacting retaliatory laws which tax an Oklahoma company 4 percent of premiums, for example, if their own companies are taxed 4 percent in Oklahoma. Of the 10 States other than Oklahoma in which my company operates, 8 have such retaliatory laws.

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Our second and equally important objection to House bill 4245 has to do with the principles involved and our belief that the measure involves gross inequities. At this point the matter resolves itself into a conflict of interests between the mutuals and stock life companies. My friends of the mutual companies can and will speak for themselves, as they have done very effectively on this issue; I speak for one stock company.

Whenever the life insurance business is discussed in general, much is made of the fact that more than 60 percent of the insurance in force in this country is in mutual companies, the fact that the mutuals have three-fourths of the total assets of the industry, and so on. The trend, it is said, is more and more toward the mutualization of life companies. And it is axiomatic that the big get bigger, although among the 10 largest life companies in the United States 4 are stock companies. But it is also a fact that the vast majority of life companies are stock companies. Geographically, they represent a far greater area of our country than do the mutuals. Therefore, if you accept the premise that the tax in question is a tax on business—which it is, despite the arguments of the mutuals, that it would fall directly on policyholders—you must accept the fact that any inequities in allocation of the tax liability which favor the mutuals will weight most heavily against a majority of the companies in the industry. And that is precisely what we believe would occur under this bill. The continuing emphasis in its preparation has been to place a greater share of the tax burden on stock companies, I would like to trace, briefly, the course of this legislation.

Several weeks ago the Treasury prepared a draft bill, which involved a two-phase tax base. The first phase would have assessed a tax on investment income, and the second—aimed primarily at stock companies—would have applied an additional tax on what we call net gain from operations, or underwriting profits. This measure was proposed after public hearings were held by the Way and Means Committee last fall on the overall life company tax question. No hearing were held on the Treasury draft bill. The industry, naturally, gave as much thought to this draft as time would permit, because the Ways and Means Committee was preparing to start the preparation of its own measure. Representatives of stock companies felt that if a special tax base applicable principally to stock companies was inevitable, it should be concerned with the distribution of dividends to stockholders as a more realistic measure of "profits," rather than gain from operations. This latter type of tax base was suggested in lieu of the phase 2 proposed in the Treasury draft. It would not be difficult to imagine our consternation upon learning that the Ways and Means Committee bill simply added the third phase, instead of substituting it for phase 2 of the Treasury draft. I would call your attention to the fact that all this happened in a relatively short period of time.

Of paramount importance in this matter is the principle involved. We are gravely concerned about it. On the question as to whether this measure discriminates against stock companies in favor of the mutuals, let me tell you that my own company's 1958 tax—if we were a mutual—would be approximately $47,000 as compared to the $107,000 we would pay as a stock company. Any tax bill which embraces special levies on stock companies, and which permits mutuals to deduct so-called dividends to policyholders, not only places an unfair additional burden on stock companies but also gives the mutuals a tremendous competitive advantage. Quite frankly, we believe such a measure would contain the seed of the stock companies' destruction. It might well contain the seed of the mutuals' destruction as well, because once such a principle is established in the law, it would only remain for some future Congress to reduce the deductions these companies could take as a result of their dividends, or perhaps eliminate them entirely.

What would be the alternatives if House bill 4245 fails of passage? Much has been said about the 1942 life company tax law, which has been inoperative for many years and which would be highly imperfect as a permanent statute. As imperfect as it is, however, we would much rather be taxed under this law on our 1958 operations than under House bill 4245, pending further studies leading to the enactment of a fair and equitable permanent law. Another alternative, which was suggested during the House debate on the bill, would be to renew for 1 year the Mills stopgap measure, with an amendment designed to adjust the tax formula with respect to certain "specialty" companies whose business is largely term insurance and whose taxes on investment income, therefore, are very low in proportion to their earnings.

Finally, I should like to mention a thought which comes to mind with increasing frequency. It has to do not only with the matter of fair distribution of the tax load between stock and mutual life companies, but also with the larger issue of taxes on all life companies, as compared to the taxes imposed on other types of thrift and savings institutions. I refer to the fact that the Constitution guarantees "equal protection under the law," and that applies to corporate entities as well as human beings. The dollars paid to life insurance companies by individuals for their own security and the protection of their families are taxed far more heavily than the dollars these people entrust to banks, savings and loan associations, or any similar depositories. The time may well be near when the whole question of these inequities should be the subject of adjudication.

Thank you.

The CHAIRMAN. Are there any questions, Senator Kerr?

Senator KERR. Mr. Hill, I notice in your statement you say:

> It would seem to me, Mr. Chairman and members of the committee, that in the preparation of any tax bill involving anticipated yields sharply higher than those which might be expected as the result of existing taxes on normal business growth, serious consideration should be given to a gradual application of the new tax so that the impact would be lessened.

Have you given thought to the preparation of an amendment which, if enacted, would achieve that result?

Mr. HILL. Senator, we would be glad to attempt to draft an amendment. We have not done it.

What I have in mind is a feature such as, I believe, the Treasury itself came forward with last April, to lessen the impact by grading the tax of any type which would increase the——

Senator KERR. The present rate?

Mr. HILL. Would increase the net result, the amount of money raised.

Senator KERR. I would request that you do prepare something along that line and provide it to the committee.

Mr. HILL. Yes, sir; we will.
(The information referred to is as follows:)

ATLAS LIFE INSURANCE CO.,
*Tulsa, Okla., March 12, 1959.*

Hon. ROBERT S. KERR,
*Senate Office Building,*
*Washington, D.C.*

MY DEAR SENATOR: At the conclusion of my testimony before the Senate Finance Committee on H.R. 4245, the life insurance company tax proposal, you requested that I submit suggested amendments in connection with my contention that any permanent law which sharply increases the tax burden of life companies should have provision for a graded application in order to lessen its immediate impact on the industry.

As stated in my testimony, we urge that the 1942 tax law be made applicable to the 1958 operations of life companies. We recommend that beginning with the tax year 1959, the application of phase II of the pending bill be graded over a 5-year period. This could be accomplished by either of the following methods:

1. For the 1959 tax year, a credit of an amount equal to 50 percent of the taxable income arising under phase I of the pending bill could be allowed against the phase II taxable income. Similarly, a 40-percent credit could be allowed for the 1960 tax year, with a decrease of 10 percent in each succeeding tax year until finally such credits would run out in a 5-year period. This would not, of course, reduce the tax yield under phase I of the bill.

2. As an alternative, the impact of the tax under phase II could be reduced by making this tax effective in 10 percent step increases under a 5-year period beginning with 1959 operations.

I regret that lack of time and access to industrywide statistics prevents me from furnishing you an estimate on what effect these suggested changes would have on revenue.

In connection with my belief that the bill, as passed by the House, discriminates against stock companies in favor of the mutuals, we urge that the deduction allowance under phase II of 10 percent of the increase in reserves on nonparticipating business be increased to 12 percent. This would be a step toward offsetting the advantage the mutuals would have under the present bill through the provision for deducting policyholder dividends.

Mr. Menge and I enjoyed our visit in Washington last week, and we are most appreciative of your courtesies and interest in this very important matter.

With kindest regards, I am
Very truly yours,

JOHNSON D. HILL, Jr.

Senator KERR. That is all.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Hill, in your statement you state that your own company's 1958 tax, if you were a mutual, would be approximately $47,000 as compared to $107,000 you pay as a stock company.

Would you furnish for the committee and for the record a breakdown of how you arrived at that computation?

Mr. HILL. We will be glad to do that, sir. I doubt if we are in position to at the moment.

Senator WILLIAMS. Will you furnish it for the record?

Mr. HILL. Yes.

(The information referred to is as follows:)

ALL FIGURES GIVEN BELOW ARE ESTIMATES, BUT ARE CORRECT AS WE UNDERSTAND THE PROPOSED LIFE INSURANCE COMPANY TAXATION LEGISLATION AS IT APPLIES TO ATLAS LIFE INSURANCE CO., TULSA, OKLA.

| | |
|---|---|
| Taxable investment income (subpart B) | $104, 210 |
| Taxable income (subpart C) | 135, 192 |
| Total taxable income | 239, 402 |
| Normal and surtax estimate (1958) | 107, 019 |

On the assumption that Atlas life paid dividends to policyholders of $254,000 [1] the estimated taxable income would be under—

| | |
|---|---|
| Subpart B | $104, 210 |
| Subpart C | 8, 167 |
| Total taxable income | 112, 377 |
| Normal and surtax estimate (1958) | 47, 817 |

The CHAIRMAN. Senator Frear?

Senator FREAR. Mr. Hill, what was the investment income of your company for 1958?

Mr. HILL. About $1,100,000, Senator.

Senator FREAR. Your operations income?

Mr. HILL. $252,000. You mean the net gain from operations?

Senator FREAR. Well, I am going to ask you what other income you had in addition to those two, so you might give me a total of all of them.

Mr. HILL. Well, the figure shown as net gain from operation is, I believe, $309,000.

Senator FREAR. That includes operations and other income, rents or what not, anything?

Senator FREAR. $309,000. So that makes a total of $1,409,000?

Mr. MENGE. Operating income?

Senator FREAR. Total income; total net income.

Mr. MENGE. Are you speaking of the net income as determined on the Federal income tax form or in the annual statement?

Senator FREAR. As it would be determined on your Federal income tax form?

Mr. MENGE. $850,000.

Senator FREAR. $850,000.

Then what is the difference between $859,000 and $1,111,000 that you designate as investment income?

Mr. MENGE. Those are the deductions that we are permitted to take under the law.

Senator FREAR. Then $859,000 is your taxable base?

Mr. MENGE. Yes, sir.

Senator FREAR. In an ordinary company what would be the corporate tax on $859,000 of taxable profit?

Mr. HILL. I presume it would be the 52 percent rate that would apply.

Senator FREAR. It would be nearly 52 percent anyhow; it would be 52 percent on $759,000. But you are going to pay a tax, if this bill is enacted, as I understand it, of $107,000.

Mr. HILL. Yes, sir.

Senator FREAR. That is quite a bit less than $425,000 would be; is that right, sir?

Mr. HILL. It is.

Senator FREAR. But you think that is an inequitable tax?

Mr. HILL. I am not sure——

Senator FREAR. Or an excessive one, whichever one you want to call it?

[1] Dividends are arrived at by taking in the aggregate—

| | |
|---|---|
| ½ of 1 percent of the policy terminal reserves | $97, 940 |
| 10 percent of the year's cost of mortality assumed in the policies | 90, 660 |
| Total renewal premium loading less ½ total company expenses | 65, 400 |
| Total dividends assumed | 254, 000 |

Mr. HILL. I am not sure we are comparing alikes, Senator.

Quite frankly, sir, we are not prepared to answer questions or to discuss with you the details of this tax bill because, frankly, we have not had an opportunity to go into it as much as we would like to. We have not had the advantages that some of the other witnesses have had who have been working on that thing in connection with the joint committees, and so on.

Senator FREAR. I appreciate that, and I will accept that.

I guess Mr. Menge has been spending his time on this formula that has been produced, and I think it is a pretty good one.

Mr. MENGE. No, you have had me mistaken.

Senator FREAR. You mean you do not deserve that credit?

Mr. MENGE. No, sir.

Senator FREAR. Thank you for admitting it. Not many people on the Hill would make the admission that you have made.

Mr. MENGE. There are two Menges; I am not he.

Senator FREAR. Thank you, Mr. Hill.

The CHAIRMAN. Senator Gore?

Senator GORE. Does your company write credit insurance?

Mr. HILL. We have a very small volume of group credit life insurance.

Senator GORE. You say that you are opposed to this bill for two reasons: Your first reason being that it increases your own tax liability by as much as 80 percent in 1 year.

Now, in the case of specialty companies with very little, if any, income from investment, but having income from short-term operations, which now pay very little, if any, taxes, the tax increase under this bill would be not 80 percent but it might be 8,000 percent.

Do you think a good reason for opposing a bill is that it provides a percentage increase of tax liability on certain companies?

Mr. HILL. I feel, Senator Gore, that the 8,000 percent impact which you suggest might apply to a very, very small segment of our industry, whereas the overall effect on all companies would average out a 70 percent, and in our own case would be greater than that.

Senator GORE. I think, so far as I am concerned, the specialty concerns to which I have referred ought to be taxed as an ordinary corporation, and required to pay the corporate rate. That is how I presently feel about it, but I am open to further education on the subject.

It occurred to me that it was not valid to oppose a bill which might be otherwise equitable merely because it provided a given percentage increase.

That might be an indication that your company had not previously been paying its fair share of taxes.

Mr. HILL. Well, I suggest, Senator, that an 80-percent increase in 1 year is a tremendous increase.

Senator GORE. I agree; I agree it is. But it might indicate that the Congress had in the past been remiss in its duty, as well as that it might now be levying too heavy a burden. Whichever the case might be, the yardstick is whether the pending bill is a fair and equitable tax proposal; would you not agree?

Mr. HILL. Are you asking me whether I think it is a fair——

Senator GORE. No; I am asking shouldn't that be the yardstick?

Mr. HILL. Indeed it is, and I am sure, Senator, that the bill which comes out of this committee will be a fair and equitable bill; we hope it will be.

Senator GORE. I agree with you that this committee will undertake sincerely and earnestly to write a fair and equitable bill. I did not think it did so last year, but I believe it will this time.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

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

The committee will adjourn until 10 o'clock tomorrow morning promptly.

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

HOME LIFE INSURANCE CO. OF NEW YORK,
*Richmond, Va., March 5, 1959.*

Hon. HARRY F. BYRD,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: I am writing you regarding H.R. 4245 on taxation of life insurance companies.

Even though I am in the life insurance business, I have felt for some time that the companies should receive favorable tax treatment, and probably some day this will be done. I do feel, I must write to say, that it looks to me the present bill pending is discriminatory between the mutual companies and the stock. I do not feel that one should receive favorable tax treatment over the other and there should be no difference made in the method of taxation. It would seem to me that if you are going to encourage life insurance companies to use higher interest rates on policy reserves you would also make it mandatory to do so. Also, I believe that the mutual companies should be allowed proper deductions with any deficit that may arise if the operating gains fall short of investment income. And, if I may suggest revising the provisions on qualified pension plans so that they receive the same tax treatment as trusteed plans do since pensions are becoming a definite part of our economy. This to me would seem to be a must on any sort of taxation affecting pension plans.

Trusting that the few items mentioned above will merit consideration, I remain,

Respectfully yours,

WILLIAM M. DUDLEY.

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UNION LIFE INSURANCE CO.,
*Little Rock, Ark., February 27, 1959.*

Hon. J. WILLIAM FULBRIGHT,
*Senate Office Building, Washington, D.C.*

DEAR SENATOR FULBRIGHT: Inasmuch as you are no doubt receiving many statements in opposition to the proposed life companies Federal income tax bill by other companies, I am taking the liberty of writing you our position on this proposed bill.

We are ready to accept and favor the general pattern of the new three-phase approach to the Federal income tax for life companies. We do, however, urge that certain changes in the definition of the "deduction rate" used in the bill be made, as recommended by the Life Insurance Association of America. With this change we feel the bill would be reasonable both in its technical approach and in the tax imposed upon life insurance companies.

In taking this position we are motivated by two main points; first, that the tax burden, while great, is the least that the industry will be permitted by Congress to bear, and, secondly, that the field of life insurance taxation is exceptionally complicated and the Mills committee has dealt with this difficulty in a fair and sincere manner to derive a bill with ultimate fairness.

While the tax impact will vary widely among companies, this should not be taken as prima facie proof that it is unsoundly conceived. It is our opinion that in the long run the supposed discriminations, hardships and bias will prove to be greatly exaggerated or nonexistent in practice.

In short, we feel that the time has come to accept the best answer that has been put forward for a permanent solution to our tax problem. We are not optimistic that any better solution can be brought forth and, therefore, urge your support of the bill with the suggested modifications, if possible.

Thank you very much for your consideration.

Yours very respectfully,

J. WYTHE WALKER, *President.*

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THE MUTUAL LIFE INSURANCE CO. OF NEW YORK,
*Little Rock, Ark., March 4, 1959.*

Senator J. WM. FULBRIGHT,
*Senate Office Building, Washington, D.C.*

DEAR SENATOR FULBRIGHT: H.R. 4245 imposes a very unfair tax on the savings of millions of Americans who have their money invested in life insurance. The tax legislation does not give full credit for dividends to policyholders. As you know, these dividends are actually the return of an overcharge.

I trust you will look into this bill carefully and amend it so that it will not discriminate against the initiative of millions of Americans in their effort to provide security for themselves and their families.

Sincerely,

STANLEY FALK.

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THE MERCHANTS NATIONAL BANK OF FORT SMITH,
*Fort Smith, Ark., March 2, 1959.*

Hon. J. W. FULBRIGHT,
*U.S. Senate Office Building, Washington, D.C.*

DEAR SENATOR FULBRIGHT: While in Washington last week to testify before the Senate Antitrust Monopoly Committee, I did some work with reference to H.R. 4245, the new tax bill concerning the life insurance industry, and wanted to write and tell you my feelings concerning this bill.

Bill, while this proposal may be acceptable to some of the large eastern life insurance companies, it is very destructive, it seems to me, to the business in our State. Under the provision of this proposed bill, the tax load is distributed unfairly and in such a way as to seriously prejudice the continued growth of business in States such as Arkansas. The so-called steps 2 and 3 of this proposed tax are particularly discriminatory and step 3 seems designed to legislate companies out of business, rather than to raise revenue.

I will certainly appreciate any help that you can give to us in reflecting Arkansas' position on this injurious legislation.

Again, I would like to thank you, Bill, for the splendid cooperation and help which you gave me while in Washington.

Best personal regards.

Sincerely,

C. B. WHITESIDE, *Vice President.*

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SALT LAKE CITY, UTAH, *March 4, 1959.*

Senator FRANK E. MOSS,
*U.S. Senate, Washington, D. C.:*

As the representative of thousands of policyholders in our area and your home area we feel it extremely important on how you vote on H.R. 4245. If this bill passes it appears that the tax will be about 5 times as great as on other forms of savings which is obviously unfair.

JAMES L. NEVILLE,
*President, Salt Lake Association of Life Underwriters.*

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SALT LAKE CITY, UTAH, *March 5, 1959.*

Senator FRANK E. MOSS,
*U.S. Senator from Utah,*
*Washington, D.C.:*

We are most concerned that the bill H.R. 4245 does not give full credit of dividends to policyholders as a return of premium which is what they are. This is a matter of concern to the thousands of policyholders in Utah. Our association, the agents, and the thousands of policyholders of Utah hope that you will support our stand by amending this bill.

JAMES L. NEVILLE,
*President, Salt Lake Association of Life Underwriters.*

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JOHN HANCOCK MUTUAL LIFE INSURANCE CO.,
*Richmond, Va., March 5, 1959.*

Hon. HARRY F. BYRD,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: The proposed method of taxing the income of life insurance companies is in effect an additional tax on the savings of millions of farsighted and thrifty Americans. Inflation is unquestionably the greatest present threat to our economy. It is eating away values and taking us along a very dangerous course. Life insurance is anti-inflationary. In fact, the institution of life insurance is one of the strongest forces working against inflation. To levy an additional tax on the companies is to further tax the public and to discourage savings which might help in the effort to retard the inflationary spiral.

You and your fellow Senator from Virginia have through your efforts, saved the country millions of dollars. You are, I am sure, cognizant of the fact that proposed new method of taxing the income of life insurance companies could have a very bad effect upon the efforts of millions to save and invest through life insurance. You are again called upon to oppose legislation which is not good for the public and which is unfair to particular companies. It is admitted that a revised method of levying an income tax upon life insurance companies is needed, but let's not have it in the form and to the extent now proposed.

Respectfully yours,

WILLIAM R. GARDNER.

STATEMENT OF ORVILLE F. GRAHAME, VICE PRESIDENT AND GENERAL COUNSEL OF THE PAUL REVERE LIFE INSURANCE CO. OF WORCESTER, MASS.

We heard the testimony given before the Senate Finance Committee on the 3d, 4th, and 5th of March, 1959, and wish to support the testimony of witnesses to the effect that H.R. 4245 places a very heavy burden on thrift and as compared to the burden placed on other forms of savings.

We also wish to support the suggestions made relative to tax-free interest and the dividends received credit and the use of the individual company's own earned interest rate for the determination of the reserve deduction. We also support the general pattern of H.R. 4245 in its attempt to keep a competitive equality between stock and mutual companies. There are, however, two points which from our experience we believe deserve special consideration, and we feel that we are asked to pay more than our share of the total tax.

TRANSITION PERIOD

We have seen figures which indicate that the consequences of this bill do not have uniform application on all companies as compared to the stopgap law which has been in effect. A few companies may get a tax reduction while others have no substantial change. Overall the increase is approximately seventy percent but for this company the tax is quadrupled. On the basis of 1957 figures our individual company tax was $340,000 and under the stopgap law would be $431,000 for 1958. On the basis of H.R. 4245 we anticipate our tax would be increased to $1,356,800 with $1,024,000 coming from phase one and $332,200 from phase two. Total dividends to stockholders for 1958 were $552,000. On the basis of the 1942 law our 1957 tax would have been $594,000 and for 1958 would be $731,000. While the annual statement for 1958 would show for this company an underwriting profit of $1,500,000 we contend these figures because of long-term commitments are subject to misinterpretation. This will be discussed further in the second part of this statement.

This company writes ordinary individual and group life insurance and long-term individual disability contracts and has little so-called credit insurance in force. Premium rates as in all companies are calculated on expense loadings determined with considerable regard for the tax situation and particularly with the year 1958 closed we do not feel that H.R. 4245 should be fully effective without a transition period. Stock values of small investors may be needlessly disturbed by radical changes in the tax formula.

We have suggested to our Massachusetts Senators an alternative of twice the stopgap law or the 1942 law as a maximum with H.R. 4245 otherwise applying.

A practical alternative as a transition period which we could support was suggested in the testimony of Russell H. Matthias, speaking for the State Farm Life Insurance Co., of Bloomington, Ill. He suggested a formula which limits the combined tax from phases 1 and 2 only of H.R. 4245 to a maximum of either (1) a percentage of the tax under the stopgap formula in effect prior to 1958, or (2) a percentage of the tax under H.R. 4245, whichever is the larger. The maximums he suggested as appropriate are:

For 1958, 175 percent of stopgap or 50 percent of H.R. 4245, whichever is larger;

For 1959, 200 percent of stopgap or 60 percent of H.R. 4245, whichever is larger;

For 1960, 225 percent of stopgap or 70 percent of H.R. 4245, whicever is larger;

For 1961, 250 percent of stopgap or 80 percent of H.R. 4245, whichever is larger;

For 1962, 275 percent of stopgap or 90 percent of H.R. 4245, whichever is larger.

Note that the foregoing limitation would not apply to phase 3.

We call attention again to the statement in a letter by Mr. Robert B. Anderson, Secretary of the Treasury, to Chairman Mills, of the House Ways and Means Committee, dated April 10, 1958, when he said that provision should be made a gradual transition to the new method over a 3- to 5-year period. "During this transition, the tax would be computed as a weighted average of the tax under the new method and the tax under the present stopgap method, with gradually increasing weight to the new method."

We sincerely urge some form of transition formula which would permit a company to adjust its tax picture to the new and much increased tax obligations. A quadrupled increase in the tax for 1958 over 1957 is a very harsh result, particularly when it comes after the tax year has closed.

NONPARTICIPATING LIFE AND LONG-TERM DISABILITY CREDIT

A very necessary provision in a Federal income tax law is a provision so that nonparticipating companies will have a cushion similar to that possessed by the mutual companies through their right to adjust premiums by dividends which they can do by reason of the overcharge portion in their premium. This is particularly true where there is a longrun commitment on personal disability insurance. A disability reserve is necessary for a level premium but may not build up in the same degree as in life insurance where death or maturity is certain, but the hazards of such disability insurance from the longrun viewpoint are as great or greater. We know that most life companies had to cease writing permanent and total disability insurance during the depression and several important companies became insolvent. A substantial surplus for policyholders is necessary and it is more important to have it available for use than it is if charged as a liability on any formal reserve basis.

A policy paying $100 a week benefits means that the policy can pay $5,200 a year. If such a claim runs 20 years the total payments are $104,000. Needless to say, a large surplus is necessary to carry such insurance, where the benefit period or when the insurance term is long such as to age 65 or for life and where the policy is guaranteed continuable at insured's option and especially under a guaranteed premium, as in our case. In this situation the 25 percent of reserves or 60 percent of premiums is barely adequate as a maximum in phase 3 and the 10 percent of reserves which can be used in phase 2 for nonparticipating insurance may not be sufficient protection. The surplus of companies writing long-term disability insurance was indeed adversely affected during the period 1930–40.

We wish to support the suggestion in the statement by Mr. John T. Acree, Jr., president of the Lincoln Income Life Insurance Co., of Louisville, Ky., that there should be an alternative to the allowance of 10 percent increase in nonparticipating reserves, which would be 5 percent of premiums on nonparticipating contracts of a duration of 5 years or more. If this provision is not allowed and if the maximum permitted is not adequate the Congress will be taking a grave responsibility in discouraging sufficient means to cover long-term disability needs of the enterprising citizen. This suggestion was also supported in the statement to your committee filed by Mr. Jarvis Farley of Massachusetts Indemnity & Life Insurance Co., of Boston.

It should be noted that the maximum limitation on policyholder surplus in phase 3 is now in the alternative, one limit being based on reserves and the other on premiums. The suggestion for an alternative nonparticipating premium credit, especially for long-term disability protection, would fit the same alternative pattern.

It is believed to be a reasonable supposition that substantially less than the 50 percent of underwriting gain should be considered as profit under phase 2 on long-term disability contracts, with phase 3 including the maximum limitation of 25 percent of reserves or 60 percent of premiums correcting any error in such supposition.

As has often been said the annual statement of a life insurance company was not designed to show profit or loss. Much emphasis has been made on the reserve factor which follows from the requirements of a level premium. To have an adequate surplus for a hazardous business is one of the necessities of this business and the creation of this surplus should not be considered a net operating gain in the sense of other business corporations.

You can appreciate that we do not think our taxes should increase in 1 year from $340,900 to $1,356,800. We therefore believe that there should be a transition period and because of long-term commitments there should be an alternative annual premium credit for nonparticipating insurance, especially for long-term disability contracts which are not only hazardous but still considerably experimental.

Several of our largest competitors in the long-term disability field are the largest mutual life companies, which can rely on the dividend cushion and other premium adjustments. One such company testified at the recent hearings that its tax for 1958 would be about $68 million. This represented without amendments 12.477 percent of the total tax. Such company according to "Best's Life Insurance Reports" had in 1957 13.739 percent of the assets and 14.208 percent of the life insurance in force.

We support that company's claim that this tax is too heavy a charge on thrift. We think that is especialy true in our case. We compute our tax liability for 1958 under H.R. 4245 as constituting 0.249 percent of the total tax on all life companies but we had only (at the end of 1957) 0.141 percent ($648,-191,000) of the total life insurance in force ($458,359 million) and 0.138 percent ($139,355,000) of the total assets in all companies ($101,309 million). While we recognize that some disparity will result we would like some reasonable period of time to study this result and, if inevitable, to adjust to it.

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MIDLAND EMPIRE LIFE INSURANCE CO.
*Atchison, Kans., March 10, 1959.*

Hon. HARRY F. BYRD,
*Senate Office Building, Washington, D.C.*

DEAR SENATOR BYRD: Five years ag , my associates and I started a project which has been a lifelong ambition, i.e. the formation of a new life insurance company. In the intervening years, we have devoted most of our waking hours to build this company. Frankly, to date, our success has been very modest, principally because the giants of the industry have been willing and able to subsidize their new agents far beyond any possible return which the agents could develop in the present and immediate future. They have been able to do this because of their dominant position and almost unlimited assets. In addition, of course, their reputation and national advertising have presented formidable barriers. We have been able to continue in the field only because our company writes a substantial amount of credit and other term insurance, and have been willing to utilize the earnings from this field to build our ordinary life operations.

Accordingly, we earnestly feel that we must most respectfully call your attention to the features proposed in bill H.R. 4245 which is presently before your committee. This bill has been worded in a most discriminatory fashion to eliminate those of us who are still trying to compete with the few major insurance companies, although we are willing to invest our savings and our accrued earnings in this most one-sided battle.

The Treasury Department itself has stated that the objectives of a new formula for taxation of life insurance companies should be one that should not discriminate against any particular type of company and which will give fair treatment to all. There has been a great deal of discussion about helping small business and certainly here is a good place to actually do something to help.

Only the minority of companies writing predominantly term insurance will be heavily taxed by step 2 which is based on underwriting profit. The large companies will, of course, have a decided competitive advantage since their asset position produces sufficiently large investment income to shelter their underwriting gains. This means that we small companies will either go out of business or must purchase a life insurance company which has sufficient net investment income to provide an umbrella so to speak, under which their underwriting gain can be protected. This will be next to impossible for most of us.

Step 3 was added to the new tax proposal and is purely theoretical in its application to all except the small companies writing predominantly credit life or term insurance . This step applies the full corporate rate to the balance of underwriting profit as it is used for dividend purposes. This is a vicious new departure in taxation, as in effect it taxes distribution of income, and, if allowed to remain in the act, will merely invite more destructive tax measures on all types of corporations.

There is no logical reason to discriminate against and treat the so-called specialty companies differently with respect to lines of business which have traditionally been regarded as life insurance business and certainly have served, and will continue to serve, a most important public service.

We earnestly solicit your consideration to influence opposition in votes against step 2 and particularly step 3 of the new tax proposal, H.R. 4245.

Sincerely,

G. E. WAINSCOTT,
*President.*

THE HOLM AGENCY,
*Providence, R.I., March 4, 1959.*

Hon. JOHN O. PASTORE,
*Senate Office Building, Washington, D.C.*

DEAR SENATOR PASTORE: I am writing you concerning bill H.R. 4245 which refers to Federal taxation of life insurance companies. Although I am vitally interested in the welfare of the life insurance industry, to which I have devoted the entire 31 years of my business life, I would like to make it clear at the outset that I am writing you on behalf of first, the thousands of policyholders in the State of Rhode Island, and in particular, on behalf of the many thousands of Connecticut Mutual policyholders in this State. One of the satisfying factors in my long experience in this business, has resulted from the service phase of life insurance, the good that it has done and will do for millions of American families.

As you are aware, the Senate Finance Committee is holding a hearing on this bill on Tuesday, March 3, 1959. I am sure that the facts of the picture which will unfold at this hearing will be easily accessible to you. I have complete confidence in your desire to support or oppose legislation based only on your measured and studied opinions. Since this legislation is of utmost importance to millions of American families, I am certain that you will thoroughly explore the facts in this case. I am hopeful that your study of this matter will give you the details which will substantiate the statements I am about to make concerning this bill and the Federal taxation of life insurance companies.

I consider this legislation burdensome and unjustified for the following reasons:

(1) It is direct taxation on the savings of American life insurance policyholders and beneficiaries. In effect, it taxes policyholders on the amount defined as taxable net income at the corporate rate of 52 percent. If the Federal Government accessed the net income defined by the law to individual policyholders, the total income tax they would pay, at individual rates, would be approximately only one-third the amount the Government seeks to collect through this legislation. It is therefore a tax at an excessive rate on the ordinary citizen, who already suffers most from both heavy taxes and inflation.

(2) It is an established fact that life insurance is already taxed about three times as heavily as other forms of savings. This proposed legislation would substantially add to the excessive discrimination. Neither mutual savings banks, savings and loan associations, or cooperatives pay a comparable tax.

(3) Amazingly enough, this tax falls with greatest severity upon companies which have taken extra precautions for the safety of their policyholders. I refer to the companies which compute their reserves at conservative rates of interest since they would be required, under this bill, to pay a higher rate of tax on their investment income than those companies which have based their reserves upon less conservative rates.

(4) This legislation would discourage the efforts of individuals to provide for the security of their own families thereby impairing the effectivenss of life insurance as a force for economic stability. In the unselfish opinion of qualified men, it is in the national interest that people of this country be encouraged to provide for their own future welfare through savings and life insurance which will help to stem the tide of increasing dependence upon the public treasuries.

(5) Never has a business or institution been asked to assume such a tremendous increase in Federal taxes at one time. This bill provides for what amounts to a 70 percent overall increase in a single year, and an 86 percent increase to the policyholders and beneficiaries of my company because we have done one of the most outstanding jobs in the history of the business from an investment and savings in mortality standpoint. In my opinion, these percentage figures indicate justifiably how excessive this Federal tax would be. In mutual life insurance companies, the weight of all taxes falls directly on the policyholders and beneficiaries. This statement has been made above, but bears repetition.

(6) The life insurance industry does not only expect to, but wishes to pay its fair share of the burden of operating the American Government today, particularly so in view of the additional costs involved in the cold war. However, no single industry should be made to pay a predetermined amount of tax simply because of a government's immediate need for revenue. Even before hearings were held by the House Ways and Means Committee it was assumed, in preparing the Federal budget, that life insurance taxes would produce about $500 million of

revenue for 1958. Even that amount would be excessive compared to the taxation of other forms of savings and thrift, but when it is compared to the estimated revenue from H.R. 4245 of $845 million, it is further indication of the excessiveness of this tax legislation.

What to do about this, Senator? It appears that in order to raise the amount of revenue from life insurance companies, it will be necessary for Congress to pass this bill in some form. However, in order to have it written in some way approaching an equitable form, it would appear that it should be amended. If you feel that these facts I have brought forth are sound, and I can assure you they can be substantiated, I will appreciate your devoting your efforts and energies to having this bill amended.

I have always felt that the pluralities which you have developed in recent election years have indicated the people's confidence in you on a purely nonpartisan basis. As a result, I am confident you will do everything within your power to effect the amending of bill H.R. 4245.

I apologize for writing you at such length. On the other hand, I know of no briefer way of dealing with what is admittedly a very complex and a very important problem. To repeat briefly, it is my hope that you will agree with the viewpoints expressed above and that you will work toward a fair mitigation of this proposed tax burden.

Sincerely yours,

W. K. R. Holm, Jr., *General Agent.*

(Whereupon, at 4:50 p.m., the committee adjourned to reconvene at 10 a.m., Thursday, March 5, 1959.)

# TAX FORMULA FOR LIFE INSURANCE COMPANIES

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**THURSDAY, MARCH 5, 1959**

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

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

Present: Senators Byrd, Kerr, Long, Smathers, Anderson, Douglas, Gore, Talmadge, McCarthy, Hartke, Williams, Carlson, Bennett, Butler, and Curtis.

Also present: Senator Thomas J. Dodd.

Elizabeth B. Springer, chief clerk; L. N. Woodworth, economist, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The meeting will come to order.

Senator Dodd will present the first witness.

Senator DODD. Thank you, Mr. Chairman. I appreciate the opportunity to do so.

Although I am not a member of the Senate Finance Committee, I asked for the privilege of introducing to the committee a distinguished citizen of my State, Henry S. Beers, the president of the Aetna Life Insurance Co., of Hartford, Conn.

I have known and respected Mr. Beers for many years. He is recognized and respected throughout the country for his administrative ability, his thorough understanding of complex public issues, and his important service to countless civil and charitable causes. Above all, he is respected for his fairness, his objectivity, and his sense of public responsibility.

Long before he was elevated to the presidency of the Aetna Life and affiliated companies, Henry Beers was regarded throughout the insurance world as one of its most brilliant actuaries. His pioneer work in developing the field of group insurance has helped to make it possible for millions of Americans to enjoy the benefits of life, accident, and hospitalization insurance at low group rates which would be otherwise unavailable.

His contributions to the business world have gone hand in hand with numerous contributions to the field of public affairs. He is an architect of the unemployment compensation program in the State of Connecticut, which is one of the finest in the Nation.

Despite heavy burdens placed on him as the head of a vast worldwide business organization, and despite the additional duties which he has assumed on a variety of civic and business committees, his deeply ingrained sense of public duty impelled him to run for local public office in his hometown of Glastonbury, Conn., where he serves his townspeople on the board of finance.

Those of us who have heard him testify at previous hearings know he does not come here merely as a representative of a business interest. He will bring to this hearing, as always, his devotion to the public interest. This, added to his vast knowledge of the field of insurance taxation, gives a special weight to what he has to say.

The committee and the country can learn a great deal from Mr. Henry Beers, and I consider it a great honor to come here with him today and to present him to the members of this distinguished committee, and I am indeed grateful to you, Mr. Chairman, and to the members of the committee, in allowing me to present Mr. Beers.

The CHAIRMAN. Senator Dodd, it is always a pleasure to have you before this committee.

Mr. Beers.

## STATEMENT OF HENRY S. BEERS, PRESIDENT, AETNA LIFE INSURANCE CO., HARTFORD, CONN.

Mr. BEERS. Mr. Chairman, I am very grateful to Senator Dodd for his good words. After my appearance here is over, I will admit that he has been too kind and too complimentary.

As Senator Dodd has said, I am the president of Aetna Life Insurance Co., Hartford, Conn., a stock life insurance company. Our company also operates a participating department. Under our charter, our stockholders are not entitled to any part of the profits of the participating department. Our company's business is divided about 63 percent in the stock department and 37 percent in the participating department, if you take the proportionate assets of the two departments as an indication of relative size.

As far as the application of H.R. 4245 goes, our company partakes of some of the characteristics of both stock and mutual companies. Like most stock companies, we would, under present business conditions have to pay a substantial amount of tax under phase 2 of the bill. Like most mutual companies, we would usually get no reduction in our phase 1 tax in years in which operating gains under phase 2 are less than taxable investment income under phase 1, even substantially less.

I am talking here about what has been referred to as the negatives. The reason for this is that our company is paying to participating policyholders a substantial amount of dividends and to certain classes of nonparticipating policyholders a substantial amount of what the bill calls "similar distributions to policyholders in their capacity as such."

The foregoing will indicate the general nature of my personal interest, and my company's interest, in some of the controversial issues.

In November of 1958, I appeared before the Ways and Means Subcommittee to present a plan of taxation developed by a committee of insurance people which had been studying the so-called "investment income" type of tax bill. Our plan, which was then known as the Menge plan, had two phases and, so far as general pattern went, was somewhat the same as a combination of phases 1 and 3 of the present bill. The interposition of phase 2 increases the revenue considerably, and changes the philosophic basis of the plan somewhat. Nevertheless, I favor the general pattern of H.R. 4245, although I join with those other witnesses who have and will urge strongly that this bill constitutes an extraordinarily burdensome increase in taxes. In this I concur with the statement of my home district's Congressman, Honorable E. Q. Daddario, made on the floor of the House during the debate on the bill. I stress the fact that this bill would raise much more revenue even than the apparent goal of the Treasury, of $500 million. To correct this, several specific factors in the bill should be changed, but its general pattern can be maintained. It is probably the pattern most acceptable to the largest number of life insurance companies as a reasonably equitable method of taxation in raising revenue of the aggregate amount contemplated.

At this point I would like to interpolate a seemingly trivial but actually serious question. The insurance business has had the impression that the goal was $500 million. All think that much too high, some very much too high, but budget needs, plus our failure to explain our business clearly to the public and to Congress, put us in the position where, I guess, we had best swallow the bad news and try to like it.

But here is my question:

If the goal is the budget amount of $500 million, does that not apply to fiscal 1960? If that is correct, the law you pass ought to have only about $450 or $460 million as a goal for our 1958 tax, which is the amount for fiscal 1959, from the standpoint of the budget.

The bill before you would raise about $558 million for fiscal 1959, about $600 million for fiscal 1960.

My own ultimate acceptance of the general pattern of H.R. 4245 is not due merely to the practical consideration that some adjustments in specific factors can make the tax yield come out at about the right amount. I am impressed, and pretty well convinced, by the philosophy of the three-phase approach as explained in the House Ways and Means Committee report.

If you didn't take the special nature of life insurance into account, you would wonder why some amounts should be put into the so-called policyholders surplus account in phase 3, instead of being taxed right away in phase 2. This policyholders' surplus account is necessary for the reasons stated in the Ways and Means report; namely, that the long-term nature of life insurance policies makes it impossible to determine with certainty what a life insurance company's annual profits are. What this means to me is that what may look like stockholders' profits today may be needed tomorrow to pay policyholders' claims. I am not talking imaginative theory.

I have seen my own company's apparently ample surplus disappear in the depression of the early 1930's. I have watched millions of supposed surplus go into unforeseen permanent-total disability losses, into reserve increases needed to compensate for investment yields falling to levels previously considered impossibly low, into increased annuity reserves to compensate for the ever-increasing longevity of pensioners. I came into the life insurance business just after the terrible death rates of the 1917–18 influenza epidemic.

The long-term protection of policyholders and their beneficiaries must be the first consideration in the financial management of any life insurance company, stock or mutual. The provisions of phase 2 and the policyholders' surplus account in phase 3 of the bill allow a stock company to build up, before taxes, funds for this long-term protection of policyholders and their beneficiaries; at the same time, it protects the Treasury against these funds being converted into dividends to stockholders except after payment of appropriate income taxes.

The proper purpose of phase 3 of the bill is to see that no untaxed profits go to stockholders. The proper purpose of phase 2 is to permit and encourage the building up, before taxes, of appropriate funds, in addition to actuarial reserves, for the long-term protection of a company's ability to make good on its policies' promises.

I should add that, if stock companies were required to build up these funds after taxes, they would be put at a completely unfair competitive disadvantage compared with mutual companies. The latter, with their higher premium rates and their available recourse in time of trouble to reducing policyholders' dividends, need carry less surplus for long-term protection of policyholders.

To summarize, I believe that the total net income of stock life insurance companies can be safely taxed through the use of the pattern of phases 2 and 3 of the bill.

When I say "safely," I mean safely from the standpoint of the companies, for this is the first total net income tax formula I have seen that permits a stock company to remain financially sound in the face of the competition of the mutual companies; and I mean safely from the standpoint of the Treasury, for the plan can protect the Treasury against profits being passed out to stockholders free of tax.

The foregoing also are my reasons for supporting the specific provision of phase 2 for taxing half of the excess of operating gain over taxable investment income; the balance to go to "policyholders' surplus fund" in phase 3 for taxation if ever converted into stockholders' dividends.

They are also my reasons for supporting the deduction in phase 2 of 2 percent of group premiums and 10 percent of reserve increases for nonparticipating life insurance, because, in the words of Mr. Mills' presentation to the House of Representatives—

> the stock companies selling nonparticipating policies do not have this leeway—

that the mutual companies have—

> and consequently the bill permits this 10-percent buildup as a contingency fund for this business out of taxable income.
>
> Also of importance to stock companies is a contingency reserve allowed under the bill equal to 2 percent of the premiums on group insurance business.

Obviously, I am discussing this bill backward, first phase 3, then phase 2. Now I come to phase 1, where there is an important specific factor that needs attention.

The bill uses an artificial mean earnings rate in phase 1 for the determination of the investment income reserve deduction. I do not find the explanation of this in the House Ways and Means Committee report convincing. The use of an average industry rate is reminiscent of one of the most criticized features, sometimes called the "global" feature, of past legislation. This mean earnings rate seems to have been a device to increase the tax yield—and it increased the yield beyond the goal. It is contrary to the correct philosophy underlying the adjusted reserve method. The individual company's own earned rate should be used, as called for by the original philosophic basis of the adjusted reserve method, to put companies on the same tax basis if their reserve assumptions differ but they are alike in all other respects. At the House Ways and Means hearings I gave an example of how it worked, which interested them, but which would take 5 minutes to read, so I will omit it at this time.

Senator KERR. Do you want to put it in the record in addition to your statement?

Mr. BEERS. I would like to, sir.

The CHAIRMAN. Without objection, it will be inserted.

(The example referred to by Mr. Beers is as follows:)

This proposal of the industry subcommittee contains two new features. The first of these is a new method of computing the policy and other contract liability deduction, which for lack of a better name I would like to refer to as the "adjusted reserve method." There is no averaging of interest earnings among companies. The new method for determining the taxable net investment income involves making a computation of the amount of reserve interest credit which would be needed to maintain the reserves of each particular company revalued on the basis of the company's interest rate actually earned in the taxable year. When this amount has been determined, it is deducted from the total net investment income of the company. This policy and other contract liability deduction recognizes the policyholders' interest in that portion of the net investment income of the company which is set aside in policy and other contract reserves, a principle which had been embraced in the Federal laws on the taxation of life insurance companies since 1921. It is only the method of computing the policy and other contract liability deduction which is new. Probably this formula is clear to all of you, but I have worked out a numerical example of its operation and it will take me only a few minutes to present it to you.

Consider two companies alike in all respects except that one carries actuarial reserves based on a 3 percent interest assumption; the other carries actuarial reserves based on a 2½ percent interest assumption. Suppose that the 3 percent assumption results in aggregate reserves of $95 million while the 2½ percent assumption results in aggregate reserves of $100 million. For the sake of this example, we may assume if we wish, although it is not necessary, that the two companies have exactly the same kinds of life insurance policies on their books and exactly the same amounts of each kind of policy at each age; also that each company owns the same kinds of investments as the other and exactly the same amount of each kind.

You will notice that in setting up the figures in this example I have supposed the aggregate reserves to differ by 5 percent ($95 million in one case and $100 million in the other) because the interest assumption was 3 percent in the first case and 2½ percent in the other. I did this on the basis of a recognized approximation, or rule of thumb, that actuaries have observed to be nearly exact in many different cases; on the average the dollar aggregate of reserves will be changed 1 percent for each one-tenth of 1 percent change in the interest assumption (or 10 percent for each 1 percent).

It is suggested that the income tax law use this rule of thumb because it will do reasonable justice, and rigorously accurate mathematical recomputation would not change the tax enough to justify the time and expense of a recomputation.

Suppose then that each of my hypothetical companies has $120 million of assets invested in mortgages and corporate bonds yielding $3,900,000 of interest per year. A quick division shows that the rate of interest yield is 3¼ percent. Our question is how much interest we should consider that each company has earned on its actuarial reserves. Remember that our two companies are alike in every respect except for a difference in actuarial judgment. One company was more conservative in fixing its reserve standard at 2½ percent compared with 3 percent while the other company set up $5 million less reserves and consequently holds $5 million more surplus. The new approach solves this problem of equivalent tax treatment by requiring that the reserves be recalculated by the rule of thumb to the reserve level resulting from the use of each company's actual rate of interest earning, namely, in our example, 3¼ percent. This makes each company's recomputed reserve come out at about $92,500,000—that is 2½ percent less than one, 7½ percent less than the other—and in each case the interest earned on reserves would be considered to be 3¼ percent of this $92,500,000, which comes to very nearly $3 million. The taxable interest would therefore be $900,000.

Mr. BEERS. Instead of using only the earned rate of the taxable year, it is probably better, and still equitable, although presently more expensive to us, to use the 5-year average based on the individual company's earnings of the taxable year and the 4 preceding years. I am speaking of the same 5-year average amendment others have proposed. Let me give you the most accurate figures I find for the effect of this amendment. This change will reduce the mutual companies' tax by $39,500,000 in phase 1, increase it by $2,100,000 in phase 2, we think, a net reduction of $37,400,000 for mutual companies.

The change will reduce the stock companies' tax by $13,200,000 in phase 1, increase it by half that amount, namely, by $6,600,000 in phase 2, a net reduction of $6,600,000.

This changes the stock companies' share of the total tax from 30½ percent of the total revenue to 32 percent.

That is up from about 25 percent under last year's stopgap legislation.

It is obvious that this new legislation is going to make a material difference in the present competitive balance between stock and mutual companies. I will be so immodest as to ask some credit for waiving my objections to this.

This change will not reduce the aggregate yield of H.R. 4245 enough to bring it down to the goal. A $558 million estimate for the bill, less $44 million, which is the sum of the reduction I have talked about so far, leaves $514 million as the probable yield after that one amendment.

The goal is either $500 million here; or it is $500 million for fiscal 1960, in which case the goal is $450 million or $460 million here.

Consequently, several other factor changes can be considered. Several have been and will be presented to you in the course of these hearings. I would like to express a belief in the special propriety of two of them. I myself would be inclined to change the treatment of tax-exempt interest to make it completely tax-exempt.

By that I mean that if our company were faced with a choice between keeping somewhat larger cash balances uninvested or buying a few tax-exempt bonds, our income tax ought to be exactly the same whichever choice we decided upon.

It has been estimated by an assistant of mine that under the present bill my company would pay a tax of about 27½ percent of the interest we receive on any tax-exempt bonds we were to buy in this example. This does not seem to me to constitute true tax exemption.

The other specific factor I mention is somewhat similar, namely, the treatment of the 85 percent dividends-received deduction.

We estimate that in the kind of example I just mentioned to you we would pay a tax of about 30 percent on any dividends we receive on stocks bought with money we might otherwise have left uninvested. If we really got an 85-percent credit and paid tax on 15 percent of the dividends, the tax would be nearer 8 percent than 30 percent.

I would like to mention one other feature of the bill, one of which I approve, namely, the treatment of reserves for qualified pension plans. I understand that these provisions of the bill need some technical corrections. Except for that, I strongly endorse these provisions in the bill.

The gradual elimination over the next 8 years of the existing discrimination against insured pension plans is fully justified. It will help equate the treatment of smaller employers presently at a disadvantage as compared with large employers, as pointed out in the House Ways and Means Committee report, and it will give fairer treatment to all employers and insurance companies who enter into insurance annuity contracts to provide qualified pension plans.

May I add one short final paragraph.

In these hearings the keen, deep differences of opinion among the different kinds of life insurance companies have several times been very apparent. Nevertheless, I hope that the committee has noticed that our area of agreement is much larger than our area of disagreement. For the first time in years, almost all of us are united in the two most important subjects that have been mentioned here. I refer to the common endorsement of nearly all companies of the general three-phase pattern of the bill, and I refer to the suggested amendment to a 5-year individual-company-earned interest rate.

So, as much as we differ and as keenly as we differ, please notice the great extent to which we are in agreement.

I thank you.

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

As I understand your statement, you prefer H.R. 4245 to the present law; namely, the 1942 formula.

Mr. BEERS. Yes, sir.

The CHAIRMAN. Do you favor making H.R. 4245 operative in 1958?

Mr. BEERS. Yes, sir.

The CHAIRMAN. One other question. You say:

> I estimate that, under the present bill, my company would pay a tax of about 80 percent on any dividends we received on stocks bought with money we might otherwise have left uninvested.

Would you explain that?

Mr. BEERS. I can send you the calculation on which this was based, but I cannot give it to you. It was made by an assistant upon whom I rely.

The point is that tax-exempt—I beg your pardon. The point is that the dividends which a company receives are divided in the calculations under phase 1 between, you might say, the investments of reserves and the investments of surplus and other funds, and the part which is allocated by the Treasury to the investments of reserves is said by the Treasury already to be tax-exempt, and therefore it should not be tax-exempt again.

The portion which is allocated under phase 1 to surplus and other liabilities is taxed, and the Treasury says that that portion is eligible for the 85-percent dividend credit.

Now, when we come to phase 2, we lose half of any credit we got under phase 1; or in phase 2 we get back anything we suffer under phase 1. When we come to phase 2, the proportions are a little different, and I regret to say that I do not know the technical details of the bill well enough to describe it to you.

But the calculations have brought out that if we buy a small amount of stocks with otherwise uninvested cash, this is the effect; and if you desire the calculation, my associate will be very glad to prepare it.

The CHAIRMAN. Yes, I would like to have it to put into the record.

(The information referred to follows:)

MEMORANDUM FOR INSERTION IN RECORD OF SENATE FINANCE COMMITTEE HEARING MARCH 5, 1959, IN TESTIMONY OF HENRY S. BEERS

The following table shows the calculation of Federal income tax for the Ætna Life Insurance Co. for the year 1958, computed in accordance with H.R. 4245 on three different assumptions.

Column I shows the tax resulting from 1958 operations using figures which are very close to those which will actually be developed from the books of the company.

Column II shows the tax computed from the same figures but with one additional assumption, namely, that a sufficient amount of the company's cash had been invested to produce an income of $100,000 from tax-exempt (municipal) bonds.

Column III also shows the tax computed from the same figures used in column I with one additional assumption, namely, that a sufficient amount of the company's cash had been invested to produce an income of $100,000 from stocks normally entitled to the 85 percent dividend credit.

| | I | II | III |
|---|---|---|---|
| Taxable income, phase I | $35,310,000 | $35,353,000 | $35,357,000 |
| Tax at 52 percent | 18,361,000 | 18,381,000 | 18,386,000 |
| Taxable income, phase II | 2,500,000 | 2,508,000 | 2,509,000 |
| Tax at 52 percent | 1,300,000 | 1,304,000 | 1,305,000 |
| Total tax | 19,661,000 | 19,688,000 | 19,691,000 |
| Increase in tax | .............. | 27,000 | 30,000 |

Column II shows that the assumption of an additional investment in tax-exempt bonds increases the total tax to be paid by the company by $27,000. Since the additional interest income is $100,000, it follows that this additional income has been taxed at the rate of 27 percent.

Column III shows that the assumption of an additional investment in stock eligible for the 85 percent dividend credit increases the total tax to be paid by the company by $30,000. Since the additional dividend income is $100,000, it follows that this additional income has been taxed at the rate of 30 percent.

A detailed calculation of the company's tax for each of these three examples is attached.

[In thousands of dollars]

| | I | II | III |
|---|---|---|---|
| Mean assets of company* | $3,425,000 | $3,425,000 | $3,425,000 |
| Investment yield* | $117,000 | $117,100 | $117,100 |
| Investment yield rate, percent | 3.416058 | 3.418978 | 3.418978 |
| Industry required interest rate, percent | 2.785700 | 2.785700 | 2.785700 |
| Deduction rate, percent | 3.100879 | 3.102339 | 3.102339 |
| Mean life insurance reserves* | $2,440,000 | $2,440,000 | $2,440,000 |
| Average interest rate on reserves,* percent | 2.650879 | 2.650879 | 2.650879 |
| Reserves adjusted to deduction rate | $2,330,200 | $2,329,844 | $2,329,844 |
| Deduction for investment yield on adjusted reserves | $72,257 | $72,280 | $72,280 |
| Calculation of proportion of tax-exempt interest and dividend received credit not allowed: | | | |
| Deduction for investment yield | $72,257 | $72,280 | $72,280 |
| Deduction for interest paid* | $7,500 | $7,500 | $7,500 |
| Small business deduction | $25 | $25 | $25 |
| Total | $79,782 | $79,805 | $79,805 |
| Investment yield* | $117,000 | $117,100 | $117,100 |
| Ratio, disallowed phase I, percent | $68.19 | $68.15 | $68.15 |
| Required interest on mean reserves | $64,681 | $64,681 | $64,681 |
| Deduction for interest paid* | $7,500 | $7,500 | $7,500 |
| Small business deduction | $25 | $25 | $25 |
| Total | $72,206 | $72,206 | $72,206 |
| Investment yield* | $117,000 | $117,100 | $117,100 |
| Ratio, disallowed phase II, percent | 61.71 | 61.66 | 61.66 |
| Calculation of net taxable investment income (phase I): | | | |
| Investment yield* | $117,000 | $117,100 | $117,100 |
| Less tax exempt interest* | −1,000 | −1,100 | −1,000 |
| Less dividend received credit* | −5,000 | −5,000 | −5,085 |
| Less small business deduction | −25 | −25 | −25 |
| Total, net investment income | 110,975 | 110,975 | 110,990 |
| Deduction for investment yield | 72,257 | 72,280 | 72,280 |
| Deduction for interest paid* | 7,500 | 7,500 | 7,500 |
| Less disallowed tax-exempt interest | −682 | −750 | −682 |
| Less disallowed dividends received credit | −3,410 | −3,408 | −3,465 |
| Total, policy and contract liability deduction | 75,665 | 75,622 | 75,633 |
| Difference, taxable investment income | 35,310 | 35,353 | 35,357 |
| Calculation of net gain from operations (phase II): | | | |
| Net gain before disallowance of tax-exempt interest, etc.* | 36,607 | 36,607 | 36,622 |
| Add disallowed tax-exempt interest | 617 | 678 | 6177 |
| Add disallowed dividend received credit | 3,086 | 3,083 | 3,135 |
| Total, net gain from operations | 40,310 | 40,368 | 40,374 |
| Calculation of tax: | | | |
| Taxable investment income | 35,310 | 35,353 | 35,357 |
| Tax at 52 percent | 18,361 | 18,384 | 18,386 |
| 50 percent of excess of operating gain over taxable investment income | 2,500 | 2,508 | 2,509 |
| Tax at 52 percent | 1,300 | 1,304 | 1,305 |
| Total tax | 19,661 | 19,688 | 19,691 |

*Items marked with an asterisk show figures which are to be determined from the books of the company, the particular figures used being close approximations. Items not so marked are the result of arithmetical calculation in accordance with the terms of H.R. 4245.

The CHAIRMAN. Under this bill, of course, the tax is approximately 13 percent on income from investment capital. I imagine the effective rate was 51 percent for all corporations, and you are taxed on 25 percent of that figure.

Mr. BEERS. It differs tremendously among companies. The tax under phase 1 is 52 percent of a portion of a company's interest, and what that portion is, whether 10 percent, 20, 30, 40, or 50, depends upon the relationship of its adjusted reserves with other funds, so that there is a difference among all companies, and I do not know our own percentage.

The CHAIRMAN. I am speaking of what is defined as investment income. That is taxed at the normal corporation rate, is it not?

Mr. BEERS. What is defined as investment income is taxed under phase 1 after deducting the interest on reserves.

The CHAIRMAN. I understand that.

Mr. BEERS. At 52 percent, and then—yes, and then we also, I think, pay some tax on interest under phase 2.

The CHAIRMAN. But the net income from investment capital is taxed at 13 percent, approximately—one-fourth of 51 percent; isn't that right?

Mr. BEERS. I don't think it works out that way, sir. I think it depends on the particular company.

The CHAIRMAN. Your explanation of this bill must be incorrect, then. It says that investment income is taxed as an ordinary corporate income, which is one-fourth, as I understand it, of the average of 51 percent. You say that is not correct.

Mr. BEERS. I don't understand the situation, sir, I am sorry.

The CHAIRMAN. Will the staff explain how much of the staff income is deducted.

Mr. WOODWORTH. On the average the policy and other contract liability deduction is likely to work out to be a deduction of somewhere around 75 percent. Of course that will vary from company to company. In addition this will vary depending on the amount of dividend income involved since this is subject to an 85 percent deduction.

Mr. BEERS. That is based on the industry as a whole?

Mr. WOODWORTH. Yes.

Mr. BEERS. I didn't remember that average in the report. But for the industry as a whole I have no reason to question the figures at all. For each company it will differ, but in connection with this discussion you will notice that I am not discussing our whole tax divided by our whole interest. I am only discussing the effect of buying a few more stocks, or in the previous paragraph, a few more municipal bonds.

The CHAIRMAN. I was speaking of net investment income. Will the staff make it clear whether there is any variation from the 52 percent taxation?

Mr. WOODWORTH. There will be a variation depending upon the size of the policy and other contract liability deduction of the individual company. On the average that deduction is likely to work out to something like 75 percent. But it may vary widely from that on a company-by-company basis.

Mr. BEERS. Thank you.

The CHAIRMAN. What is it; it is 13 percent, approximately?

Mr. WOODWORTH. On the average a tax of about 50 percent on the 25 percent of the net investment income remaining would work out to be approximately 13 percent.

The CHAIRMAN. For what reasons—I would like this included in the record, I think it is important—why would that vary from company to company if that is the net investment income?

Mr. WOODWORTH. That will vary because of the fact that the policy and other contract liability deduction is made separately and individually for each company depending upon their own earnings rate and either their own or the industry average assumed rate. Moreover, this individual company deduction rate is applied to the individual company's reserves subject to certain adjustments.

The CHAIRMAN. I am only speaking of step 1.

Mr. WOODWORTH. That is what I am referring to also.

The CHAIRMAN. I would like to have that in detail as to what the variation is and you think the average is 13 percent, then, of all the companies, approximately, on invested income?

Mr. WOODWORTH. Yes; I think it will approximate that although where dividends are involved the effective rate will be much lower on this particular type of income.

The CHAIRMAN. And your company may have some peculiar situation where you say you are taxed 30 percent?

Mr. BEERS. I would like to mention, sir, that 30 percent is not our average tax on investment income. It is only the tax on a—what you might call a marginal tax rate, if we buy a few more stocks.

The CHAIRMAN. You use an expression here which I don't understand. "If we proceed on stocks bought with money which we might otherwise have left in uninvested." What does that mean?

Mr. BEERS. Supposing, for example, we might look at our bank balances and think it might be possible to invest a million dollars in stocks, or possibly we ought to keep that money in the bank so as to have plenty of cash to operate our business with. If we were to decide that we had enough money in the bank so that we could afford to buy a million dollars worth of stocks, then we would receive some dividends on those stocks, it might be $40,000.

Now, under the bill that $40,000 is divided under phase 1, with the result that when we trace it through phase 1 and phase 2, we think that the tax would work out, the extra tax from having collected that $40,000, would work out at about $12,000.

The CHAIRMAN. I am speaking of phase 1.

Mr. BEERS. No; I was speaking of phase 1 and phase 2.

Now, under phase 1, I think that a part of that 30 percent would be collected, and the rest under phase 2.

The CHAIRMAN. It must follow, then, that some companies pay less than 13 percent. If you pay as much as 30 percent and the average was 13, then some companies would pay less than 13 percent.

Mr. BEERS. We pay as high as 30 percent on some investments, and much lower on others when you come to figure our average. The phase 1 part of this 30 percent might be 26 percent. Then under phase 2, we would have to pay an additional 4 percent.

The CHAIRMAN. My question is directed to phase 1. I have got to take this bill step by step in order to understand it. I want to know what will happen under phase 1.

Mr. BEERS. Under phase 1——

The CHAIRMAN. When you make your tax returns I assume you make it on tax 1, and then other changes are made in accordance. You actually pay 30 percent on some income, and I would like to understand how it is derived under phase 1.

Mr. BEERS. It is right, but I should mention that we analyze the income differently from the way that the Treasury analyzed the income when it prepared this bill.

The CHAIRMAN. Then it naturally follows that the average of 13 percent means some companies pay less than 13 percent, is that right?

Mr. BEERS. That is right.

The CHAIRMAN. I would like to understand that. That is a rather important question involved.

Senator Williams.

Senator WILLIAMS. I would like to ask a question in connection with that same question asked by the chairman.

You speak of the variation in determining the investment income in phase 1. That variation would be developed between the different companies prior to reaching the net figure, and after you reached that net figure there would be no variation but you would all pay 52 percent on the 25 percent, or the 12.5 percent, is that not true? Would not your variation be before you reach your taxable figure, or would it be after?

Mr. BEERS. I am somewhat confused. It seems to me that the variation——

Senator WILLIAMS. I am confused, too.

Mr. BEERS. The variation is reached when we are dividing our total investment income between the portion that applies to reserves and the portion that applies to other things.

Senator WILLIAMS. That is correct.

Mr. BEERS. And that is the big reason for the variation.

Senator WILLIAMS. That is right.

Mr. BEERS. After you have determined how much of your interest applies to other things, you multiply that by 0.52 except for the small company adjustment.

Senator WILLIAMS. When you reach that point where you compute your tax there is no variation in the formula, is that correct?

Mr. BEERS. I think that is correct, if I understood your question correctly. I think I did understand it. I think that is correct.

Senator WILLIAMS. But it is my understanding that this variation would be between the different companies as to setting up your reserves.

Senator KERR. You mean in the amount of money to which the tax rate will apply?

Senator WILLIAMS. Yes.

Mr. BEERS. I think you are right, sir.

Senator WILLIAMS. Once you reach that taxable base, there is no difference in the formula, as I understand it.

Mr. BEERS. I think that is right. I would like to know whether the staff—whether that sounds reasonably correct.

Mr. WOODWORTH. Yes; once you reach taxable investment income, there is no difference. Of course, there is a difference before you reach that point.

Senator WILLIAMS. Oh, yes.

The CHAIRMAN. I would like the joint committee staff to furnish a memorandum to the committee showing any companies, if it is possible for any companies to pay less than 13 percent on their investment income.

(The memorandum subsequently submitted by L. N. Woodworth of the Joint Committee on Internal Revenue Taxation follows:)

The chairman has asked for illustration showing how the tax on investment income can vary from the average of 13 percent referred to in the prior discussion. The tax is, on the average, 13 percent of net investment income because, on an industrywide average, the policy and other contract liability deduction is 75 percent of net investment income. The usual corporate tax rate of 52 percent applied to the remaining 25 percent of net investment income is equivalent to a tax of 13 percent on 100 percent of the net investment income.

The variation in effective tax rate from company to company can be illustrated by taking the following example holding all factors constant in three cases except the company's net investment income and earnings rate:

| | Case 1 | Case 2 | Case 3 |
|---|---|---|---|
| Assets | $10,000,000 | $10,000,000 | $10,000,000 |
| Reserves | $9,000,000 | $9,000,000 | $9,000,000 |
| Net investment income | $400,000 | $370,000 | $300,000 |
| Company's earnings rate [1] ... percent | 4.0 | 3.7 | 3.0 |
| Company's assumed rate on reserves ... do | 2.5 | 2.5 | 2.5 |
| Industry average assumed rate in prior year ... do | 3.0 | 3.0 | 3.0 |

[1] The company's earnings rate actually is determined by dividing the company's investment yield by its total assets. Investment yield differs from net investment income in that it requires the adding back to the latter of any exempt interest, any interest partially excluded, the 85 percent of the dividends received which were previously excluded, and the 5 percent small business deduction. To avoid complexity in the examples these differences between investment yield and net investment income are ignored.

CASE 1

Given the above assumptions, the deduction rate of the company in case 1 would be 3½ percent, or halfway between the company's earnings rate of 4 percent and the industry average assumed rate of 3 percent (the industry assumed rate is used in this case rather than the company's own assumed rate since the industry rate is the higher). Under the bill, for every 1 percent of increase in the deduction rate over the company's own assumed rate the reserve is adjusted downward by 10 percent. Since here the 3.5 percent deduction rate is one percentage point above the company's assumed rate of 2.5 percent, the reserve is adjusted downward by 10 percent. Thus, the $9 million of reserves for the purposes of this computation is reduced to $8,100,000. As a result, the reserve deduction in this case would be $8,100,000 multiplied by 3.5 percent, or $283,500. This deducted from the $400,000 of net investment income (assuming there are no deductions for interest paid or for pension trust reserves) leaves a taxable investment income of $116,500 which is 29 percent of the net investment income. The tax on $116,500 (30 percent on the first $25,000 and 52 percent on the remainder) is $55,080. This is 13.8 percent of the $400,000 of net investment income.

CASE 2

The deduction rate of the company in this case would be 3.35 percent, or halfway between the earnings rate of 3.7 percent and the industry average assumed rate of 3 percent. This deduction rate is eighty-five hundredths of 1 percentage point above the company's own assumed rate of 2.5 percent. Therefore, under the 10-to-1 ratio the company's reserves would be adjusted downward by 8.5 percent. Thus, the $9 million of reserves for purposes of this computation is reduced to $8,235,000. Multiplying this adjusted reserve by the deduction rate of 3.35 percent gives a deduction of $275,873. This deducted from the $370,000 of net investment income leaves a taxable investment income of $94,127 which is approximately 25.4 percent of the net investment income of $370,000. The regular corporate tax on this $94,127 is $43,446 or 11.7 percent of net investment income.

CASE 3

In this case the deduction rate of the company is 3 percent, since the company's earnings rate and the industry average assumed rate are both assumed to be 3 percent. This 3 percent deduction rate is half of a percentage point above the company's assumed rate of 2.5 percent. Therefore, under the 10-to-1 ratio the reserve is adjusted downward by 5 percent. Thus, the $9 million of reserves for purposes of this computation is reduced to $8,550,000. The reserve deduction in this case, therefore, would be $8,550,000 multiplied by 3 percent or $256,500. This deducted from $300,000 of net investment income leaves a taxable investment income of $43,500. The regular corporate tax in this case is $17,120 or 5.7 percent of net investment income.

SUMMARY

It will be noted that the tax payable in these three cases expressed as a percent of net investment income varied from 13.8 percent to 5.7 percent because of different assumptions with respect to the earnings rate. Other variations in tax, expressed as a percent of net investment income, could arise as a result of variations in the relative size of reserves, compared to total assets, and as a result of variations in the assumed rates of the individual companies involved. The percentage relationships of taxable investment income to net investment income are, of course, also influenced by the fact that the first $25,000 of taxable income is subject to a 30-percent rate. If larger amounts of taxable income were involved, these percentages would be higher than indicated in the examples given above. This also would be true if phase 2 income were taken into account in these cases.

DIVIDEND INCOME

No attempt was made in these cases to take into account the special characteristics of dividends eligible for the dividends received deduction. In case 1 if $100,000 of the investment income had been dividends, the company would have received an additional deduction of $85,000, reducing its net investment income to $315,000. This would not effect its earnings rate, but its policy and other contract liability deduction would be reduced by $85,000 multiplied by the ratio which $283,500 (the policy and other contract liability deduction) bears to $400,000 (net investment income before the deduction for intercorporate dividends received, etc.). The amount of this cutback would be $60,244. If this is offset against the $85,000 deduction available in arriving at net investment income the net benefit of having the income in the form of dividend income, rather than some other form of investment, is a decrease in the tax base of $24,756. This amount represents 85 percent of the portion of the $100,000 of dividend income remaining after the regular policy and other contract liability deduction.

Senator KERR. Do you mean 13 percent of their——

The CHAIRMAN. 13 percent net tax. They pay 52 percent on 25 percent of their investment income; that is 13 percent. This man says that he pays 30 percent.

Senator KERR. Would the chairman run that by again? [Laughter.]

The CHAIRMAN. This witness says that he pays 30 percent under step 1. If he does that, and the average is 13 percent, other companies must pay less than 13 percent. I want to understand exactly how that is brought about. I am asking the staff, to submit a memorandum to the committee as to how he can pay 30 percent, and whether there may be change from company to company.

Mr. BEERS. Shall I try to prepare a memorandum on that, or is the staff undertaking that?

The CHAIRMAN. I think you ought to give us a memo explaining what you said in your statement, that you pay 30 percent.

Mr. BEERS. Yes; I will try to, sir. But I would just like to add at that time that the average we pay is not 30 percent. What we pay 30 percent on is the special kind of income referred to in my discussion of tax-exempt——

The CHAIRMAN. But you use the language here.

Mr. BEERS. Dividends on stock.

The CHAIRMAN. You use the language "Dividends on stocks bought with money we might otherwise have left uninvested."

Mr. BEERS. That is right, sir.

The CHAIRMAN. I would like to know what that means; whether you leave it uninvested or not, that is a matter of your discretion, I assume.

Mr. BEERS. That is correct. So we figured our tax, if we left it uninvested; we figured our tax if we invested it; we divided the additional tax by the additional dividends, and it came out at 30 percent. That is what I would call a marginal tax rate rather than an average tax rate.

I will try to supplement this by a memorandum, sir. I am sorry not to have included it.

Senator WILLIAMS. In your memorandum if your average is comparable to the industrywide average of 12.5 to 13 percent, and if you are paying 30 percent on a portion of your income, you must have some which is tax-exempt. Could you also include that, because there must be quite a variation in your own taxable income.

Mr. BEERS. Yes.

Senator WILLIAMS. If your average is lower you must have some down either where it is not being taxed at all, or else very low.

Senator KERR. Mr. Beers, you have been very gracious and, I think, very lucid.

Maybe it is just a little early for me this morning. If I understood the basis of the possibility of your paying 30 percent on dividends, it has to do with dividends on stock purchased out of resources allocated to reserves.

Mr. BEERS. I was treating the amount as invested without regard to any allocation of assets to reserves.

Senator KERR. You told us of dividends coming to you from stocks which had been bought by funds that were in different categories or classifications.

Mr. BEERS. Right.

Senator KERR. Would you then explain again those two categories?

Mr. BEERS. Yes, sir. I think so; I will try.

Senator KERR. Give us a description of those two categories of funds so that one as uniformed as I can understand it.

Mr. BEERS. I think, sir, the first part of this explanation ought to be over the head of an eighth grader, and the second part ought to be within the comprehension of an eighth grader.

Senator KERR. Then start with the second part. [Laughter.]

Mr. BEERS. I would seem to disregard your question if I did.

Senator KERR. You do not mean to tell me that the question I asked you cannot be answered in language which an eighth grader can understand?

Mr. BEERS. May I answer it, and then explain why perhaps I think that.

Under the bill, if we invest some cash in stocks, the bill requires us to divide that cash into two parts, one part of which is considered to be in the reserve section of our assets, and the other part is in the surplus and miscellaneous liability section of our assets.

Senator KERR. You know, that is what I thought I asked you when I opened this conversation, if you had not told us, that this situation arose by reason of the fact that a part of your money was invested out of reserve funds and part of it out of surplus funds, and I understood you to say, no, that the reserves had nothing to do with it.

Mr. BEERS. I am sorry. The bill does require just exactly what you understood and what I said.

Senator KERR. All right.

Mr. BEERS. And if you figure it that way, you——

Senator KERR. Let us start now with the funds out of your reserve assets or reserve accounts. Is that proper terminology?

Mr. BEERS. That is suitable, I would think, for this purpose.

Senator KERR. Let us say you invest enough money out of that which either on your own books or under the requirement of this bill is a part of your reserve funds, and you get $100,000 in dividends.

If you were an ordinary corporation, you would owe taxes on 15 percent of that. As I understand it, you have told us that under this bill that would not be the case with you and your company with reference to this $100,000 income. You did not tell me that? What did you tell me?

Mr. BEERS. Well, may I first point out that if we had invested reserve funds sufficient——

Senator KERR. I was assuming now that this was an investment of reserve funds which produced $100,000 in dividends.

Mr. BEERS. Then, under the bill, we have also invested money in nonreserve funds in the same kinds of stock that brings us in an income of probably $40,000.

Senator KERR. You mean the money you invest out of your surplus account in the same stock at the same price produces less dividends than if you invest it out of reserve funds?

Mr. BEERS. If our surplus and miscellaneous fund is in proportion to our reserve fund of 40 to 100, then when we invest $140,000 we are required to say that $100,000 is reserve investment and $40,000 is surplus investment. That is what the bill requires.

Senator KERR. That is because of the relationship of the size of one fund to the other?

Mr. BEERS. That is right. That is quite correct.

Senator KERR. You see, you have that in eighth grade language, and I understand that.

Mr. BEERS. Right, sir, and that brings out——

Senator KERR. So you have $100,000 worth of dividends out of stock bought with reserve funds.

Mr. BEERS. Right.

Senator KERR. And the relationship being 100 to 40, then you have $40,000 of dividends on stock bought with nonreserve funds.

Mr. BEERS. Correct.

Senator KERR. If you were just an ordinary corporation, 85 percent of that $100,000 would be exempt and 85 percent of that $40,000 would be exempt. What is the situation under this bill?

Mr. BEERS. All right. The situation under this bill is that the $100,000 is exempt already because of the reserve interest deduction, as we all know. The $40,000——

Senator KERR. That is an unjustified assumption, "as we all know."

Mr. BEERS. I withdraw it, sir. [Laughter.]

Senator KERR. You see, because I want more of this eighth grade language, so that I will know what you know.

Mr. BEERS. I will try to avoid that.

Senator KERR. It is a complimentary assumption, but one to which I am not entitled.

Mr. BEERS. Now the $40,000——

Senator KERR. No. This is $100,000.

Mr. BEERS. This $100,000 is treated by the bill as part of the interest which is made exempt because earned on reserves. Therefore, under the bill——

Senator KERR. I do not believe you quite mean that. Do you mean it is treated as part of the money which produces a certain amount of interest on the reserves? Because it is not coming to you as interest. It is coming to you as dividends.

Mr. BEERS. That is better language, sir. That is better language than mine. It is correct.

The $100,000 is not taxable because it would not be taxable no matter what kind of investments it came from, because it is part of the interest that makes up——

Senator KERR. It is a part of the money that goes to provide that certain additional increment for your reserve fund that you are permitted as an exemption under the bill.

Mr. BEERS. Yes, sir.

Senator KERR. Is that correct?

Mr. BEERS. May I adopt those words.

Senator KERR. So that the exemption in another statute of 85 percent on dividends of outside stock coming to an owner of a corporation is of no benefit to you with reference to the investment of that money in this particular category of security.

Mr. BEERS. I agree.

Senator KERR. Now then let us go to the $40,000 that comes to you on the stock you bought out of surplus funds. How is that treated under this bill?

Mr. BEERS. Fifteen percent of $40,000 is $6,000. We have to pay a tax on only $6,000 of that, of those dividends. Therefore, we pay a tax of, say, $3,000. All of our figures are not precisely correct.

Senator KERR. I understand that. That is approximately 52 percent.

Now then is that, the computation of those two figures, the basis of your statement here that your company would pay about 30 percent on any dividends?

Mr. BEERS. It works out that way, sir.

Senator KERR. I say, is the situation that you and I have succeeded jointly in describing here the basis for that conclusion?

Mr. BEERS. No, sir. Because I must now—let me try to use the seventh grade language.

Senator KERR. That would be fine. [Laughter.] I will get you a senatorial service award [laughter], distinguished service award, if you will do that.

Mr. BEERS. You and I have availed the services of a chap who went through college and got a doctor of philosophy degree in mathematics, and we got him to figure our tax before we invested that money which brought in $100,000 in dividends here and $40,000 in dividends there, and we also got him to figure our tax after we had invested the money that way.

Senator KERR. Was there any relation between the two?

Mr. BEERS. And when we asked what the difference in tax was, he said the difference in tax was $40,000, which is 30 percent of the $140,000 in dividends that we received.

I am sorry, sir, I cannot tell you how that chap figured that, because he went to college and got a doctor of philosophy degree in mathematics, but that is really what happened, and I will file a report proving it.

Now in sixth grade language——

Senator KERR. I did not have the benefit of one of those technical educations, and I have never been limited by one, either [Laughter.]

Mr. BEERS. If I have to pay $40,000 in tax because I collected another $140.000 in dividends, then I think I am taxed 30 percent, regardless of what the bill makes me do about surplus and reserves and all that sort of stuff.

Senator KERR. Well now you and I were getting along pretty good here as long as were discussing this thing step by step, but on the basis of what you told me, I understood that this $100.000 was not taxable at all because it took that to get you the amount of money equal to a certain interest rate on your reserves, and that was exempt. Is that not what you told me?

Mr. BEERS. I told you that, sir, that is right. That is right.

Senator KERR. And then you told me that there was 15 percent of the $40,000 taxable, and that would be approximately $6,000 taxable, $3,000 tax.

Mr. BEERS. That is right.

Senator KERR. Well, it would take a doctor of philosophy degree or something to get $40,000 out of that, because you now tell me that this boy who got—what college gave that fellow a doctor of philosophy degree? [Laughter.] That must have been one of those eastern colleges. [Laughter.] I want to tell you no Oklahoma college would give that guy a doctor of philosophy degree. [Laughter.] If he took those two figures, now, $100.000 income on which he paid no tax because it was exempt once entirely, and 85 percent the second time, and then you paid $3,000 tax on $40,000, and he came up with the assurance to you that you had paid $40,000 tax—is that not what you have told us?

Mr. BEERS. Senator, that is what I told you about how the bill works, and you have described it most clearly and accurately. But I have also said that the net effect is that we are $40,000 out of pocket, and that is in cash.

Senator KERR. Then I want to say that the Treasury's hand is quicker than the eye. [Laughter.]

Mr. BEERS. If you do not mean that in a derogatory sense, I agree with you. [Laughter.]

Senator KERR. I never saw two men in more complete agreement to start with and to end with, and having been further apart between times. [Laughter.]

Now there must be some way for us to get this so that I can understand it. As I get your statement, the doctor of philosophy degree has given you this assurance and you have accepted it without understanding; is that right?

Mr. BEERS. No, sir.

Senator KERR. You understand it. Well, then, I want you to share it with me. Let us go back and start over now, because we have got $100,000 income in dividends on stock that you bought with reserve funds, that is what we started with, was it not?

Mr. BEERS. Yes, sir.

Senator KERR. And since that dividend on that amount of money did not exceed the interest rate which is exempt under the law, you owe no taxes on it and you pay no taxes on it, and you have still got it and it is added to that reserve account.

Mr. BEERS. That is what the bill says, but I do not think it is correct.

Senator Kerr, may I point out this: that the $100,000 we are talking about is treated by the bill exactly the same whether it comes from municipal bonds, common stocks, or utility bonds, and the philosophy of the bill, the reasoning of the Treasury, the reasoning of the Ways and Means Committee, and the reasoning which you have so clearly described, says that we get a deduction for that whether it comes from utility bonds or stocks or municipal bonds, and I do not think that is correct philosophy, because I think——

Senator KERR. Wait a minute. You see, I do not know whether the word you use there when you say "correct" is what I was describing and saying accurately, and I would like for us to get together. You mean you do not think it is correct philosophy for the Treasury to say to you that whatever you invest those surplus funds in you can only get an exemption on the income once?

Mr. BEERS. No, sir. I mean it is unfair for them to say if we invest some funds in a tax-exempt way that we can get additional tax-exempt credit on only four-fourteenths of the amount invested.

Sentaor KERR. Where did you get that four-fourteenths?

Mr. BEERS. That is our example of the $100,000 on this side and $40,000 on the other.

Senator KERR. But you have not got this $40,000 over here in this exempt account. You have got the $100,000 in the reserve account, have you not?

Mr. BEERS. The bill makes us say that we do.

Senator KERR. They do not make you say you do unless you have, do they?

Mr. BEERS. I would say "Yes." For tax purposes they say we must treat it as if it were there. In plain fact, I think it is not there. What I really think, sir, and what I urge, is that these investments ought to be treated as if it were all made from surplus funds and none from reserve funds, and that is the difference of opinion between the Treasury and me.

Senator KERR. Let me see if I understand the effect of that. What you want them to do is to let you invest both your reserve funds and your surplus funds in whatever legitimate, lawfully permitted investments you decide to put it in?

Mr. BEERS. Yes, sir.

Senator KERR. Take your deductions which any corporation other than an insurance company making an investment would be permitted to take?

Mr. BEERS. Yes.

Senator KERR. Let the taxable portion of it come into your general account; that is, regardless of where the $140,000 comes from, let you have an exemption of 85 percent of it, if it is dividends, when it first hits your pocketbook.

That would leave $21,000 of it taxable.

Mr. BEERS. Yes.

Senator KERR. Then let you take enough of that to meet your reserve requirements exempt.

Mr. BEERS. Yes.

Senator KERR. Do you reckon they would have to make any contribution to you to have enough to do it?

Mr. BEERS. No, sir.

Senator KERR. You would see to that.

Mr. BEERS. I think, sir, that we would not approach that point, but I do not know. It might be that some companies, it might be that our company some day might have all of its reserve and surplus funds in tax exempts and stocks, I do not know.

Senator KERR. It looks to me like I could imagine a situation there where a company never would pay any taxes, by investing their money in tax-exempt securities and in stocks on which they would owe a tax with reference to just 15 percent of it.

Mr. BEERS. It could eliminate its tax under phase 1 except, I think, for the tax on the 15 percent. I think it could, yes, sir.

Senator KERR. You are recommending quite a shift. I want to say now I understand what you recommend, and I appreciate that.

Mr. BEERS. I am flattered, and I wish that I had convinced you. I hope that you will think about it, and I am sure you will.

Senator KERR. Well, I will tell you, the further I go in thinking about it, the worse your position gets. [Laughter.]

You see, it looks to me like if you take reserve funds—and you have got to have that reserve in assets of one kind or another, which might include cash, is that not right—you have got to have it in some kind of a piece of paper which represents an asset.

Mr. BEERS. Yes, sir.

Senator KERR. A Government bond or a stock or a mortgage.

Mr. BEERS. Or a bank statement.

Senator KERR. It has to be in some kind of identifiable pieces of paper which constitute a promise to pay, or cash, which actually is only a promise to pay, you know. That is all that is, is it not?

Mr. BEERS. Will you excuse me, sir. I think you are probably right.

Senator KERR. Well, now, have you got a piece of paper in your pocket?

Mr. BEERS. This is a silver certificate, just like this.

Senator KERR. No, it is not just like that. That is just a promise to give you that other thing if you bring it down and demand it, is it not?

Mr. BEERS. You know more than I do.

Senator KERR. But what does it say?

Mr. BEERS. "There is on deposit——

Senator KERR. What does it say on the top of it?

Mr. BEERS. "This certifies that there is on deposit in the Treasury of the United States one silver dollar."

Senator KERR. Then what does it say?

Mr. BEERS. "$1 in silver payable to the bearer on demand."

Senator KERR. In other words, it is just a promise to pay.

Mr. BEERS. I give up.

Senator KERR. In other words, it is just a promise to pay, is it not?

Mr. BEERS. Yes, sir.

Senator KERR. Do you have a piece of paper which is not a silver certificate? If you do not have, one of those boys will loan it to you.

Mr. BEERS. I have to look in a different pocket for that, sir.

"Will pay on demand to the bearer."

Senator KERR. Who will?

Mr. BEERS. The United States of America, although it is called a Federal Reserve note.

Senator KERR. Yes.

Well, now, you see, that is a part of the facade of the Federal Reserve System. They tell this committee when they come here that they do not represent the U.S. Government, but when they print that paper they say they do. You see, even if you have got cash in that reserve fund, all that it amounts to is a promise to pay, is it not?

Mr. BEERS. Yes, sir.

Senator KERR. Then, if you take an asset of that reserve fund that is not bearing interest, or bringing dividends, and you put it into something which will, as I understand your position you are asking us to provide in this bill that that income would be treated as though it had not been obtained or secured by you from the investment of those reserve funds.

Mr. BEERS. Right. I am afraid, sir, that I look at it from the sixth-grader's point of view, and not from the college graduate's.

Senator KERR. How would a sixth-grader regard it?

Mr. BEERS. He would think if it cost him $40,000, that was his tax, and $40,000 divided by $140,000 is 30 percent.

Senator KERR. I do not know whether the average sixth-grader could take those figures and get at that result, anyway. But then I do appreciate the fact that, working together here, you have enabled me to understand your position.

Mr. BEERS. Thank you.

Senator KERR. That is an accomplishment.

The CHAIRMAN. Mr. Beers, I just want to ask for an additional bit of information.

You say: "I estimate that under the present bill my company would pay a tax of about 27½ percent of the interest we received on any tax-exempt bonds * * *."

I wish you would include an explanation of that also.

Mr. BEERS. I think the principles, sir, are exactly the same, except here we have a 100-percent exemption instead of 85.

The CHAIRMAN. Just explain why it is that in one case it is 30 percent and in the other it is 27½.

Senator Williams.

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. Mr. Beers, I have been listening to this discussion about title I, section 1, of this bill. I want to ask this question: Do you believe that policyholder dividends should be permitted to create or increase an underwriting loss to be applied against step 1?

Mr. BEERS. I am taking no position on that. There is a lot to be said on both sides, and I am not against any additional favorable amendments which any substantial and public-spirited group of companies urge upon you.

I urge you, sir, that the strong priority, as indicated by all of us, is in connection with the 5-year average. On the other, I have no position.

Senator CARLSON. Well now, do you have a choice between taking this 5-year average or the other plan?

Mr. BEERS. The 5-year average or the dividend deduct?

Senator CARLSON. Deduction.

Mr. BEERS. Yes, sir; I have a strong preference, and I urge you strongly, there is clear equity in favor of the 5-year average; and there is, as you have heard, a considerable dispute on the other point.

Senator CARLSON. That is the reason I asked the question. We are going to have to make a decision, and we want some help.

Mr. BEERS. I have tried to give you what help I can.

Senator CARLSON. I believe I understood you correctly earlier in your testimony you suggested that this proposal, H.R. 4245, apply to 1960 instead of 1959; is that correct?

Mr. BEERS. I hope that you would consider the target of $500 million to be a fiscal 1960 target instead of a fiscal 1959 target.

Senator CARLSON. Would that mean that you would like to have the taxes for 1958 collected in 1959 be paid on the 1942 formula?

Mr. BEERS. You ask me, sir, an exceedingly difficult question. I have tried not to pay too much attention to the taxes of my own company when it came to the minor variations in this bill which are being projected, because if I looked at the exact figures of my own company, I always got selfish, and if I looked at the answer to your question, I unfortunately know that I would be tempted to be selfish.

Let me say this: I do not urge you to use the 1942 tax for any year.

Senator CARLSON. The question gets down to this one result that we are going to have to arrive at. We are going to have to collect taxes on the 1942 basis or we are going to have to collect them on H.R. 4245.

Mr. BEERS. May I answer, with suitable amendments.

Senator CARLSON. We, of course, are considering the bill that has passed the House. We have not reached any agreement on any amendments yet.

Mr. BEERS. I urge you, sir, to attempt to obtain the adoption of H.R. 4245 with suitable amendments.

Senator CARLSON. I have heard your testimony, and I was interested that you approve of the collection by the Treasury of $500 million. There would not be any question about that, as I understood your statement. But there was a question as to whether we should begin in 1959 or in 1960; is that not correct?

Mr. BEERS. What I meant to say was that you had margin for several amendments, since you could make several amendments and still hit a target of $500 million for fiscal 1960. That would mean hitting a target of perhaps $450 million for fiscal 1959. All of the estimates that are being given you, or nearly all, are for fiscal 1959.

Insurance people refer to it as the 1958 tax.

Senator CARLSON. I was afraid of that.

From the standpoint of the budget the important factor, of course, would be collections and not liabilities. Therefore, collections in the fiscal year 1960 will be largely liabilities of insurance companies in 1958 if we follow that suggestion.

Mr. BEERS. I thought we paid most of our 1958 tax before July 1, 1959. Is that not correct?

Senator CARLSON. I think if you pay it on the 1942 basis at the present time, you will.

Mr. BEERS. Yes, whatever law applies.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Senator Smathers.

Senator SMATHERS. Mr. Beers, first, may I ask you this question. If we followed your recommendation with respect to the 5-year average for each company, would it be possible for us to reach the target figure of $500 million?

Mr. BEERS. I am awfully sorry, I did not hear that question.

Senator SMATHERS. If we followed one of your recommendations and change the formula with respect to determining the deduction rate, and went to the 5-year average, which I think is what you recommended, would that not so reduce the tax that we could not collect, under this bill, $500 million for the 1958 taxable year?

Mr. BEERS. The best figures I have seen, and I think they can be pretty well substantiated, indicate that after making that amendment, the collection for our calendar year of 1958 would be $514 million.

Senator SMATHERS. Was that the Treasury estimate? I presume you were here when the Treasury spoke, was that their figure, too?

Mr. BEERS. I think that that is within the range that the Treasury estimated and the people who assembled this $514 million figure, I don't know whether they have discussed with the Treasury the exact figure or not. You see I have been giving very close estimates.

Senator SMATHERS. All right, sir.

No other questions, Mr. Chairman.

The CHAIRMAN. Senator Butler.

Senator BUTLER. No, thank you.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Mr. Beers, I know that you have had a very strenuous time in cross-examination by the Senator from Oklahoma, and I may say that anyone who tangles with Senator Kerr is under a very severe intellectual discipline.

The question I now ask——

Senator KERR. Would the Senator yield?

Senator DOUGLAS. Yes.

Senator KERR. I would hope that the gentleman from Connecticut wouldn't have that reaction to what I did because I never approached a situation with more humility in my life than I did in my effort to join him in getting into this record an accurate portrayal of his position.

Senator DOUGLAS. This was merely preparatory, Senator Kerr, to saying that the questions which I now ask will be on a much lower intellectual level. [Laughter.]

Mr. BEERS. Sir, may I say to the Senator from Oklahoma that I tried to answer his questions soberly and carefully—but may I say that I wish we had grade schools like his in Connecticut. [Laughter.]

Senator DOUGLAS. May I say this, that you now can be in a much more relaxed frame of mind.

Do I understand that the present bill provides at least the following two types of special treatment for underwriting gains:

First, that it taxes only half of the underwriting gains and leaves the other half untaxed.

Am I right on that?

Mr. BEERS. Phase 2 taxes half and leaves half untaxed.

Senator DOUGLAS. That is right.

Mr. BEERS. Under phase 2.

Senator DOUGLAS. So we are agreed on that.

Do I also understand there is a special untaxed deduction of 10 percent of the net additions to reserves?

Mr. BEERS. That is correct, sir.

Senator DOUGLAS. So that there is deducted not merely the full amount of the reserves, but 110 percent of the reserves set aside; is that right, the full amount plus an added 10 percent?

Mr. BEERS. Yes, sir

Senator DOUGLAS. Now, may I ask what is the justification for this favorable treatment for stock companies in view of the built-in mortality savings due to the use of outdated mortality tables used in computing the tax? I have here the Life Insurance Fact Book——

Senator KERR. You mean computing the premium, don't you, Senator? You mean the mortality tables used in computing the premiums.

Senator DOUGLAS. No, just a moment. These are the mortality premiums.

Senator KERR. You said used in computing the tax.

Senator DOUGLAS. Let us strike that language, and say this: I have the following policyholder death rates which appear on page 58 of the Life Insurance Fact Book, and do I understand that the mortality table which is used is the so-called commissioner's standard ordinary 1941 tables?

Mr. BEERS. In general and for a very large share of the business, yes.

Senator DOUGLAS. Is it used by your company?

Mr. BEERS. It is used by our company for all business issued in the last quarter century, roughly.

(Mr. Beers subsequently advised that the correct length of time was about 12 years.)

Senator DOUGLAS. Now, I find that the average death rate per 1,000 lives exposed in the thirties was 7.5 to the 1,000.

I find that the death rate for 1957 is 6.1 to the 1,000, or a decrease of 19 percent in the death rate.

Now, doesn't this fact provide sufficient protection against temporary adverse mortality experience?

Mr. BEERS. I do not think so, sir.

Senator DOUGLAS. Why not?

Mr. BEERS. The difference in death rate during normal times is actually causing our accounting methods to throw off a mortality profit which is available to us as money that we can use for additional expenses, special losses, and things of that sort.

Senator DOUGLAS. Well, then, it is. The reduction in the death rate is yielding additional profits, too.

Mr. BEERS. It is, in itself, developing additional profits; that is correct, and that decreases the amount of surplus we must otherwise hold for the protection of our policyholders; that is correct. If it weren't for that we would have to hold still higher surpluses.

Senator DOUGLAS. May I ask this question:

Doesn't it also result in giving you a built-in protection within your reserve account?

Mr. BEERS. It does, which is somewhat of an offset to the built-in loss we have from the inflationary increase in our expenses, and the built-in loss we had until quite recently from the decline in interest rates in the thirties and forties compared with the twenties, and so forth.

You are correct. It does give a built-in additional margin of surplus.

Senator DOUGLAS. I am very glad to have you say that, because no less than three life insurance presidents have testified that it did not give any built-in protection, and I am very glad to have you say that because it bears out what would seem to me to be the obvious facts in the case.

Mr. BEERS. May I comment, sir, that the words they used were different from the words you used, and I do not think that they would disagree with what I said, nor that I have disagreed with them.

Senator DOUGLAS. I know the reluctance to disagree with your colleagues.

Mr. BEERS. My colleagues may not agree that I have given you the right impression, but I think they would.

Senator DOUGLAS. But you do say it gives added built-in protection within the reserve account?

Mr. BEERS. I do.

Senator DOUGLAS. Why isn't that enough to meet the increased dangers which you mentioned, the fact that in some one year you may have another influenza epidemic which might compensate for investment years following that in which the death rate was possibly very low, and so forth? Don't you already have a 19-percent protection?

Mr. BEERS. No; we don't have a 19-percent protection, except in the sense that we have a protection of 19 percent of this year's death rate at the age you mention. That does not mean 19-percent protection in any other sense. It means a substantial protection.

Senator DOUGLAS. Yes.

Mr. BEERS. I might mention that insofar as this analysis is cocernde, it applies equally to stock and mutual companies.

Senator DOUGLAS. I see.

Mr. BEERS. And it is still necessary for stock companies to carry substantially higher contingency reserves or surplus, whichever you call them, in addition to actuarial reserves in order to be as safe as mutual companies.

Senator DOUGLAS. Why do they need to do this?

Mr. BEERS. In order to be as safe as mutual companies we need to carry extra reserves, because the mutual companies have a built-in safety factor of a dividend schedule, and in times of stress they can reduce their dividends, a very painful thing to do.

Senator DOUGLAS. Yes.

Mr. BEERS. That was brought out in the House Ways and Means Committee report, and Mr. Mills' presentation to the House.

Senator DOUGLAS. Let's follow that up a little bit. You mean you need to have more cash to protect you against claims?

Mr. BEERS. More assets to protect us against disaster, whatever form the disaster takes.

Senator DOUGLAS. Are you any more subject to disaster than the mutuals?

Mr. BEERS. I would say we are about as subject as the mutuals; yes, sir, about the same.

Senator DOUGLAS. So this is not an argument for the rejection of one-half of the underwriting gains, is it?

Mr. BEERS. This is an argument that we should be permitted to salt half of our underwriting gains away in policyholder surplus account where it is available for policyholders and their beneficiaries in the event of disaster.

Senator DOUGLAS. Well, now, you call this a policyholder surplus, and I believe the Treasury calls it a policyholder surplus, but I think this is very inexact. I think it ought to be called a surplus without reference to policyholder because who has the legal claim to this surplus? Is it not the stockholders in a stock company?

Mr. BEERS. Not until after all policyholders' claims are satisfied.

Senator DOUGLAS. I understand. But they have a claim to the residual; isn't that true?

Mr. BEERS. I don't know whether that is a good claim, sir.

As long as we are a going company they do not have any claim to it, because we don't dare distribute it to them.

Senator DOUGLAS. Well, to whom does this surplus belong in a stock company, then?

Mr. BEERS. It belongs to the policyholders and other creditors, and insofar as they don't need it, it belongs to the company until distributed to the stockholders, at which time, if it ever occurs, the tax is payable under phase 3. I said "if," not "when," sir.

Senator DOUGLAS. What?

Mr. BEERS. I said "if," not "when."

Senator DOUGLAS. I understand.

Mr. BEERS. I have been in the business only 30-odd years, but I have seen enough to know what can happen.

Senator DOUGLAS. Well, legally, who has the claim to this surplus? Legally, to whom does this surplus belong?

Mr. BEERS. The stockholders cannot demand that it be paid to themselves, as I understand corporation law. I don't think the stockholders can demand we pay cash dividends in excess of what we consider sound.

Senator DOUGLAS. For whom do the directors act in a stock company?

Mr. BEERS. They act for the stockholders, whose first obligation is to policyholders.

Senator DOUGLAS. I understand, but they are elected by the stockholders, are they not?

Mr. BEERS. They are.

Senator DOUGLAS. And I thought they owed to the stockholders an obligation to see that the stockholders had a claim to residual earnings.

Mr. BEERS. I think, sir, they have an obligation to stockholders to treat policyholders properly, and to account for anything that they don't need to the stockholders. This is not money that the company does not need.

To bring this out, sir: Let me point out that if, for example, the stockholders came together and said, "We are going to get out of this business, let's quit, divide up the surplus, and so forth," they would find that although as a going concern we have a surplus of so much and so many million dollars, as a liquidating concern we don't have that surplus. We amortize our bonds, we carry our mortgages at par, and if we tried to liquidate those today at indicated market values—and we couldn't get even that—but at indicated market values they would lose five-sixths of their surplus just on those two items alone.

That money in a legal sense may seem to belong to the stockholders, but it is not available to them.

Senator DOUGLAS. I would prefer to conduct this discussion in terms of abstract principles, but I have had an analysis made of the experience of certain stock life insurance companies, of which your company is not one, I may say, but I have here a record of one company which I believe to be accurate, a stock company which in 1957, I think, made $13,945,000, distributed $5 million in cash dividends to stockholders, and paid an actual income tax of $53,000, or less than one-half of 1 percent upon the profits which presumably were largely made from underwriting gains.

Now, I don't want to name that company because I don't believe in going after individuals in this matter. It is quite probable that everything they did was legal. But we have to protect the public interest, Mr. Beers, and the question that I am raising is that in view of the protection which you already have built in through the improvement in the death rate, how strong do you think this case is to have half of the underwriting gains exempted from taxation, and then in addition to get 100 percent allowance for the actual amounts turned over to reserves?

Mr. BEERS. Well, Senator——

Senator DOUGLAS. In other words, the directors of this company evidently thought that stockholders were entitled to a cut in that $14 million that they made. They distributed $5 million of it. The tax which was paid was only $53,000.

Mr. BEERS. I do not defend the stopgap law, nor do I defend the 1942 law, as it might apply to a case of that kind. Although, of course, I do not know any of the details of why that worked out that way.

On the face it sounds like one of the features which Congress has been looking for a way to correct. On the face it looks like a case where the tax would be many, many times greater under this new law.

Senator DOUGLAS. But my point is that only half of these underwriting gains will be taken in so-called phase 2.

Mr. BEERS. Only half of them will be taken, except that in that particular case I think the company will reach the maximum limits on policyholders' surplus rather quickly, and thus——

Senator DOUGLAS. This sounds as though you did know the company.

Mr. BEERS. No, sir, I am just judging from the two figures you gave me, and a company that is in that position is bound to have very small reserves. So that a company with very small reserves will very quickly reach the limits that are in the bill.

Senator DOUGLAS. It could be.

Mr. BEERS. That also, I might say, is a company which is extraordinarily unusual in the life insurance business, and to examine how this bill will work for an extreme example of that kind would require more knowledge of the company than I have or probably could get from their published reports.

Might I say that you mentioned that half the undrewriting profits were exempt from tax. And may I say that that is true in phase 2——

Senator DOUGLAS. Correct.

Mr. BEERS. With a possible tax in phase 3 if it should turn out that the other half is really surplus and not needed for actual policyholder payments.

Senator DOUGLAS. Well, but as I understand that, the taxation in phase 3 will only apply when the sums are actually distributed or when the reserves are equal to 25 percent of the value of the policies; is that true?

Mr. BEERS. That is how the bill is written. I think there is an alternative limit of——

Senator DOUGLAS. Sixty percent of premiums.

Mr. BEERS. 60 percent premiums.

Senator DOUGLAS. Well, take the latter and extend it further: What is the average surplus of the stock companies, in percentage terms?

Mr. BEERS. I don't know the figures, but my general impression is that the average is between 10 and 15 percent. That is a general impression.

Senator DOUGLAS. So that this surplus of 25 percent is a very liberal figure, is it not, and in practice would not be reached in the near future by any appreciable number of companies, isn't that true?

Mr. BEERS. I agree to what you say, sir.

Senator DOUGLAS. So that phase 3 is beyond the horizon, so to speak.

Mr. BEERS. Phase 3, amendment to phase 3 should be—amendment to the factors in phase 3 should be carefully considered by your committee.

Senator DOUGLAS. I mean the present phase 3 is really way off in the dim yonder, so to speak.

Mr. BEERS. So far as my own company, that is so. As far as most—as far as a great many companies go, that is so. Whether it is not so with respect to some companies, I wouldn't know.

Senator DOUGLAS. But you say the average is between 10 and 15 percent.

Mr. BEERS. Yes.

Senator DOUGLAS. So roughly you would have to have a doubling of existing reserves before this test would apply.

Mr. BEERS. I suspect the particular company you mentioned, sir, may have a surplus many times over its reserves.

Senator DOUGLAS. I am speaking now for the industry as a whole.

Mr. BEERS. For the industry as a whole, you are right.

Senator DOUGLAS. As the surplus accumulates, what effect will this have on the market value of the capital stock?

Mr. BEERS. There are people in this room much more able to answer that than I. I might say this, that the effect on the market value of the common stock in contemplation of this law, in my inexpert opinion would be quite different from the effect on market value when it appeared that there was no tax ever payable on such surplus as appears in our statement from year to year. This law changes that completely.

Senator DOUGLAS. What I am trying to get at is the ultimate effects of the bill as it came over from the House. The issue is whether these underwriting gains should be taxed or only half of them taxed.

Now, to the degree to which you have 100 percent deduction for reserve accumulations, you get a further tax benefit which is not included in the tax bill; isn't that true?

Mr. BEERS. I am sorry—I don't follow that. Will you ask that again, please.

Senator DOUGLAS. Let me state that question again.

To the degree that the bill does not tax operating gains, and hence causes the surplus to be greater, will not that tend to cause the value of the stock in the stock company to be higher than it otherwise would be?

Mr. BEERS. I am not at all sure, sir. There is an eventual tax that would have to be paid before the increase in surplus could ever be captured by the stockholders. I understand, and I think you will find it is true if you investigate it, that in Canada, where the tax law is quite different, and where any surplus has to be taxed before it can go to the stockholders as will be the case under this new law, the market prices reflect the tax method as compared to the way the market prices in the past have reflected what has happened in this country. That is, I don't think that the stock prices will go up the way they have in the past, based on increases in company surplus.

Senator DOUGLAS. The point I am trying to make out of this is that this claim that there is sufficient protection because if the surplus is distributed, it will be taxed in phase 3, is made partially ineffective and is offset by this fact; namely, that if it is not distributed the surplus itself rises, the value of the capital stock would rise, and hence it will be possible for the owners to sell the stock and then only pay a capital gains tax of 26 percent instead of income tax which might be much higher for the higher brackets, or the corporation income tax which would be 52 percent instead of 26 percent.

Mr. BEERS. I think the stock analysts in this are smart enough to read the law.

Senator DOUGLAS. My question is: "Is not my surmise correct?"

Mr. BEERS. I believe not, sir.

Senator DOUGLAS. I would like to have you submit a memorandum indicating why it isn't correct.

Mr. BEERS. I can tell you now, Senator. The reason is that in the future a tax will stand between the surplus and the stockholders which does not now stand between surplus and stockholders.

Senator DOUGLAS. Because half of the operating gains will be taxed.

Mr. BEERS. Whatever operating gains are not taxed ought to go into policyholders' surplus, and at that point a tax stands between that surplus and the stockholders, and if that doesn't affect the market they are not as smart as I think they are.

Senator DOUGLAS. Mr. Chairman, I want to say here and now that I think the use of the term "policyholders' surplus" is a very unfortunate one in the case of stock companies. The questioning yesterday clearly indicated that in the case of stock companies this is not policyholders' surplus, and I think that we should substitute for this the term "surplus," and then possibly draw a distinction between surplus as it applies in the case of the mutuals and as it applies in the case of the stock companies.

I ask the technical staff, if they are about, to consider that matter, and ask the representatives of the Treasury to consider that matter.

Mr. BEERS. May I respectfully disagree?

Senator DOUGLAS. That is all, Mr. Chairman.

The CHAIRMAN. Are there any further questions?

Senator McCarthy.

Senator MCCARTHY. No; thank you very much.

Senator LONG. Mr. Chairman, may I ask one question of the witness? I haven't asked my questions.

I would like for you to help me understand the basis upon which stock companies are allowed this 10 percent deduction when they transfer funds over into the surplus account. This deduction is not allowed to mutuals. What is the basis upon which that is justified?

My impression was that it is justified, but I would like to understand it better.

Mr. BEERS. Well, my reason is the mutual companies do business on a larger premium basis, and return part of that premium to policyholders in the form of dividends. If catastrophe strikes them, they can protect themselves; they can protect their ability to carry out their contracts by reducing policyholders' dividends, of course a very painful thing to do.

Stock companies do not have that resource. They, therefore, need to carry substantially more surplus or contingency reserves in addition to their technical actuarial reserves, than the mutual companies need to do, and for that reason, Mr. Mills has said that:

> The stock companies do not have this leeway—

he is referring to the dividend leeway—

> and consequently the bill permits this 10 percent buildup as a contingency fund for the business out of taxable income; also of importance to stock companies is a contingency reserve allowed under the bill equal to 2 percent of the premiums on group business.

May I put into the record at this point, lest I be misunderstood as having misstated what I think is the actual effect of the words used in the bill, I am afraid that the actual words used in the bill don't require that this 10 percent and 2 percent be put into contingency reserves or policyholder surplus funds. I do not defend the allowance of these amounts to the companies as additional profits which they can pay untaxed.

Senator LONG. In other words, you contend that they are entitled to that additional 10 percent deduction only if they actually put that into a reserve to protect their policies?

Mr. BEERS. That is right, and it ought to be taxed if paid to stockholders.

Senator LONG. This surplus account exists to protect their policyholders.

Mr. BEERS. If the policyholders don't need it, as they probably will some day due to some catastrophe that I don't foresee, they can pay it to stockholders, but only after having it taxed.

Senator LONG. Let me ask you this: Is there any basis by which a mutual company, by virtue of charging these larger premiums, or for some other reason, would earn larger deductions than a stock company, which might also contribute to this problem?

Mr. BEERS. I hadn't thought of any.

Senator LONG. Yes. In other words, as far as you are concerned, the basis for that 10 percent is that the stock companies charge a premium which is estimated to be a premium to protect the policies, but they have to have a surplus in the event that their losses run higher than they anticipate?

Mr. BEERS. As soon as we make money on any class of policies so that we develop a surplus on that class, if we are going to be faithful to our trust we have to put that money into surplus to hold for policyholders until it amounts to something substantial, and it is only after that that we can pay dividends to stockholders, and we have to be faithful to our trust because we are dealing with people who pay us premiums for 10, 20, 30 years to protect their families. We are in a different position from corporations that are not charged with that public trust.

Senator LONG. Do I correctly understand you that speaking for your company, which is one of the larger among the stock companies, you personally would not insist upon that 10 percent allowance unless the 10 percent actually were put into surplus for just that purpose?

Mr. BEERS. That is my stand.

Senator LONG. Yes. But your feeling is that for failure to have something of this sort you are at a very substantial competitive disadvantage with the mutuals, because by charging higher premiums and annually remitting back these dividends to the policyholders, they, in effect, are holding this surplus which you otherwise would not have?

Mr. BEERS. Yes, sir; I agree to that.

Senator LONG. Yes.

Senator SMATHERS. Mr. Chairman, may I ask one more question?

The CHAIRMAN. Senator Smathers.

Senator SMATHERS. In phase 3 where we have what amounts to a deferral of the tax on 50 percent of the net operation income as I understand it it is your position that you do not think that should be taxed because, first, it is a deferment, and then for the reason that Senator Long says you need to have this surplus in the event of some catastrophe, which of course mutual companies have by virtue of their larger premium payments.

What effect would the 25-percent limitation have on the surplus of your company?

Mr. BEERS. I think that if this law had been in effect from the beginning, and disregarding the difference in taxes that we would have paid, that we would have about half of that amount now.

Senator SMATHERS. What is the situation with respect to some small companies, some of the small companies that are just newly in the business, would it be correct to say they would not even be up as high as you with respect to the 25-percent limitation?

Mr. BEERS. A good many of them would be a lot lower.

In fact, those that have been in existence only for a few years in many cases will have less surplus than their stockholders originally paid in, and by the way, this policyholders' surplus fund ought to be so fixed that if stockholders pay surplus into the company they get credit for it.

Senator SMATHERS. So that actually in your judgment this limitation will have no bearing as a practical matter for a number of years to come?

Mr. BEERS. The precise ceilings which are stated in the bill would not. I do not defend those precise ceilings.

Senator SMATHERS. Would you explain to me, how the 60-percent limitation of the total amount of premiums in any 1 year would work?

Mr. BEERS. A company which had a lot of term business, possibly group life insurance, possibly accident, health, possibly credit insurance, would have quite small reserves compared with premiums, and consequently, 60 percent of premiums would be a larger margin for them than would be 25 percent of reserves, and in the case of a company like that, the ceiling would be 60 percent of premiums.

Senator SMATHERS. Then your general conclusion is that these limitations are limitations of safety and solvency for companies rather than a tax dodge, to improve the position of your shareholders in your company?

Mr. BEERS. The ceiling should be so fixed that they meet the test which you have stated; yes, sir.

Senator SMATHERS. Well, do you think these ceilings do meet that test? That is my question.

Mr. BEERS. I think they are on the high side.

Senator SMATHERS. You mean by that that they are on what we would say is the conservative side with respect to the policyholders; they overprotect, they lean, if they are weighted they are weighted on the side of the policyholders rather than the stockholders?

Mr. BEERS. That is correct; they are weighted on the side of the policyholders; yes, sir. They are not weighted on the side of the Treasury.

Senator SMATHERS. Well, how about the stockholders?

Mr. BEERS. They are liberal to stockholders, sir.

Senator SMATHERS. They are liberal as far as the stockholders are concerned.

You would think that there would be no great objection made if this committee changed those limitations in some respects, lowering them, we will say, from 25 percent to 10 percent?

Mr. BEERS. I would prefer not to state a precise figure; otherwise I say "Yes."

Senator SMATHERS. Otherwise you would say what?
Mr. BEERS. Yes, sir.
Senator SMATHERS. That is all.
The CHAIRMAN. Senator Gore.
Senator GORE. Mr. Chairman ---
Mr. BEERS. Excuse me. Somebody has just reminded me, that you should watch the needs of the new company, if you change these ceilings.
Senator SMATHERS. Yes.
Mr. BEERS. Because the new company needs special consideration.
Senator GORE. Mr. Chairman, unfortunately another meeting of the Atomic Energy Committee required my absence from this committee, and I haven't had an opportunity to hear all of this gentleman's testimony. Therefore, I am at a loss to know just what has been covered.
I have one question. I am sure I would have had more if I had heard all of your testimony, because you are an able witness.
Before I depart, in response to Senator Kerr you assumed an instance in which the surplus and miscellaneous funds were in proportion to the reserve funds as 40 is to 100.
How does that compare with the proportion in relationship to your own company today?
Mr. BEERS. I don't know, sir.
Senator GORE. Thank you. [Laughter.]
Let me ask you, is there one here on your staff who would know?
Mr. BEERS. No; I have no staff here. Let me think a minute and maybe I will recall what the answer is.
Senator GORE. What I really am——
Mr. BEERS. 30 to 70—the relationship is somewhere between, I guess, around 70 to 75 percent reserves and the rest, other funds, I guess, I can try to answer the question——
Senator GORE. How would this proportion which you assumed, 40 to 100, compare with the industry, would you have an idea on that?
Mr. BEERS. I don't know that, but it may be that the staff does know.
Senator GORE. What I am trying--let me come to the point I am trying to lead up to. My questions are clumsy and your answers inadequate.
Mr. BEERS. I am very sorry.
Senator GORE. Well, I mean that kindly, you don't have the information, and I don't blame you for that.
What I am trying to get at is whether or not this bill would provide both an opportunity and a temptation for companies to make arbitrary, or otherwise, shifts to the reserve account in order to take advantage of the deductions for reserves, thereby lessening what their taxes otherwise would be.
Mr. BEERS. There will be a tendency for this law to influence companies in fixing their reserve assumptions in determining how much money they are going to put in reserve. I don't think there will be a tendency to influence the companies to set up higher reserves, or lower. I think that decision would be made much more nearly on straight business principles regardless of taxes.
But there will be some tendency to be more conservative with respect to mortality, and less conservative with respect to interest, be-

cause that will be of some slight assistance to them in connection with taxes, although it will be so slight, it is hardly worth all the calculations it will take.

Senator GORE. Well, you have these mathematicians employed anyway.

Mr. BEERS. Yes; and we have some machines to help them, sir.

Senator GORE. Well, we have only one in this committee.

It seems to me you have answered me both ways. In the first instance you said "No", and in the second instance you said "Yes", although it might not be worth the cost.

Mr. BEERS. I first said that I didn't think companies would increase the aggregate amount of reserves merely to save taxes, and in the second place, I said that the amount of reserves they do set up will be calculated by different formulas that produce about the same result, but they will tend to pick formulas more conservative on mortality and less conservative on interest, because that will tend to reduce their tax slightly.

It is like in our personal life trying to spend money to meet our expenses by reducing our income instead of by increasing our personal expenses, because if you reduce your income you save the taxes on it, while if you increase your personal expenses you don't. It is that kind of an effect.

Senator GORE. Then you have said "Yes" and "No", slightly. [Laughter.]

Mr. BEERS. I should like to submit, sir, that I have answered two separate questions.

Senator GORE. Well, I submitted one. [Laughter.]

Mr. BEERS. One very good question, which I interpreted as being a compound question.

Senator GORE. Well, I didn't ask you—of course, you are at liberty to place your own interpretations on the question, but if I asked one compound question, I didn't realize it, I assure you.

I have a note that during my absence you suggested that the so-called 10 percent compensating deduction and the 2 percent be treated for tax purposes similarly to the policyholders' surplus, so called.

Mr. BEERS. I referred to Congressman Mills' explanation of those factors and said that I agreed with his explanation, and that the only inference I could draw from it was that those factors should be treated that way. That is a long way of saying "yes," sir.

Senator GORE. I am making remarkable improvement.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator McCarthy.

Senator McCARTHY. I have a question with regard to this 10 percent deduction they are talking about.

Is there a possibility of some discrimination between a stock company with an underwriting gain, as opposed to one with an underwriting loss in the application of that, when you move from one phase to the other and back again?

Mr. BEERS. That is a little too subtle for me. I just don't know. I can see both sides of that question.

Senator McCARTHY. Is there a possibility that there might be?

Mr. BEERS. I take no stand on it. I don't know.

We will have an operating gain under normal circumstances larger than our taxable investment income, and therefore it would affect us the same either way.

Senator McCARTHY. That is all, Mr. Chairman, thank you.

The CHAIRMAN. Mr. Beers, I want to thank you very much for your testimony. I think you have been fair and frank.

Before these hearings started the Chair was approached by the insurance representatives asking for full hearings by reason of the fact that hearings have not been held in the House on this bill, and searching hearings, and I think you will agree today that the hearings have been very searching.

Mr. BEERS. I hope that I have been helpful, sir.

The CHAIRMAN. I think you have, sir, and thank you very much.

Our next witness is Mr. Paul E. Martin, the Ohio National Life Insurance Co.

I would like to say, Mr. Martin, that Senator Lausche has called me and said that you had a particular problem to present.

## STATEMENT OF PAUL E. MARTIN, ADMINISTRATIVE VICE PRESIDENT, THE OHIO NATIONAL LIFE INSURANCE CO., ACCOMPANIED BY WILLIAM J. SCHMID, GENERAL COUNSEL

Mr. MARTIN. Thank you, sir.

Mr. Chairman and members of the committee, I am Paul E. Martin, administrative vice president of the Ohio National Life Insurance Co., of Cincinnati, Ohio. I appear here on behalf of that company, in place of our president, M. R. Dodson, who could not be here because of a prior commitment out of the country this week.

We wish to point out that the proposed bill relating to the taxation of the income of life insurance companies fails to give adequate consideration to the situation of any stock company in the process of mutualization (conversion to a mutual company). This is especially true if retirement of all outstanding shares would have reduced surplus funds of the company below an amount considered adequate to safeguard against contingencies, and if for that reason the company embarked upon a plan of stock retirement gradually over a period of years, with funds to be provided out of current earnings.

A specific example as it applies to the Ohio National Life Insurance Co. will be used to illustrate this point.

The stockholders and policyholders of Ohio National Life agreed upon a mutualization plan in 1941. The price was set at $40 a share for the 82,858 shares outstanding, involving a total payment of $3,314,320. This sum amounted to slightly more than the combined capital and surplus of the company existing at that time. To maintain an adequate operating surplus, the mutualization plan contemplated an annual retirement of shares, by lot, to be paid for out of current earnings. During the mutualization period, stock dividends were limited to $1.25 per share.

After several years' delay due to litigation which was resolved in the company's favor, the plan was formally approved by the superintendent of insurance of Ohio in 1949 and shares have been called annually since that time. During the 9 years ending with 1957, earnings totaling $2,481,440 were used to call 62,036 of the outstanding shares.

The cost of retiring shares called in 1958 was $279,840 and all remaining shares were called on January 5, 1959 for retirement February 5, 1959, at a 1959 cost of $553,040. The total cost for the 2 years combined is $832,880. Were it not for these mutualization costs, most, if not all, of these required dollars would have been disbursed through an increased schedule of dividends to policyholders. Such did not occur because policyholders' dividends were maintained at a level which would avoid a reduction in the ratio of surplus to assets.

The proposed bill provides for a deduction of dividends to policyholders—sections 809(d)(3) and 811 (a) and (b)—in the determination of gain from operations. In our opinion, if gain from operations is to remain as a part of the tax base, a deduction also should be permitted for payments (other than dividends) to stockholders under a mutualization program committed for by the company prior to the effective date of this legislation. Such payments represent a liability to the company equal to the balance of the purchase price for remaining shares agreed upon under the mutualization laws of the State of domicile. Surely there is as much reason to permit a deduction for such required payments as for policyholders' dividends which are not guaranteed.

Unless some relief is provided, the proposed bill assumes a retroactive aspect. To the extent that capital is retired after 1957, a tax is incurred on operating earnings used for this purpose. In the case of Ohio National Life, this tax totals $216,548.80 for 1958 and 1959 combined, since our gain from operations substantially exceeds our taxable investment income. Had such a tax been contemplated at the time the mutualization plan was committed for, a lower price might well have been fixed in the plan for retirement of the stockholders' interest.

As a matter of fact, Ohio National Life's Federal income tax would be more than doubled from 1957 to 1958. We are particularly hard hit by the so-called phase 2 of the bill; yet we issue no specialty business. Our operations are limited to participating ordinary insurance and a very small amount of group.

While we firmly believe relief should be granted in the case of prior commitments made under a mutualization plan—and this next statement is an aside—we would also like to respectfully draw attention to the fact that phase 2 of the proposed tax method in its present form may constitute a serious deterrent to future mutualization of stock companies. We doubt if this was the intention of its authors.

The relief which I speak of in the case of a mutualization plan committed for prior to the effective date of this bill could be provided by inserting an additional deduction in subpart C, "Gain and Loss From Operations."

We would be happy to assist the staff of the committee in any way in which we can in the wording of such a provision.

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

Will you submit in writing your proposed amendment?

Mr. MARTIN. Yes, sir.

The CHAIRMAN. Will you submit that in the form of an amendment?

Mr. MARTIN. We will be glad to do that.

The CHAIRMAN. Senator Douglas, any questions?

Senator DOUGLAS. No questions.

Mr. MARTIN. Thank you very much, sir.

(Mr. Martin subsequently submitted the following for the record:)

PROPOSED AMENDMENT TO H.R. 4245, TO CORRECT THE RETROACTIVE ASPECT OF THE BILL AS IT AFFECTS A LIFE INSURANCE COMPANY IN PROCESS OF MUTUALIZATION UNDER A MUTUALIZATION PLAN COMMITTED FOR PRIOR TO THE PROPOSED EFFECTIVE DATE OF THE BILL

In subpart C, "Gain and Loss From Operations," section 809(d), an additional deduction should be inserted immediately following paragraph (8) at the bottom of page 24 of the February 9, 1959, print, as follows:

"(9) Any distribution during the taxable year to shareholders in acquisition of stock pursuant to a plan of mutualization agreed upon prior to January 1, 1958, under the mutualization laws of the taxpayer's State of domicile."

The above addition would require the following changes on page 25 of the February 9, 1959, print of the bill:

Paragraph (9) of section 809(d) would be renumbered as paragraph "(10)".

The reference in the first sentence of section 809(e), to subsection (d)(9), would be changed to refer to subsection "(d) (10)".

Senator BENNETT. Mr. Chairman, at this point in the hearing, if there is no objection, I would like to have inserted the statement of Mr. Carl A. Hulbert, insurance commissioner for the State of Utah. Mr. Hulbert, before assuming his present important position, was a very prominent and highly respected attorney with many years of experience in the field of insurance law. I am confident that his statement was prepared only after he had carefully examined all facets of the tax bill we now have under consideration, and how it might affect the State of Utah and insurance companies doing business in the Beehive State.

I hope that all members of the Finance Committee will read and give full credence and consideration to the suggestions and recommendations contained in Mr. Hulbert's excellent statement.

(The statement referred to is as follows:)

STATEMENT BY CARL A. HULBERT, COMMISSIONER OF THE DEPARTMENT OF INSURANCE OF THE STATE OF UTAH

Mr. Chairman, I had originally hoped to be able to appear in person to express my views on H.R. 4245 but due to the long distance involved and the press of business in my department it has proved impossible for me to do so. At Senator Bennett's invitation I am taking the opportunity of expressing myself by means of this statement.

At the outset, I want to assure you that I have no intention of attempting to tell the distinguished members of the Finance Committee how to write a tax bill or how to tax life insurance companies. I don't profess to be a tax expert. It is my firm opinion that all of us must bear our fair share of the tax burden and life insurance companies are no exception. I am concerned, however, over certain provisions of the bill.

It is my understanding that, under the bill, companies are allowed a tax deduction for amounts required to maintain actuarial reserves. Such a provision is sound. However, I understand that amounts placed in other reserves which are required by a State department insurance may not be deductible. I think this is unfortunate and feel that the Senate Finance Committee should correct this oversight.

For example, under Utah law, it is the duty of our department of insurance to assure the financial stability of life insurance companies operating within the borders of our State. Our department requires the filing of annual reports reflecting the operations and financial condition of each company licensed to do business in the State of Utah. The report is a standard one and the form is endorsed and approved by the National Association of Insurance Commissioners. In order that policyholders in Utah may be fully protected, we find it necessary to insist that companies maintain reserves adequate to protect policyholders. The Utah law does not require companies to maintain any reserves whatsoever for annuities, disability benefits, or accidental death benefits.

So these reserves which companies set up are not reserves required by law. Therefore a company would have to throw out these reserves in computing their gains from operations for purposes of estimating their taxes under this bill. This would penalize a company for complying with a commissioner's order. These reserves are necessary for a sound company operation. At present, I have a bill before our legislature, now in session, which would make these reserves required by law but whether or not this bill will become law is a moot question.

I am confident that there are at least a half a dozen States that do not have statutes requiring reserves for these classes of insurance. Not all of these reserves are actuarial reserves. For example, a common reserve required by my department is a security valuation reserve. This is a reserve set up on the books of each life insurance company as a hedge against security losses. There are other similar reserves and it is a part of my job as State commissioner of insurance to insist that companies maintain different types of reserves in order that policyholders may be protected.

I believe that the creation of reserves and additions to reserves which are required by a State insurance department should be a deduction from gross income for tax purposes. Unless the Senate changes the bill to specifically provide for this, I think that our decision as to the type of reserve required and the amount of such reserves may be ignored for Federal tax purposes, and that companies complying with our orders may incur the penalty of disallowance of a tax deduction.

I think it highly probable that our rulings as to the amount of such reserve will be challenged by the Treasury Department. For example, I find that rulings issued by other regulatory agencies have been ignored by the Internal Revenue Service in computing tax liability. (See *Gulf Power Company* in 10 T.C. and *National Airlines* in 9 T.C.)

I think the implications raised by these cases should be borne in mind by the committee when it begins its deliberations in executive session on this bill.

I was heartened to read the colloquy between Representatives Simpson and Mills concerning the usurpation of State regulatory power on page 2340 of the Congressional Record of February 18. Mr. Mills said:

"* * * We are trying to preserve as best we can in this bill the management of this industry in the hands of the State regulatory agencies and not to change in any way that situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or anyone else in Washington the regulatory authority."

Despite this assurance I think the provisions of the bill encroaches upon our regulatory powers. In my State of Utah the income received from the payment of premium taxes is the seventh largest source of revenue. I think it highly probable that my State will have to increase the premium tax in the near future. I needn't spell out for you the effect the tax proposed by H.R. 4245 will have on any attempted increase in the taxation of premiums. I cannot believe that the Congress of the United States would deliberately infringe upon the powers of the various State departments of insurance in protecting the interest of policyholders everywhere. I do think, however, in view of the possible tax effect of some of our rulings with respect to contingency and other reserves, that the Finance Committee should make it abundantly clear that the authority of State insurance departments to regulate and control the reserves of life insurance companies be maintained and recognized for tax purposes.

Under the provisions of the McCarran Act, the Congress receded to the various States the right to regulate the insurance business. I do not want the McCarran Act repealed by implication or by placing the Treasury Department in a position of being a coregulator of insurance along with the State departments.

As administrator of State government I feel it is my duty to express my opinion of H.R. 4245 to the committee and ask that you consider some amendments which will protect State's rights. Specific statutory language should be inserted in H.R. 4245 which will insure that the right and duty of a State commissioner of insurance to regulate all reserves and otherwise control the financial operations of a company subject to his jurisdiction cannot be challenged by the Treasury Department. It should be made perfectly clear that the Commissioner of Internal Revenue has no authority to question the existence of or additions to any reserve required by a State insurance department.

I deeply appreciate the opportunity of having my comments made a part of the hearing record and want to thank the committee for their consideration of this statement.

The CHAIRMAN. The next witness is Mr. Francis V. Keesling, Jr., of West Coast Life Insurance Co.

## STATEMENT OF FRANCIS V. KEESLING, JR., FIRST VICE PRESIDENT AND GENERAL COUNSEL, WEST COAST LIFE INSURANCE CO.

Mr. KEESLING. Mr. Chairman and members of the committee, my name is Francis V. Keesling, Jr., first vice president and general counsel of West Coast Life Insurance Co., a stock company with home office at San Francisco, California. I am appearing here on behalf of my company, and I appreciate this opportunity to come before you.

First of all, Mr. Chairman, I am happy to be here to participate in the christening of this new committee room.

However, I hope that the limited number of chairs in relation to the number of life companies is no indication that the mortality under the final legislation will eliminate us to the extent that this room will be more than ample to accommodate the life insurance industry at future hearings.

Senator DOUGLAS. Do you think there is such a danger?

Mr. KEESLING. I hope not, sir. When the bill——

Senator DOUGLAS. In its present form do you think there is such a danger?

Mr. KEESLING. Frankly, Senator, I have not yet been able to understand clearly all of the provisions.

I believe from my testimony that some of these items that have been brought out here are so confusing that the committee may decide that it should go into more amendments or perhaps, even some different form.

When I came up here on the Hill as liaison officer for the Selective Service System during the years 1940–45 and later for the city and county of San Francisco respecting its Washington problems, I learned that I could be of greatest help to the committees, as well as being most effective, by laying the facts out on top of the table—analyzing them, and then considering various possible solutions—jointly with the committee. I shall try to do that today. However, I find it won't be necessary to present all of my statement in view of what has already been presented by other witnesses. With your permission, I shall however make a few additions.

Mr. Chairman, I am fully aware of the gigantic task and responsibility this committee has in trying to maintain a tax structure that will produce the vast amount of taxes required for survival in this international and space age, a tax structure which will fall fairly and equitably on all taxpayers. I am equally aware that this committee, Mr. Chairman, desires to obtain from the life insurance industry segment of that overall tax structure an amount of tax that will be large enough in relation to taxes paid by others, and yet which will not, when added to the heavy State taxes, impair the industry and adversely offset the national economy.

Also, I am sure that this committee, in accord with the position and philosophy repeatedly expressed for many years by Members of Congress, and by both mutual and stock companies, desires to have a tax bill that will continue, and that will not upset, the competitive balance between mutual and stock companies. It is my sincere belief that my comments fall within those principles and goals.

You will obtain from the testimony presented before this committee and also before the House committee, considerable data on the large amount and heavy impact of the taxes levied by the States. I shall therefore not duplicate, but shall merely supplement, that data with some statistics obtained from a recent survey of taxes levied on life insurance companies in comparison with taxes levied on other corporations. At this point, Mr. Chairman, I respectfully request that this schedule and explanatory material be incorporated in the record.

The CHAIRMAN. Without objection.

(The schedule referred to is as follows:)

*Comparison of the tax impact under the bank and corporation franchise tax with the tax impact under the California insurance company premium tax, 1954–57*

[In percent]

| | Effective tax rates | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | General corporations, 1954–57 [1] | 1954 | | 1955 | | 1956 | | 1957 | |
| | | Commercial bank | Average rate for the 21 life insurance companies | Commercial bank | Average rate for the 21 life insurance companies | Commercial bank | Average rate for the 21 life insurance companies | Commercial bank | Average rate for the 21 life insurance companies |
| 1. Including capital gains and losses: | | | | | | | | | |
| 1.1 Method 1: Allocating a portion of net gain from operations (adjusted) to California business | 4 | 8 | 12.7 | 8 | 15.5 | 7.7 | [2] 24.3 | 7.9 | [3] 25.0 |
| 1.2 Method 2: Assuming all business conducted in California | 4 | 8 | 12.9 | 8 | 15.9 | 7.7 | [2] 25.2 | 7.9 | [3] 25.4 |
| 2. Excluding capital gains and losses: | | | | | | | | | |
| 2.1 Method 1: Allocating a portion of net gain from operations (adjusted) to California business | 4 | 8 | 19.4 | 8 | 20.6 | 7.7 | 20.1 | 7.9 | 22.4 |
| 2.2 Method 2: Assuming all business conducted in California | 4 | 8 | 19.9 | 8 | 19.9 | 7.7 | 20.1 | 7.9 | 21.1 |

Percentage of the total dollar amount of California life insurance business written by the 21 life insurance companies covered in this study:

| | |
|---|---|
| 1954 | 77.3 |
| 1955 | 77.5 |
| 1956 | 77.6 |
| 1957 | 76.4 |

[1] In addition, general corporations pay local taxes on their personal property. Commercial banks are exempt from this tax as are life insurers. It is held that the effective tax rate for general corporations would approximate that of commercial banks if their personal property taxes were included, based on the method applied by the State authorities in arriving at the bank and corporation franchise tax rate applicable to commercial banks.

[2] The figures are for the 20-company average, excluding New York Life Insurance Co. The aforementioned company's effective tax rate was very high due to exceptionally large capital losses in relation to net gain from operations (adjusted) experienced by same in 1956.

[3] The figures are for the 18-company average, excluding Massachusetts Mutual Life Insurance Co., New England Mutual Life Insurance Co., and New York Insurance Co. The above-mentioned companies' effective tax rates were very high due to exceptionally large capital losses in relation to net gains from operations (adjusted) experienced by same in 1957.

Mr. KEESLING. The schedule is pertinent to the principle that in considering both the size of the tax and the method of levying the tax, the amount and impact of State taxes must be evaluated. This data discloses that after making adjustment for personal property taxes and other exemptions, the State of California taxes life insurance companies much more heavily than other companies. The life companies are taxed as much as 500 percent more.

Senator CARLSON. Mr. Chairman, I wonder if I could interject there; what is this 500 percent more, of what?

Mr. KEESLING. More of taxes than they tax others.

Senator CARLSON. On what basis?

Mr. KEESLING. In the schedule, sir, if you will refer to the schedule, you will see that general corporation taxes, the general corporation tax rate, is 4 percent, and the average on the top line there for life companies, taking 21 of them, is 25 percent, and so the actual tax is 500 percent differential.

Senator DOUGLAS. Will the Senator yield?

Senator CARLSON. Yes.

Senator DOUGLAS. May I ask if there was any difference in the tax on general property of ordinary corporations and life insurance companies? Don't the other corporations have to pay taxes on land, buildings, and equipment?

Mr. KEESLING. That is right, sir, and that was taken——

Senator DOUGLAS. What about the life insurance companies?

Mr. KEESLING. They would have an offset on their real property taxes and also on their personal property.

Senator DOUGLAS. You pay a tax on your general property——

Mr. KEESLING. We pay no personal property taxes, and there is a home office real estate offset against premium taxes.

However, those were taken into consideration in formulating these, and with respect to the amount of personal property taxes on the life companies, it was very, very small.

Senator DOUGLAS. What I was trying to get at is whether these would modify that, this 5-to-1 ratio that you mentioned?

Mr. KEESLING. It is my understanding that that was taken into consideration in connection with it, sir.

Senator DOUGLAS. Are you certain of that? The figure which you gave us was 4 percent, and what—25 percent?

Mr. KEESLING. Yes. This was——

Senator DOUGLAS. And that the tax on real estate and personal property differential is what percent then?

Mr. KEESLING. It is my understanding from the people who prepared these statistics—and there is a voluminous amount of material on it—and if the committee is interested in knowing how they were formulated, that data could be made available, that the figures in the schedule are the net results after allowing for all personal property and real property variations insofar as the life companies are concerned. Therefore, after adjusting for that, the figures of 4 percent for general corporations and 25 percent for life insurance companies are the end result.

Senator DOUGLAS. I wonder if you would be kind enough to do that and produce the supporting evidence which indicates the relative general and personal property taxes paid by corporations in general, and life insurance companies as well.

Mr. KEESLING. I would be very happy to do that, Senator.

I would suggest, however, that you might not want to have it incorporated in the record because I understand it is about a foot thick.

Senator DOUGLAS. Could you summarize it; could you give a summary statement——

Mr. KEESLING. Yes, sir.

(The explanation subsequently submitted by Mr. Keesling is as follows:)

EXPLANATION OF SCHEDULE SHOWING COMPARATIVE TOTAL STATE OF CALIFORNIA TAXES AS AMONG LIFE INSURANCE COMPANIES, COMMERCIAL BANKS, AND OTHER CORPORATIONS

This study compares the total tax impact of California taxes on life insurance companies with California taxes on regular corporations and also on commercial banks. Twenty-one companies having over 75 percent of the life insurance in force in the State of California were used in the study. The necessary information was obtained from two sources:

1. The annual statements of the various insurance companies from the files of the California insurance commissioner;

2. Photostatic copies of the tax assessment role. This tax assessment role is in essence a copy of the premium tax return filed by all companies doing business in the State of California. Permission to make copies of this material was granted by the California State Board of Equalization for this purpose.

In order to make the study as conservative as possible, the net gain from operations of a life insurance company was treated as if it was substantially the equivalent to profits. In our opinion net gain from operations greatly overstates the profit of a life insurance company and therefore it could be contended that the effective tax rates shown for a life insurance company should be even higher than those set forth in the schedule.

The basic computations were made pursuant to two different methods. First it was assumed each life insurance company did its entire business solely within the State of California. Second, a part of each life insurance company's net gain from operations was allocated to the State of California in proportion to California premiums. This allocation was broken down by the type of business; namely, life insurance, annuity contracts, and accident and health business. These two methods served as a check against one another and, as the schedule reveals, each method resulted in an effective tax rate that is substantially the same.

Since there is a dispute among students of the subject as to whether or not capital gains are in fact income, each of the above methods were broken down into two parts—one which includes capital gains as income, and the other which excludes it.

In the State of California a life insurance company is allowed to deduct from its premium tax that portion of its real estate taxes attributable to its principal office in that State. An appropriate adjustment was made for this deduction which, in effect, reduced the tax impact. This adjustment varied from one company to another depending on the size of their principal office in California.

Adjustments for personal property taxes were deemed unnecessary after a detailed study was made of one large California company. In this case, all personal property owned by that company (the largest in the State of California) was valued and a computation of the personal property tax was made. This computation revealed that if the personal property tax was applicable to life insurance companies, the tax would be only approximately $25,000 out of a total tax of approximately $3,400,000.

In view of this very small impact of the personal property tax, it would have no material bearing on the total tax rates. That fact plus the fact that a computation would have had to have been made separately by each individual company, caused the chairman of the study group to decide that the personal property tax should not be computed or included.

Mr. KEESLING. I would like to say, Senator, further in answer to your question that, frankly, I was amazed when I was shown this material. It was worked out in California in conjunction with two companies, two of the largest companies in California, Pacific Mutual Life Insurance Co. and Occidental.

The Council of State Governments should be interested in this, so I talked with them and asked that they furnish comparable data for other States.

As you know, Mr. Chairman, there is a Joint Federal-State Action Committee composed of the Governors of the respective States, and also of appointees of the President of the United States, including the Secretary of the Treasury, Secretary of Health, Education, and Welfare; the Secretary of Labor, and others.

When I talked with Mr. Charles Schwan of the Washington office of the Council of State Governors recently he told me that the joint committee has not made study of this as yet—I assume because there has been no major problem on it before—or no one has brought it up.

He said, however, that it is a proper study to be referred to it. I respectfully suggest that it would be very pertinent to this study and this consideration that this committee make a request on the Secretary of Treasury to have such a study placed on the agenda of that joint committee, sir.

That excess and differential in taxes in California is quite understandable when the historical background and reasons are considered. Traditionally, the area of taxation of life insurance companies has been left preponderantly to the States. Case law and statutory law have recognized that. As a result, the State moved into that area and taxed it much more heavily than other corporations. Consequently, I respectfully request that this data be given careful consideration; and I know that your committee will do that.

It has a pertinent connection with the supplemental statement of 10 members of the House committee appearing at pages 87 and 88 of the House report, and comments by some of them on the House floor.

H.R. 4245 now appears to be a total income tax bill—at least on stock companies. Therefore, to equalize the overall Federal-State tax as between life companies and other corporations, appropriate consideration should be given by the Federal Government to the fact that California and other States tax life companies more than other companies.

As you know, Mr. Chairman, there is an analogy in the partial credit for State death taxes granted by section 20111 against the Federal estate tax. Also, I understand that the President's budget message this year has recommended that States taxes on telephones be allowed as a credit against the Federal communications tax.

I am told by industry technicians that although step 2 (subpart C) of the bill technically appears to apply to both mutual and stock companies, in actual practice it will apply almost solely to stock companies and some small mutuals. Therefore, to partially equalize that differential, it would seem advisable to make any adjustments for the impact of State taxes, in step 2 (subpart C), where some adjustment is already made. That is where the premium tax adjustment is at the present time.

One way of doing it, which I would suggest for the consideration of this committee—there may be some other way—would be to shift a portion of the present deduction of State premium taxes so that

25 percent or some other percent of it would be changed from being a deduction from taxable income of step 2, to being a credit against the step 2 tax. If mutuals in fact, rather than in form, are made subject to the step 2 tax, this credit and other credits in step 2 would be available to them also.

Frankly, I am quite concerned because, if what I have been told is correct, and not being an actuary, and not being familiar with many of the intricacies of this bill, I cannot verify this, but from some of the information I have heard around here since I have been here, and also from talking with my own actuary—and he is not here with me so I have to rely on others while I am here—the information that I have gotten is that there can be a present and future competitive advantage to the mutual companies, and competitive disadvantage to the stock companies.

Mr. Chairman, I respectfully request that your committee examine into the intricacies of this bill and make appropriate adjustments so that the competitive balance will not be upset.

Regardless of the amount of the tax on my company, and I want to stress that, regardless of the amount of the tax on my company, or any other stock company, even if it be increased tremendously, it is vital to the future of existing stock companies, and to the creation and continuance of new stock companies, that the expenses of stock companies not be increased by taxes which are not also imposed on mutual companies or, conversely, any taxes imposed on underwriting and other profits of stock companies should also be imposed on comparable profits of mutual companies, even though passed out to policyholders.

From the testimony already presented at these hearings, it seems to me that the tax does not fall with such equal impact, in view of the fact that one group apparently—it has been very apparent at these hearings—seeks deductions under step 1, while another seeks deductions under step 2. So long as the step 2 tax does not in fact fall on mutuals as heavily as on stock companies, mutuals and stock companies, not only now but it is my opinion in the future, although supposedly in the same boat, will be rowing in different directions. If so, that is not healthy for the mutuals, the stocks, the Congress, or the economy.

Not being an actuary, I cannot give you the details concerning this point. I am merely passing along what my company's actuary and some of the other technical men tell me. I respectfully suggest, therefore, that you have your committee examine into this question.

Maybe our predecessors in Congress and in the industry were not entirely stupid when they proposed the distribution on the basis of an investment income excise tax bill after they decided what the total income tax was supposed to be. At least that does not bring about this condition of pulling and hauling and rowing in different directions.

This is a very unpleasant assignment to come up here and say what I have just said, because I have many, many friends, some of my closest friends, among the mutual companies.

Regardless of how this bill comes out, I know that we are still going to be friends, but I dislike to have anything of this nature coming into the picture, not just because of the friendship aspect but because

I sincerely believe that it will adversely affect all concerned, not merely the industry but the economy.

Mr. Chairman, it is at this point where page 6 would normally appear, and it is my intention to include at this point an additional point that I would like to make.

I am sure that all stock life insurance companies would be adversely affected by any material change in the ratio of the total tax paid by stock and by mutual companies.

The ratio has been stated roughly to be 25 percent paid by stocks and 75 percent paid by mutuals.

Of course, this new bill necessarily changes the ratio somewhat. The reason is that stock life insurance companies will pay under phase II as well as under phase I, as I have already mentioned, and mutual life insurance companies will pay little or nothing under phase II, according to the figures I understand the individual company statistics show.

Any tax under phase III is payable only by stocks, as has been indicated here.

On Wednesday you heard mutual company witnesses testify about phase II discriminating against them. This is just a little hard to understand, as the real discrimination is that they do not pay the phase II tax in fact, as I have already mentioned.

As I said, the ratio in the past has been roughly 25 to 75. On page 8 of the report of the Committee on Ways and Means it is indicated that stock companies would pay 28 percent of the tax under H.R. 4245 as it passed the House. I believe this figure is too low and that the correct figure is not less than 30 percent.

Regardless of its merits, if the 5-year—and I am not commenting as to its propriety—regardless of its merits, if the 5-year average interest rate is adopted in substitution for what is now in H.R. 4245, then the stock companies will be required to pay about 32 percent of the total tax.

If there is a further adjustment which would permit mutual companies not only to pay no phase II tax, but also to pay a reduced phase I tax, there would be a further shift in the tax to the stock companies because very few stock companies, except the small ones, could reasonably expect any benefit from a so-called negative of the type under discussion yesterday and the day before. Practically all the benefit goes to the mutuals and results in a further shift in the tax burden to the stocks which would be even more discriminatory to stock life insurance.

Incidentally, two cases were mentioned in connection with constitutional questions. Although I have not had an opportunity to look them up, I would respectfully suggest that this committee check into those two cases and ascertain whether they are actually in point.

I asked someone about it yesterday—and I should not even state this for the record without checking the accuracy—but they volunteered the information that they understood that while tax cases—they had to do with a person who had received policyholder dividends, and the question was what the tax situation was with respect to that person who had received the dividends—not with respect to whether anybody paying the dividends to that person could be taxed. But that is just a matter of conjecture. The committee, in my opinion, I respectfully suggest, should look into that.

If I may, I would like to place in the record later today, Mr. Chairman, figures bearing on this shift in the burden of taxation from mutuals to stocks under the various proposals under consideration, and also showing that mutuals would pay little or no tax under phase II.

(The figures referred to are as follows:)

*Estimated Federal income taxes of stock and mutual life insurance companies, 1958 business*

[Dollar amounts in millions]

H.R. 4245 AS PASSED BY THE HOUSE

| | Phase I | Percent | Phase II | Percent | Total | Percent |
|---|---|---|---|---|---|---|
| Stock | $132.0 | 25.4 | $39.0 | 100 | $171.0 | 30.7 |
| Mutual | 387.0 | 74.6 | 0 | 0 | 387.0 | 69.3 |
| Total | 519.0 | 100.0 | 39.0 | 100 | 558.0 | 100.0 |

H.R. 4245 ADJUSTED ON BASIS OF 5-YEAR AVERAGE INTEREST RATE

| | Phase I | Percent | Phase II | Percent | Total | Percent |
|---|---|---|---|---|---|---|
| Stock | $118.8 | 25.5 | $45.6 | 95.6 | $164.4 | 32.0 |
| Mutual | 347.5 | 74.5 | 2.1 | 4.4 | 349.6 | 68.0 |
| Total | 466.3 | 100.0 | 47.7 | 100.0 | 514.0 | 100.0 |

In the estimates given above, there are reflected (1) the accrual method of accounting (2) the new formula for calculating the earned rate of interest (3) an item of 9 is included in phase II for stock companies to cover specialty companies (4) the 7 percent preliminary term adjustment is used in phase I and (5) there is no exclusion of deficiency reserves.

The above figures do not take into account phase III. Taxes under phase III are payable solely by stocks and will increase their share of the total tax even further.

The report of the Committee on Ways and Means to accompany H.R. 4245, page 8, shows the percentage of the total tax payable by stock companies under H.R. 4245 to be 28 percent and by mutuals 72 percent. The figures in the table above have been further refined and are believed to be substantially correct.

The above report, page 8, shows that under both the 1942 formula and under the 1955 formula the stock companies would be required to pay only 25 percent of the total tax, and the mutuals, 75 percent.

Mr. KEESLING. In view of what has already been stated, Mr. Chairman, in these hearings, and in view of the extension of time for filing returns until June 15, which was announced earlier this week, the committee will have ample opportunity to go into many of these things, including some of the items that appear in my testimony from page 6 on, and also what was set forth in detailed testimony that I presented before the House committee, and I respectfully request that in your deliberations you take this additional data into account, including the testimony appearing at pages 434 to 453 of the House hearings.

On a lighter note, Mr. Chairman, I hope that the committee can and will work out a good bill which will equalize the tax situation and also provide the required amount of tax. Then there would be sufficient funds to build a large enough room to seat all of us, and all of us will still be in the business so we can use it.

Senator DOUGLAS. Do I understand you that you are proposing that underwriting gains should not be taxed?

Mr. KEESLING. No, sir. I was proposing that if the tax is placed on stock companies, the tax should also be on mutuals. I didn't wish to leave that other implication.

I made the statement if mutuals are not taxed, stock companies should not be taxed; but I also made the statement conversely that if stock companies are taxed, then mutuals should be taxed.

Senator DOUGLAS. What you are saying is that you really shouldn't draw the distinction between mutuals and stock companies.

Mr. KESSLING. Yes, sir.

Senator DOUGLAS. You don't see the distinction in mutuals that presumably because of economics the gains belong to the policyholders——

Mr. KESSLING. I do recognize that, sir, and that is not what I was talking about. I believe everybody recognizes that the portion of the dividends paid to policyholders which is actually a return of capital should, of course, be taken into consideration and not be taxed. It is only that portion of the dividend that could be attributed to profits that should be subjected to the tax. I can't go into the intricacies of what that portion would be or why, and I was merely suggesting to the committee that through your own experts, through the Treasury experts and others—perhaps some of my actuary friends here—you can get the details confirming this assertion. There will be some additional actuaries testifying, I understand.

Senator DOUGLAS. Are you saying that any reductions in the cost of obtaining insurance because of the mutual principle should be subject to taxation?

Mr. KESSLING. If I understand your question correctly, sir, I believe it goes into the same field that you were very sincerely interested in your questioning earlier in the hearings; namely, about the tax differential between cooperatives and private corporations in other fields. I believe there is a different situation that exists here as between stocks and mutuals. You raise a very, very pertinent question.

I believe, Mr. Chairman and Senator, that it would be most valuable—and this is for the benefit of both the mutuals and stocks, the need for continued competitive balance between mutuals and stocks has been recognized all throughout history—for a report to be prepared by competent people—I believe some have already been prepared and put in records in previous years showing why it is that stock companies must be maintained in existence. Mutual companies come from stock companies, that it about the only way they get started. You have to have capital interested; there has to be an incentive for capital to invest in a new stock company, because otherwise you have no capital. You don't start with a mutual company. I am sure you are well aware of all this, sir.

Senator DOUGLAS. I remember that Mr. Hughes had some share in the transition of some stock companies into mutual companies, some 54 years ago. Yes, I am aware of that.

Mr. KESSLING. Yes. I am sure that you are, sir, and that is what I was referring to. I believe that ever since those days of 1906 those familiar with the situation have recognized that it is essential to maintain the competitive balance and to have new stock companies come into existence. Actually my company, the West Coast Life, was started in 1906 and probably arose out of the protective features that were put in at that time.

In connection with this, the second feature that is of very great importance—and it has been recognized by the Congress and by the mutuals and by the stocks—so that it is essential to have stock companies not only originate and then evolve into mutual companies, but that some of them continue on, and that there be sufficient incentives for capital to stay in there so that they continue on and grow like some of the stock companies have, so that they are continually in competition with the mutual companies.

A third phase that occurs to me, a very important one and it is important to the mutual as well as to the stocks, and that is the stock companies are, if anything, the pure form of capitalistic endeavor, and they are out there as a buffer, if you will, a protective buffer, between any creeping type of trend toward nationalization, or further encroachment of the Federal Government in the field of life insurance, let us say——

Senator DOUGLAS. This is very interesting. Are you saying that the mutuals are a form of creeping socialism?

Mr. KEESLING. No, sir, I didn't say that.

Senator DOUGLAS. I thought you were leading up to that point. [Laughter.]

If you did, you should make a statement for the record that they are or they are not.

Mr. KEESLING. No, I would say definitely not.

Senator DOUGLAS. You regard them as American institutions?

Mr. KEESLING. Very definitely, sir.

Senator DOUGLAS. In keeping with American ideals?

Mr. KEESLING. Very definitely, sir.

Senator DOUGLAS. Very good.

Mr. KEESLING. I would be the very last one to suggest they were, because some day we might mutualize. [Laughter.]

In addition to the problem of competitive discrimination, I have discovered in the past day or so that I am not the only one who is still confused about the intricate workings of H.R. 4245. Frankly, my company and a number of others are uncertain as to just how the intricacies of this bill work out.

Even some of those industry technicians who have been available here in Washington to work with the committee experts admit they don't know all the answers. There appear to be questions and potential questions yet to be understood or raised. I read in Monday's paper that the committee had a briefing from the technical staff. I have the highest regard for Mr. Stam and his experts, and for the staff of your committee and the House committee, and for the intelligence and knowledge of you gentlemen, but I venture to say that perhaps even some of you, too, have some questions.

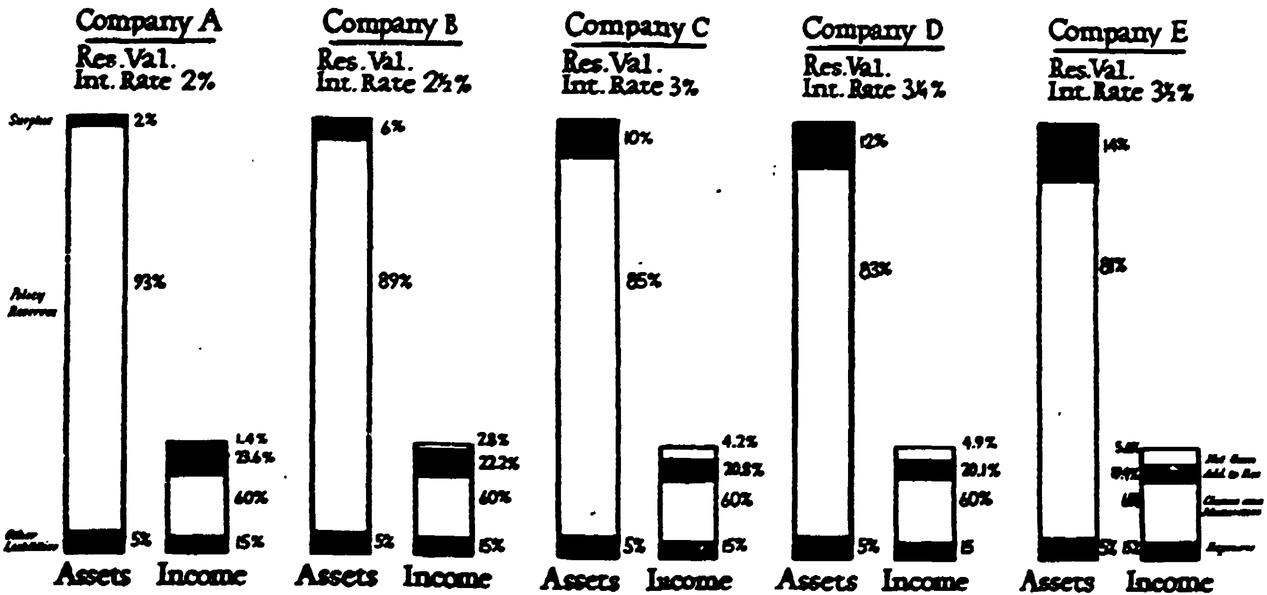
That the industry representatives still have questions is understandable inasmuch as the provisions of H.R. 4245 were not before them during the House hearings. As you know, although the Treasury witnesses in their House testimony and questioning brought out in general substance some of the principles which are now steps 1 and 2 of H.R. 4245, that was done after most witnesses had prepared their testimony, and no detailed bill came out until comparatively recently.

Among the questions which have already occurred to me are some in connection with charts and material I presented in detail to the House committee. In this connection, I respectfully request that these charts be inserted in the record at this point.

(The charts referred to follow:)

# Companies Insuring Identical People for Identical Amounts with identical Premiums & Expenses, Identical Assets and Identical Investment Income

## I Each Differing Only in Reserve Valuation Interest Rate

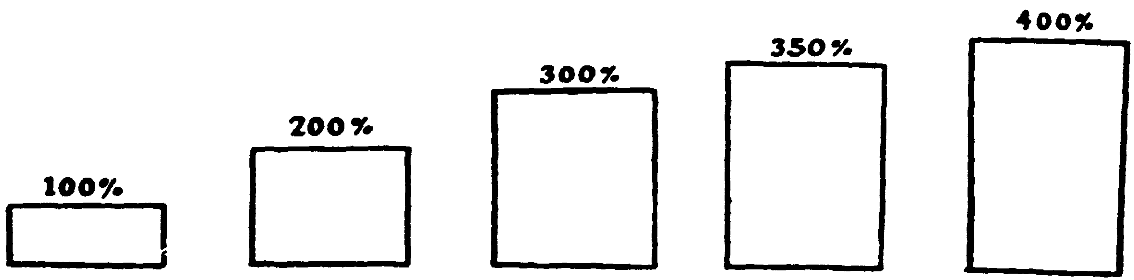


Companies Insuring Identical People for Identical Amounts with Identical Premiums & Expenses, Identical Assets and Identical Investment Income

I Each Differing Only in Reserve Valuation Interest Rate

| Company A | Company B | Company C | Company D | Company E |
|---|---|---|---|---|
| Res. Val. Int. Rate 2% | Res. Val. Int. Rate 2½% | Res. Val. Int. Rate 3% | Res. Val. Int. Rate 3¼% | Res. Val. Int. Rate 3½% |

I Net Gain from Operations Comparison
Company A - 100%

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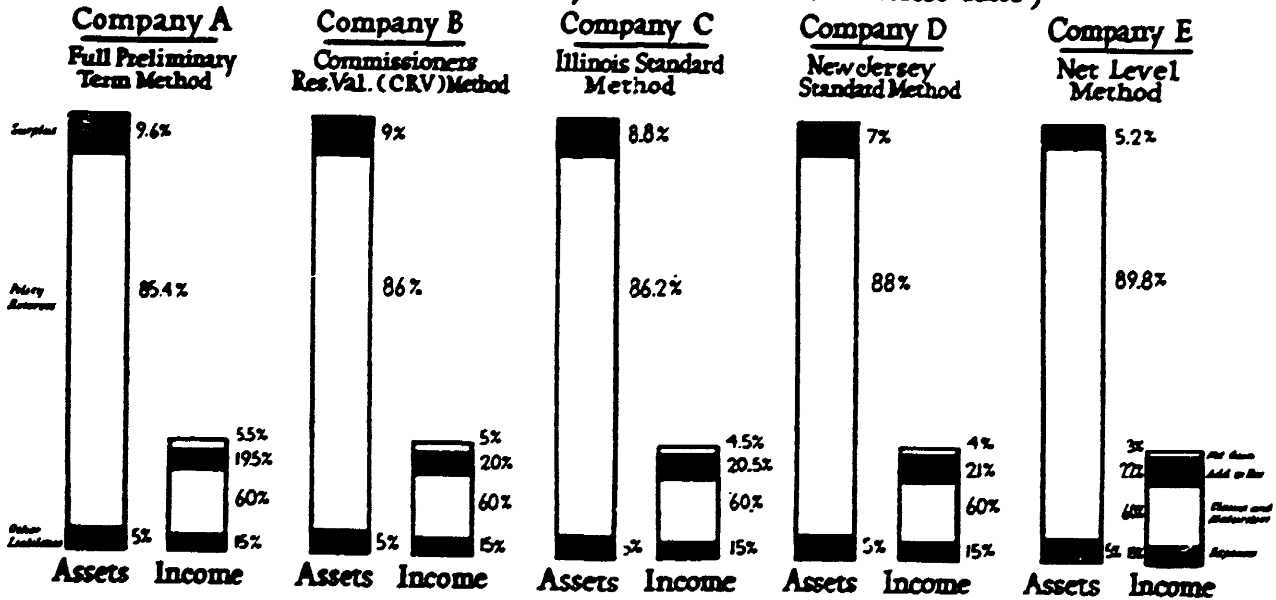
## Companies Insuring Identical People for Identical Amounts with Identical Premiums & Expenses, Identical Assets and Identical Investment Income

### II Each Differing Only in Reserve Valuation Method
(Same Valuation Mortality Table and Valuation Interest Rate)

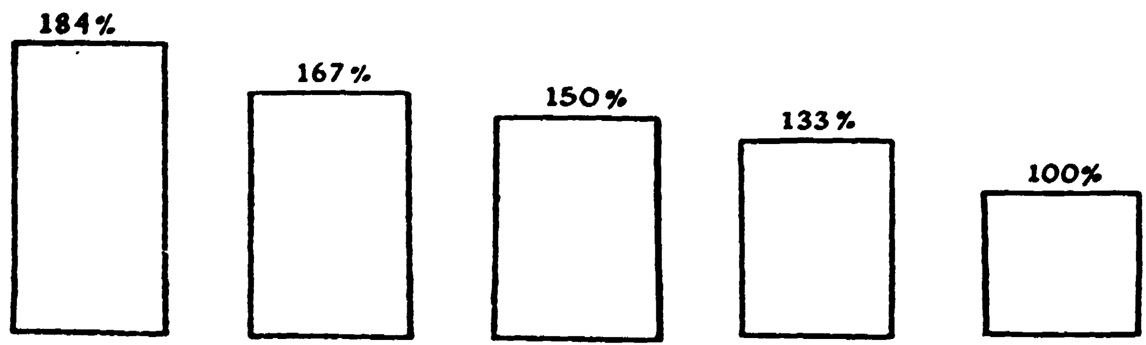


## Companies Insuring Identical People for Identical Amounts with Identical Premiums & Expenses, Identical Assets and Identical Investment Income

### II Each Differing Only in Reserve Valuation Method
(Same Valuation Mortality Table and Valuation Interest Rate)

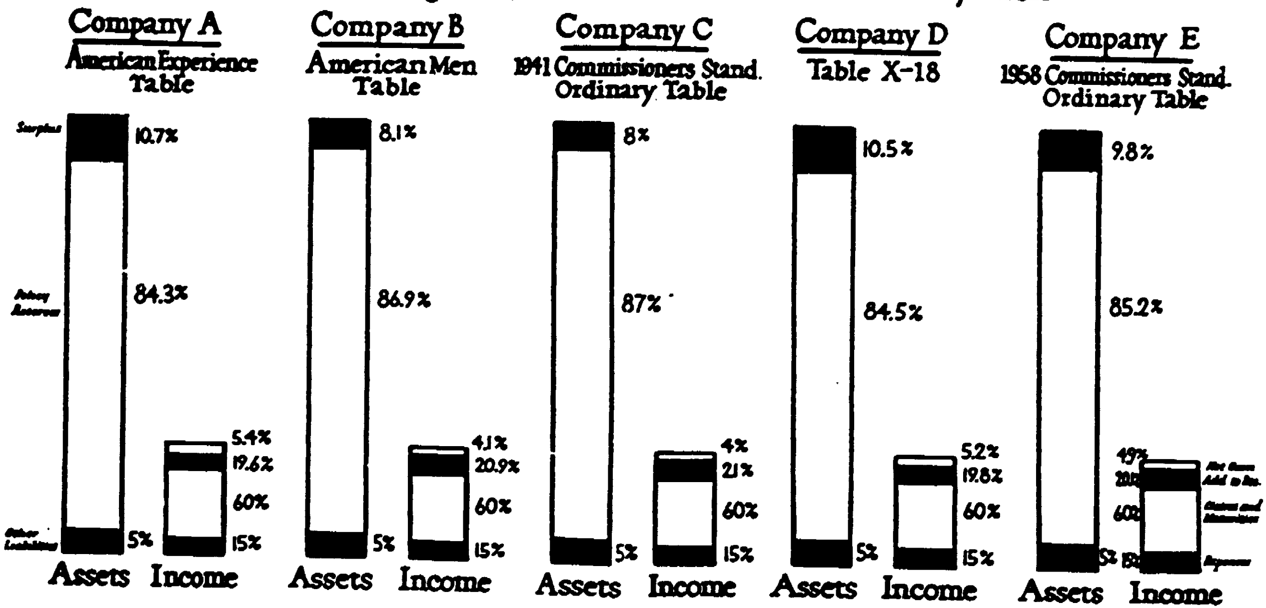
| Company A | Company B | Company C | Company D | Company E |
|---|---|---|---|---|
| Full Preliminary Term Method | Commissioners Res.Val. (CRV) Method | Illinois Standard Method | New Jersey Standard Method | Net Level Method |

### II Net Gain from Operations Comparison
Company E - 100%



# Companies Insuring Identical People for Identical Amounts with Identical Premiums & Expenses, Identical Assets and Identical Investment Income

## III Each Differing Only in Reserve Valuation Mortality Table

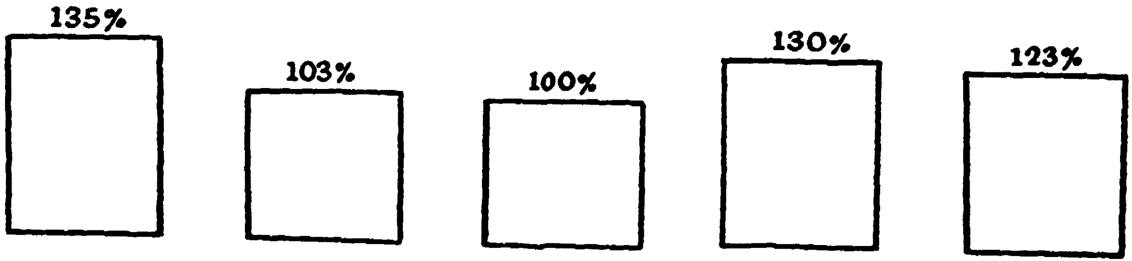


## Companies Insuring Identical People for Identical Amounts with Identical Premiums & Expenses, Identical Assets and Identical Investment Income

### III Each Differing Only in Reserve Valuation Mortality Table

| Company A | Company B | Company C | Company D | Company E |
|---|---|---|---|---|
| American Experience Table | American Men Table | 1941 Commissioners Stand. Ordinary Table | Table X-18 | 1958 Commissioners Stand. Ordinary Table |

### III Net Gain from Operations Comparison
### Company C - 100%



Mr. KEESLING. Although they are self-explanatory, I respectfully suggest you refer to the detailed explanation of them at pages 438, 448, and 449 of the House hearings. In brief, these charts show how and why five identical life companies can, as a result of a management decision, have different so-called net gain from operations and hence different taxes, unless appropriate equalizing adjustments are made. A company identical with another company, by a management decision uses a different rate of interest, or a different method of valuation, or a different mortality table in computing reserves, and ends up with a different so-called net gain from operations and hence a different tax unless an equalizing adjustment is made.

I understand that a partial adjustment is made in step 1 (subpart B) of H.R. 4245 with respect to the assumed rate-of-interest factor (see the two charts marked "I"); also that in step 2 (subpart C) adjustment is made respecting the method of valuation factors in charts marked "II". But I don't believe—at least I haven't yet found anything on it—that any adjustments are made for any of the mortality table factors set forth in the two charts marked "III."

Another troublesome point still causing me some question, also involves the use of "Net Gain from Operations" as a basis for the step 2 tax without appropriate adjustment. According to Mr. William Bruce of the California Department of Insurance, "Net Gain from Operations" as used on page four of the form required to be used by life companies in filing their annual statements was intended only for use by the department as a measure of solvency and not for use as a year-to-year measure of earned income for tax purposes. I respectfully request, Mr. Chairman, that there be inserted in the record at this point a letter from Mr. William Bruce, who is personally familiar with the drafting of that form.

(The letter referred to is as follows:)

DEPARTMENT OF INSURANCE,
STATE OF CALIFORNIA,
*San Francisco, Calif., November 25, 1958.*

Mr. F. V. KEESLING, Jr.,
*First Vice President and General Counsel, West Coast Life Insurance Co., San Francisco, Calif.*

DEAR MR. KEESLING: This is in response to your inquiry regarding the present summary of operations, page 4 of the Annual Statement for Life Insurance Companies.

When the blanks committee of the National Association of Insurance Commissioners worked on the development of this form during the period 1948–50 to become effective in 1951, it felt that items 28 and 33 should not be labeled "Net underwriting gain," "Net profit," or "Net income," as these were composite items, all of which did not in any sense represent profits.

Considerable discussion was given to the matter and in order to determine a more appropriate description of these two items and to preclude them from being misconstrued for tax purposes as "net profit" or "net income" or "net underwriting gain," it was decided to label them "Net gain from operations."

In this discussion and understanding there was uniform accord between the representatives of the State insurance departments and the representatives of the life insurance associations.

Very truly yours,

W. BRUCE,
*Chief Insurance Examiner.*

Mr. KEESLING. There is another thing that concerns me about step 2. The Treasury witnesses, in the course of their testimony before the House committee, mentioned as a possible solution, a general proposal containing something along the philosophy of steps 1 and 2 (subparts B and C) of H.R. 4245. In my testimony before the House Committee, which was substantially formulated before the Treasury witnesses appeared and brought out that suggestion, I backed the so-called two phase "Menge" proposal which in principle would be steps 1 and 3 (subparts B and D) of H.R. 4245. Therefore, my testimony before the House Committee in effect was to agree in principle with step 1 of the Treasury suggestion and to use what is now step 3 of H.R. 4245 in place of step 2 of the Treasury suggestion. Someone upset the applecart by tacking step three onto the Treasury proposal in addition to step two instead of in lieu of step two. In order to save time and avoid repetition I respectfully call your attention to the reasons which I gave to the House Committee which appear in pages 434–453 of the House hearings. There, I detailed all the many problems and deficiencies of the so-called total income method which would use so-called Net Gain from Operation as a basis for year-to-year taxation of life companies. Among other things, I pointed out the long-term nature of the life insurance business, and as examples of the continued long-term availability of the reserves, surplus and capital of stock companies for the protection of policyholders, I told the committee of several instances in the history of my company when the surplus was wiped out and the capital was depleted—once as a result of the 1918 epidemic: another time as a result of the depression of the 1930's: and another time when capital had to be turned back to surplus by reducing the par value of the capital stock.

Perhaps your committee and staff experts, Mr. Chairman, can go into all these matters, and answer them, and come up with proper solutions before whatever ultimate deadline you set. But what happens if you find you can't meet that deadline? Naturally, the industry representatives are very interested in what course of action would be taken in that event.

In the past day or so I've heard suggestions ranging all the way up and down the line from one extreme to the other as follows:

1. Don't enact H.R. 4245 in whole or in part until all the "bugs" are cleared up this year, and have the 1942 act apply until that is done.

2. Enact the bill as is, even if you know it may have some "bugs," but have it apply to 1959 income, with the 1942 act applying to 1958 income. Then during the year any "bugs" could be worked out.

3. Same as (1), except to give each company the option of using either H.R. 4245 or the 1942 act for 1958 income.

4. Enact step 1 of H.R. 4245, but hold up on steps 2 and 3 until the "bugs" are worked out.

The problem with the first suggestion is this: Unless modified, it would result in some individual company hardships.

The trouble with the second suggestion is that you would be going contrary to proper legislative process in enacting unperfected, and possibly questionable, legislation; also, the 1942 act if applied to 1958, would cause some hardships, unless amended.

The same difficulty would arise under the third suggestion, except that a company, by electing the option, might have some relief from hardship, but I question whether it would be good legislative practice.

The fourth suggestion would have three possible advantages—(a) it would shift from the individual hardships of the 1942 act to a much more equitable formula; (b) it would produce, according to the House Report, $505 million, which is $5 million more than the 1942 act would produce and $186 million more than the 1955 Mills "stopgap" act; and (c) it wouldn't result in enacting doubtful legislation without first having the "bugs" removed. This suggestion would be used only if the committee finds it impossible to remove all complications prior to the June 15 date it has set for filing returns on 1958 income.

(Supplemental remarks by Mr. Keesling.)

If I had been asked for my views on the situation, I would say that in my opinion it would be very difficult if not impossible to revise step 2 of H.R. 4245 so as to eliminate the competitive discriminations and the problems and questions which it creates, and the yet unknown problems and questions which can arise in the future. The sooner that is recognized and faced up to, the sooner we can all get back on the right track and jointly agree on a much simpler and much more just and feasible bill—one using an excise tax method for distributing the overall total amount of tax determined upon as constituting the proper taxable income of life companies. Steps 1 and 3 of H.R. 4245, with provision for offset for company operating losses and full allowance for tax exempt interest, would be an expedient and feasible method of accomplishing this. This would eliminate the so-called inequities of the 1942 law, would produce an adequate total tax and would provide a proper tax base on specialty companies.

Mr. KEESLING. Mr. Chairman, that concludes my statement and the matters I desire to submit for your consideration. I appreciate the opportunity of appearing before this committee and the attention and consideration you and your committee colleagues have granted me.

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

The next witness is Mr. Harold J. Cummings, president of the Minnesota Mutual Life Insurance Co.

## STATEMENT OF HAROLD J. CUMMINGS, PRESIDENT, MINNESOTA MUTUAL LIFE INSURANCE CO., ST. PAUL, MINN., ACCOMPANIED BY WALTER J. RUPERT, VICE PRESIDENT

Mr. CUMMINGS. Thank you very much, sir.

I. My name is Harold J. Cummings, president of the Minnesota Mutual Life Insurance Co. of St. Paul. Walter J. Rupert, vice president and chief actuary is here also. We wish to discuss just one aspect of H.R. 4245; namely, the method proposed in that bill for the treatment of the tax-free interest of the life insurance companies. So far as we know, the specific questions which we wish to raise were not discussed at any length in the hearings before the House Ways and Means Committee.

II. First, may we state candidly that this 80-year-old company is particularly interested because it has been a consistent buyer of tax-free securities for over 30 years. It has over one-fifth of its assets so invested, whereas the overall average of the industry is about 2.5 percent. We have over the years accepted the normally lower rate of return on municipal bonds in the firm belief that the interest was and would remain tax free, as indeed it has been up until now.

III. While we are especially interested for the reason stated, we come here with the full agreement of the joint tax committee of the Life Insurance Association of America and of the American Life Convention. The companies which are members of these two organizations do about 95 percent of the life insurance business in this country. We also have the blessings of the executive committee of the Life Insurers Conference, an organization composed of about 93 companies. Finally we submit a list of over 120 companies from all parts of the United States which have asked that we speak for them in this particular matter.

IV. We have prepared a memorandum, Mr. Chairman, which is this black book, which we hope states our case clearly and completely, and the entire statement is summarized for your convenience on the top sheet inside the front cover.

We submit it with several supplementary documents, and ask that it all be made a part of the record.

In the back of the black book, might I add, we have inserted remedial language that would affect our purpose, specimen forms prescribed by the Treasury for preparing our tax return and also a chart which we believe helps clear up one difficulty.

V. Now, to come to the meat of the matter, our memorandum raises three questions with reference to H.R. 4245 and its treatment of the tax-exempt interest of life insurance companies.

First. We believe that, in its treatment of tax-exempt interest, H.R. 4245 contravenes the decision of the Supreme Court in the case of *National Life* v. *United States*. We think that if it was unconstitutional to add back 100 percent of tax-free interest to the tax base under the 1921 law, then adding back only 70 percent of such interest is unconstitutional, too. But we believe that this body is quite competent to decide that question for itself. So we respectfully ask simply your attention to that part of our memorandum, pages 2, 5 and 6.

Second. We are convinced that H.R. 4245 discriminates unfairly between the life insurance companies on the one hand, and other investors in tax-exempt securities, commercial banks, stock casualty insurance companies, stock fire companies, regulated investment companies or mutual funds and the individual taxpayer, too. We believe our memo proves this quite conclusively and we hope you, too, may think so. And we register no complaint with respect to these other groups. We ask only that we receive like treatment. In this connection may we refer you to pages 18, 19 and 20 of our memorandum.

Third. We sincerely believe that, while not so intended, the treatment here given tax-exempt interest could be the beginning of the end of all tax-free securities. We will come back to that at the end of this statement.

VI. There are three common misconceptions which tend to becloud the issue:

1. One is that the treatment of tax-free interest in this bill follows the same pattern as did the 1942 law or the stopgap legislation since 1950.

2. The second is that the add back of 70 percent of tax-free income to the tax base prescribed by the bill is done to avoid a double deduction for tax-exempt interest.

3. And finally it is argued that, in the treatment of tax-exempt interest, the life insurance companies are at least better off under this bill than they were under either the 1942 or the 1950 stopgap legislation.

With respect to the first misconception we believe, and we think our memo proves that, while H.R. 4245 does indeed follow the pattern of the 1921 law which the Supreme Court declared unconstitutional, the 1942 and the 1950 stopgap legislation do not do so. We submit in evidence the forms prescribed by the Treasury for determining the amount of income tax payable by a life insurance company, which are in the back of the black book which we have turned in for the record. We think they show very simply that, in preparing the forms, the Treasury was thinking of tax-free interest as being truly tax free.

With respect to the double deduction misconception we believe our memorandum shows clearly that there is here, no question of a double deduction for the same income dollar. The question is rather, shall the deduction allowed all companies to maintain the statutory reserves which are essential to solvency, wash out about 70 percent of the deduction that one company owning some tax-exempt securities is clearly entitled to, as compared to the company that owns no such securities at all. It is not a question of a double deduction, but of one full deduction—not just 30 percent deduction—for tax-free interest.

We think our memo shows this clearly and we hope it helps to clear up what is admittedly a puzzling question.

In this connection we invite your attention to pages 12 to 16 in our memorandum and especially to page 16, and the chart that is inserted there.

With respect to the third misconception that the life companies would now, in this one respect, fare better than before, we repeat that under either the 1942 law or the 1950 legislation, tax-free interest was treated as fully tax free on the forms prescribed by the Treasury for determining a life company's income tax. How the companies could now be faring better when overall taxes are being raised about 70 percent we cannot see.

VII. At this point one might very properly ask: If H.R. 4245 were changed to allow the life insurance companies full exclusion for tax-free interest, how much less revenue would the Treasury receive?

And one answer might be, that the $563 million which the bill would otherwise impose on the 1958 income of the life companies might then, theoretically, be reduced by about $32.5 million, or 6 percent.

In fact, however, we believe instead that the revenue to the Treasury might in that event be increased. We believe that allowing the life companies to take the same deduction as is accorded all other investors, should really cost the Government nothing. After all, and as yet, tax-free interest is tax free in the hands of any investor. It is all a question of what tax rate applies to each individual owner of these securities.

For this reason the Treasury should then profit to the extent that life insurance company activity in this market might make tax-free bonds less available to buyers in the higher tax brackets. Would they not then invest in taxable securities, and so pay income taxes at rates higher than 52 percent? Does it not seem clear that, to the extent that any loss to the Treasury is claimed, to that same extent the Government must be taxing on tax exempt interest?

We do not believe and do not contend that it was the intention of the Ways and Means Committee nor of the Treasury to impose a 52 percent tax on about 70 percent of the interest of the life companies from tax-exempt securities. We do not claim that at all. In fact, it has been stated that the bill does not do so. We think our memorandum shows clearly, that as between two companies, one with and one without tax-free interest, the bill does exactly that. We have tried to illustrate this fully on pages 12 to 16, and on pages 21 and 22 of our memorandum.

VIII. In a word we believe:

1. That the Supreme Court decision in the case herein cited has never been repealed or qualified.

2. That H.R. 4245 contravenes that decision just as the 1921 law did.

3. That this is not true of the 1941 or the 1950 legislation.

4. That we are faced here, not with the question of a double deduction, but of one full deduction for tax-free interest for over 100 million small savers.

5. That instead of being better off than they were under the former legislation, the life companies are being deprived of about 70 percent of their exclusion for tax-free interest at the same time that their taxes are being very substantially increased.

6. That full exclusion is quite properly already granted to all other investors in tax-free securities, and that this is unfairly discriminatory.

7. That treating life insurance companies the same way should really cost the Treasury nothing—tax-free interest is already tax free—and that the revenue to the Treasury might instead as a result be increased.

8. That it may be fair to remember that in addition to the more than $500 million in taxes involved here, the States already impose another $300 million in taxes.

9. That the proposed law could easily be amended to avoid this injustice to the 100 million small savers who own most of the life insurance policies.

10. That, if Congress can today deprive them of 70 percent of a constitutional right, a future Congress can strip them, and all other investors in tax-free securities, first of 80 percent, then of 90 percent, and finally of 100 percent of all tax-free interest.

IX. It is this aspect of the bill that seems most serious and far reaching. This can, we sincerely believe, mean the beginning of the end of the attractiveness of tax-free securities to all taxpaying investors. That, in turn, could mean increasing difficulties to the States, counties, and municipalities—with higher costs—in their efforts to raise the social capital so sorely needed to maintain a healthy economy.

To the extent that these governmental units are so hampered in their financing, may not the Federal Government itself have to pick up the tab?

X. We sincerely appreciate the opportunity of laying our problem before you. It is a most important question for us because of the relatively high proportion of holdings we have in such securities. It is important for many smaller companies spread all over the country. We have here over 120 names of companies that have asked us to speak for them, who have been supporters of the tax-free bond market. We all ask respectfully only for the same treatment that is properly accorded all other buyers of tax-free securities.

Thank you, sir.

The CHAIRMAN. I want to thank you for a very interesting statement, Mr. Cummings. I am sorry more members of the committee are not present.

At the top of page 4 you state that the loss of revenue in this bill by the amendments which you suggest would be $32.5 million. Is that a Treasury estimate?

Mr. CUMMINGS. It is not, sir; but we have checked the figure with several sources and we think it is, theoretically, fairly accurate. But, we doubt, that there would be any loss of revenue at all.

The CHAIRMAN. I would like to ask the staff to get a statement on that from the Treasury.

(The Treasury estimate of the decrease in the revenue is $35 million to $40 million.)

The CHAIRMAN. You mentioned certain memorandums. I don't seem to have a copy of it.

Mr. CUMMINGS. Don't you have this, sir?

The CHAIRMAN. Is that too voluminous to put into the record?

Mr. CUMMINGS. I hope not, sir.

The CHAIRMAN. I have it here. It is your idea this should be inserted in the record?

Mr. CUMMINGS. Yes, sir. We didn't want to impose it all on you here. What I have said here is a mere summary. Our points are all brought out in that black book.

The CHAIRMAN. I think it is worthy of insertion. It is a very important question involved in this bill, and I will ask the reporter to insert it in the record.

(The document referred to as the black book is as follows:)

## H.R. 4245—IS IT UNCONSTITUTIONAL? IS IT DISCRIMINATORY? IS IT THE END OF TAX-EXEMPT SECURITIES?

This memorandum is intended to show that in its treatment of the tax-exempt income of the life insurance companies H.R. 4245—

I. Is unconstitutional, contravenes the decision of the Supreme Court in the case of *National Life v. United States* (277 U.S. 508);

II. It discriminates unfairly between the life insurance companies on the one hand and other tax paying groups;

III. And if Congress can now strip this one group of taxpayers of 70 percent of their exemption for tax-free income a later Congress can deprive them and all other investors in tax-free securities, first of 80 percent, then of 90 percent, and finally of 100 percent of their rights, with far-reaching results that could, in turn be the beginning of the end of tax-free municipals and make it increasingly difficult for governmental units to raise the social capital so essential to the maintenance of a healthy economy.

The claim that a double deduction would be involved, if the life insurance companies were allowed full exclusion of tax-exempt income in determining their income tax, is fallacious.

Finally, it may be well to remember that—

Tax-free income is as yet tax free in the hands of any owner of tax-exempt securities;

The U.S. Government does not lose anything because of life insurance company ownership of tax-free bonds, and if the life insurance companies were allowed to take the full exclusion for tax-exempt income as they have been heretofore—the same as all other investors—the revenue to the U.S. Treasury might even be increased.

### TAX-EXEMPT INCOME OF THE LIFE INSURANCE COMPANIES AND H.R. 4245

As already indicated, this memorandum deals solely with the proposed treatment of the tax-exempt income of life insurance companies under H.R. 4245, a bill relating to the taxation of the income of life insurance companies.

What follows is intended to prove that:

I. H.R. 4245 would unconstitutionally tax at the 52-percent corporate rate about 70 percent of the income from tax-exempt securities owned by life insurance companies, and in so doing—

II. H.R. 4245 would discriminate unfairly between the life insurance companies on the one hand and—

(1) stock casualty insurance companies;
(2) regulated investment companies and;
(3) individual taxpayers, and that—

III. If Congress can now deprive the life insurance companies of 70 percent of their constitutional right, a later Congress can strip them—and all other investors—first of 80 percent, then of 90 percent, and finally of 100 percent of such rights, which in turn could mean the end of the attractiveness of municipals to all taxpaying investors.

Each of these three statements is borne out fully in the fact-supported illustrations that follow.

## I. H.R. 4245 WOULD UNCONSTITUTIONALLY TAX THE INCOME FROM TAX-EXEMPT SECURITIES OWNED BY LIFE INSURANCE COMPANIES

In delivering the opinion of the Supreme Court of the United States in *National Life Insurance Company* v. *United States* (277 U.S. 508), Mr. Justice McReynolds stated, in part:

"One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted" (p. 519).

"What remains after subtracting all allowances is the thing really taxed" (p. 520).

And quoting from the decision in *Packard Motor Car Company* v. *City of Detroit* (1925, 232 Michigan 245), Justice McReynolds added:

"Held: that tax-exempt credits may not be taxed, directly or indirectly, and in levying a tax on property they must be treated as nonexistent."

The decision of the Supreme Court in this case has never been repealed or qualified. It is today the law of the land.

H.R. 4245 plainly proposes to contravene this decision of the Supreme Court, since—

(1) in section 805(e), step 1, it proposes to add to the amount of taxable investment income approximately 70 percent [1] of the income from tax-free securities; and

(2) in section 809(f), step 2, it proposes to add approximately the same percentage of tax-free income to the taxable net gain from operations.

Three claims are commonly made which tend to becloud the issue:

1. Two previous laws for taxing the income of life insurance companies, the 1942 law and the 1950 "stopgap" law, were subject to the same charge of unconstitutionality.

2. The "add back" of about 70 percent of tax-free income under both steps 1 and 2 in H.R. 4245, is necessary to avoid a double deduction for tax-free income.

3. Anyway, with respect to tax-exempt income, would not the life insurance companies be better off under H.R. 4245 than they were under the 1950 "stopgap" legislation?

What follows is intended to prove that H.R. 4245 follows the same pattern, is subject to the same charge of unconstitutionality as the 1921 law upon which the Supreme Court has ruled; whereas the 1942 and the 1950 "stopgap" laws were not.

That the second claim is fallacious and, while the life insurance companies would, under H.R. 4245, receive an exemption of approximately 30 percent of their constitutional exclusion from income tax on their interest from municipals, they would nevertheless be stripped of the other 70 percent, approximately, at the same time that the amount of their income taxes would be substantially increased.

[1] More or less, depending upon the relationship between taxpayers investment yield and the portion of such yield required to maintain reserves.

*1. Which law unconstitutional—the 1921 law? the 1942 law? the 1950 stopgap law? H.R. 4245?*

Three elements of the Supreme Court doctrine are pointed up on a preceding page in this memorandum. Each can be phrased as a question against which each of the above income tax laws can be tested:

1. Is the gross taxable income "subjected to a greater burden"—is more tax paid—if there is tax-free income?
2. Does any tax-exempt income remain in the net taxable income after all "allowances"—or deductions—are subtracted?
3. Does the taxable income that results, differ from what it would have been, had tax-exemp[illegible]come been "treated as nonexistent"?

Following the Supreme Court decision above cited—which is today the law of the land—if the answer to any one of these three questions, with respect to any one of the above laws, is "Yes," then that law is unconstitutional.

So let us assume two companies—

Company A has $1 million of investment income after deduction of investment expense, depreciation, etc. It has $50,000 of tax-free income.

Company B has only $950,000 of investment income, all from taxable securities.

Assume the two companies are identical, taxwise, in all other respects.

How would these two companies fare, taxwise, under each of the four bills?

*The 1921 law.*—The 1921 law prescribed that the tax would be figured this way:

| | Company A | Company B |
|---|---|---|
| Investment income | $1,000,000 | $950,000 |
| Less tax-exempt income | [1] 50,000 | .......... |
| Gross taxable income | 950,000 | 950,000 |
| To determine the tax base, take 4 percent of reserves [2] | 900,000 | 900,000 |
| From that figure deduct tax-free income of | 50,000 | .......... |
| Leaving net deductions of | 850,000 | 900,000 |
| Then, from gross taxable income of | 950,000 | 950,000 |
| Deduct net deductions of | 850,000 | 900,000 |
| Leaving net taxable income of | 100,000 | 50,000 |

[1] Quoting from Justice McReynold's statement (p. 2): "Tax-exempt credits * * * must be treated as nonexistent."

[2] Reserves assumed to be $22,500,000, of which 4 percent was deductible.

Plainly under the 1921 law the answer to all three questions is "Yes."

1. Company A, having the same gross taxable income as company B, is subject to double the tax because it "owns some (income) that is free."
2. In company A all of the $50,000 of tax-exempt income remains in the net taxable income, since, in all other respects, its figures are identical with company B.
3. The taxable income that results is emphatically different than that which would have resulted if tax-exempt income had been "treated as nonexistent."

This appears clearly to have been the reasoning of the Supreme Court in declaring unconstitutional that portion of the 1921 law relative to adjustment of deductions by the amount of tax-exempt income.

*The 1942 law.*—Under the 1942 law the income tax payable by the same two companies would have been determined like this:

| | Company A | Company B |
|---|---|---|
| Investment income | $1,000,000 | $950,000 |
| Deduct tax-exempt income | [1] 50,000 | .......... |
| Gross taxable income | 950,000 | 950,000 |
| Net taxable income | 950,000 | 950,000 |

[1] Quoting from Justice McReynold's statement (p. 2): "Tax-exempt credits * * * must be treated as nonexistent."

NOTE.—After adjustment by a flat percentage, the complement of the Secretary's ratio, corporate rates are applied.

Here the answer to all three questions is "No."

1. The gross taxable income is not "Subjected to a greater burden" if there is tax-exempt income.

2. No part of the tax-exempt income remains in the net taxable income after all "allowances."

3. The resulting taxable income is not different from that which would have resulted if tax-exempt income had been "treated as nonexistent."

Therefore the above-quoted Supreme Court decision provides no basis for attacking the constitutionality of the 1942 law.

*The 1950 stopgap law.*—Under the 1950 or "stopgap" legislation these two companies would have figured their tax this way:

| | Company A | Company B |
|---|---|---|
| Investment income | $1,000,000 | $950,000 |
| Tax-exempt income | [1] 50,000 | ............ |
| Gross taxable income | 950,000 | 950,000 |
| Net taxable income to which a 6.5 percent [2] tax rate was applied | 950,000 | 950,000 |

[1] Quoting from Justice McReynold's statement (p. 2): "Tax-exempt credits * * * must be treated as nonexistent."

[2] In the 1950 stopgap law this rate was specified in the law. In later versions it was obtained by subtracting a percentage of the net taxable income and applying corporate rates to the balance.

Here the answer to all three questions is "No."

1. Company A is not under any "greater burden because it owns some income that is free."

2. No part of company A's tax-exempt income remains in its net taxable income.

3. The resulting taxable income does not differ from what it would have been, had tax-free income been "treated as nonexistent."

There would seem to be no reason for attacking the constitutionality of the 1950 stopgap law on the basis of the Supreme Court decision quoted on page 3 of this memorandum.

Except for minor differences not related to the question at hand, the methods of determining net taxable income under the 1942 law and under the stopgap law were identical. It might be argued that the stopgap formula could have been couched in language that would have made it unconstitutional. Such an argument would seem academic—the actual form of the law was not in contravention of the doctrine expressed by the Supreme Court.

*H.R. 4245.*—Under the proposed permanent legislation, H.R. 4245, the two companies would determine their net taxable investment income, step 1, in this way:

| | Company A | Company B |
|---|---|---|
| Investment income | $1,000,000 | $950,000 |
| Tax-exempt income | [1] 50,000 | ............ |
| Gross taxable income | 950,000 | 950,000 |
| Deduction for investment yield on adjusted life insurance reserves | 700,000 | 700,000 |
| Less reduction to avoid "double deduction" | 35,000 | ............ |
| Net deduction | 665,000 | 700,000 |
| Gross taxable income | 950,000 | 950,000 |
| Net deduction | 665,000 | 700,000 |
| Net taxable investment income | 285,000 | 250,000 |

[1] Quoting from Justice McReynold's statement (p. 2): "Tax-exempt credits * * * must be treated as nonexistent."

As in the case of the 1921 law the answer to all three questions is again "Yes."

1. Company A, having the same gross taxable income as company B, is "subjected to greater burdens * * * because it owns some (income) that is tax free." Could the fact that net taxable income is now higher by only 70 percent of its tax exempt interest, instead of 100 percent higher under the 1921 law, suddenly make H.R. 4245 constitutional?

2. In company A, $35,000 of its tax-exempt income remains in its taxable income, since in all other respects its figures are identical with company B.

3. The taxable income that results is obviously different from that which would have resulted if tax-exempt income had been "treated as nonexistent."

But what about the treatment of the two companies under subparts A and C, step 2, of H.R. 4245? The figures look like this:

| | Company A | Company B |
|---|---|---|
| Net gain from operations after dividends to policyowners | [1] $2,050,000 | [1] $2,000,000 |
| Deduct tax-exempt income | [2] 50,000 | |
| Remainder | [1] 2,000,000 | [1] 2,000,000 |
| Add-back to prevent double deduction | 35,000 | |
| Taxable net gain from operations | 2,035,000 | 2,000,000 |
| Deduct net taxable investment income | 285,000 | 250,000 |
| Excess | 1,750,000 | 1,750,000 |
| Take half of excess | 875,000 | 875,000 |
| Add taxable investment income | 285,000 | 250,000 |
| Net taxable income | 1,160,000 | 1,125,000 |

[1] A part of the assumption that the companies are in all other respects, taxwise, identical: the $2,000,000 figure could be set at any other reasonable level without destroying the validity of the illustration.

[2] Quoting from Justice McReynolds' statement (p. 2): "Tax exempt credits * * * must be treated as nonexistent."

Again the answer to all three questions is "Yes."

1. Company A, having the same net gain from operations—after deducting tax-exempt income—as company B is "subject to a greater burden because it has tax-free income.

2. In company A $35,000 of its tax-exempt income remains in net taxable income after all "allowances" are deducted.

3. The resulting taxable income is different than it would have been if tax-free income had been "treated as nonexistent."

We can now get a composite picture of the constitutionality of each of the four Federal income tax laws, with specific reference to their treatment of income from tax-exempt securities—by which life insurance companies have been, or from 1958 on, may be governed:

| | 1921 law | 1942 law | 1950 law | H.R. 4245 |
|---|---|---|---|---|
| 1. Is tax burden heavier when there is tax-free income? | Yes | No | No | Yes. |
| 2. Does any tax-exempt income remain after all allowances? | Yes | No | No | Yes. |
| 3. Is the resulting tax different than if tax-free income were treated as nonexistent? | Yes | No | No | Yes. |

Following the decision of the Supreme Court of the United States which is quoted on page 3 of this memorandum, which decision has neither been repealed nor qualified and which is today the law of the land, we can now clearly answer the question: Is the law unconstitutional with reference to its treatment of income from tax-free securities?

1921 law ........ Yes
1942 law ........ No
1950 law ........ No
H.R. 4245 ........ Yes

**2. *Double deduction or no deduction?***

*Legal reserves.*—A legal reserve life insurance company is required by law to set up and maintain a liability called reserves which is clearly defined in the statutes and which is essential to solvency. These reserves are in turn reflected in policy contracts as cash values and other equities. A substantial part of all interest received each year is in this way guaranteed in advance to policyowners. So, much of all interest received must be added to their reserves year by year.

All income tax laws mentioned earlier in this memorandum have recognized that the portion of interest income needed to maintain these legal reserves must be deducted from investment income, only the free remainder being subjected to income tax.

This deduction to maintain the reserves essential to solvency is granted each company whether it owns tax-exempt income or not.

*Tax-exempt income.*—The law of the land provides that the Federal Government may not tax income from State and municipal bonds. Leaving them tax-free serves to attract investors to such securities, and so to help these governmental units raise the social capital essential to a healthy economy.

The purposes and the propriety of each of these deductions are clear. Each is intended to achieve a definite end. Neither should be confused with, and, certainly one should not be washed out by, the other.

Assume now two companies, one owning no tax-exempt securities, the other owning tax-exempt bonds, equal to the average of the industry. Each is of course allowed the stipulated deduction from investment income needed to set up the statutory legal reserves.

But under H.R. 4245 the second company would receive only about 30 percent exclusion of its tax-exempt income to compensate it for having, over the long term, invested in tax-exempt securities despite their normally lower yields. The following illustration may help to clarify the matter:

Assume two companies with the same gross investment income, $10½ million. Assume the same net gain after dividends, $4.3 million. Assume indeed that the two companies are identical in all respects except that one receives tax-exempt interest in an amount about average for the life insurance business, 2½ percent, in this instance, $262,500.

The other company owns no tax-exempt securities.

Here is how each of the companies would fare under H.R. 4245 as the bill is now drawn, and also in column 3, how the company with average tax-free income would be treated if allowed full exclusion for tax-exempt income:

| | 1st company with tax exempt income | 2d company with no tax exempt income | 1st company if allowed 100-percent exclusion |
|---|---|---|---|
| **H.R. 4245, STEP 1** | | | |
| Gross investment income | $10,500,000 | $10,500,000 | $10,500,000 |
| Deduct investment expense | 1,500,000 | 1,500,000 | 1,500,000 |
| | 9,000,000 | 9,000,000 | 9,000,000 |
| Deduct tax-exempt income | 262,500 | ............ | 262,500 |
| Net investment income | 8,737,500 | 9,000,000 | 8,737,500 |
| Deduction to maintain legal reserves | 5,800,000 | 5,800,000 | 5,800,000 |
| | 2,937,500 | 3,200,000 | 2,937,500 |
| Deduct interest paid out | 800,000 | 800,000 | 800,000 |
| | 2,137,500 | 2,400,000 | 2,137,500 |
| To avoid "double deduction," add back 70 percent of tax-exempt income | 183,750 | ............ | ............ |
| Taxable net investment income | 2,321,250 | 2,400,000 | 2,137,500 |
| **H.R. 4245, STEP 2** | | | |
| Net gain after dividends | 4,300,000 | 4,300,000 | 4,300,000 |
| Deduction to equalize reserve [1] | 1,600,000 | 1,600,000 | 1,600,000 |
| | 2,700,000 | 2,700,000 | 2,700,000 |
| Deduct tax-exempt income, same figure as in step 1 | 262,500 | ............ | 262,500 |
| | 2,437,500 | 2,700,000 | 2,437,500 |
| To avoid "double deduction," add back 70 percent of tax-exempt income | 183,750 | ............ | ............ |
| Taxable net gain from operations | 2,621,250 | 2,700,000 | 2,437,500 |
| **TAX CALCULATION** | | | |
| Taxable net investment income (see above) | 2,321,250 | 2,400,000 | 2,137,500 |
| Add 50 percent of excess of taxable net gain from operations over taxable net investment income | 150,000 | 150,000 | 150,000 |
| Tax base | 2,471,250 | 2,550,000 | 2,287,500 |
| Tax at 52 percent less $5,500 | 1,279,550 | 1,320,500 | 1,184,000 |
| Difference in income tax | 1,184,000 | ............ | ............ |
| If given full exclusion | 95,550 | ............ | ............ |

[1] For nonparticipating, group, and preliminary term business.

**SUMMARY**

Since each company receives identical deductions, except only for exclusion of tax-free interest, the question is plainly not one of double deduction for tax-exempt income; the question is rather, Shall each company be allowed the same deduction for maintenance of the statutory reserves which each must set up to remain solvent, and shall then the company owning some tax-exempt securities receive only 30 percent exclusion for its tax-free income and be required to pay an added tax at the 52 percent corporate rate on 70 percent of that income?

In this illustration: Shall the company owning some tax-exempt securities, the average for the industry, be stripped of $95,550—$1,279,550 less $1,184,000—to which an unrepealed decision of the Supreme Court says it is entitled?

Under H.R. 4245 each dollar allowed each and every company to maintain the legal reserves needed for solvency, simply washes out, for the company owning tax-exempt securities, about 70 percent of its proper exclusion for tax-free income.

Given the same gross taxable income—investment income less tax-free interest—the company owning some tax-exempt securities can actually end up with a greater net taxable income than a company owning no tax-exempt securities at all. (See p. 9 and 10.)

From another angle, if any doubt still remains as to the propriety of allowing the 100 million small savers who own most of the life insurance policies to take and keep one full deduction for their tax-exempt income, the figures in the first column on page 12 could easily be rearranged as follows:

| | |
|---|---|
| Gross investment income | $10,500,000 |
| Less investment expense | 1,500,000 |
| Net investment income | 9,000,000 |
| Deduct interest to maintain reserves and interest paid out ($5,800,000 plus $800,000) | 6,600,000 |
| Leaving interest on capital and surplus of | 2,400,000 |
| Deduct interest on tax-exempt securities | 262,500 |
| Taxable net investment income | 2,137,500 |

And if H.R. 4245 were redrawn as these figures suggest, the resulting net taxable income would be the same as is illustrated in column 3 of the table above for the company given full exemption for its tax-exempt income; which is to say that full exemption would then be given for tax-exempt interest and the life insurance companies would then be treated the same as other investors, and the admittedly confusing question of "double deductions" would be so avoided.

Surely it cannot reasonably be denied that the life insurance companies are entitled to the same full exemption extended to all others, to the extent that full exemption does not exceed the interest arising from capital and surplus.

*3. Better off? Who? How?*

With respect to income from tax-exempt securities, it is said that the life insurance companies would at least fare better under H.R. 4245 than they did under the 1950 stopgap legislation.

First, it cannot be stated too clearly, that under the 1950 stopgap legislation, tax-free income in the hands of life insurance companies is already tax free.

And, it seems specious but entirely fallacious to reason that life insurance companies are "better off" under H.R. 4245 when under that law the life companies would be stripped of approximately 70 percent of their constitutional exemption from tax on their return from municipals, at the same time that the amount of their income taxes was substantially increased.

Even more insidious are the future implications in the H.R. 4245 legislation. If Congress can now deprive the life insurance companies of 70 percent of a constitutional right, and if that attempt goes unchallenged either in Congress or in the courts, what indeed is left to prevent a future Congress from stripping them, and all other investors as well, first of 80 percent, then of 90 percent, and finally of 100 percent of such rights?

This aspect of the proposed legislation we consider most serious and far reaching. This indeed is the basis of our statement that if the proposed legislation goes unchanged and unchallenged it could mean the end of the attractiveness of municipals to all taxpaying investors. This in turn portends increasing difficulty for States and municipalities, and higher interest costs, when they try to raise the "social capital" which they sorely need. It has been estimated that the present backlog of needs for "social capital" is in excess of $50 billion.

To the extent that these governmental units are so hampered in their financing, may not the Federal Government itself have to pick up the tab?

II. H.R. 4245 would discriminate unfairly between life insurance companies and—

1. Stock casualty companies.
2. Regulated investment companies.
3. The individual taxpayer.

The preceding pages, and those which follow, surely show that the so-called adjustments to prevent double deduction in subsections 808(e) and 809(f) of H.R. 4245 are misleading misnomers.

What follows is intended to show that the same subsections would discriminate most unfairly against life insurance companies, when the proposed law is compared with the laws relating to tax-exempt income in the hands of other taxpaying groups, regulated investment companies, etc. In this respect, life insurance companies are already at a great disadvantage because of the relatively heavy burden of combined Federal and State taxes already imposed upon them.

*1. Stock casualty companies*

Stock casualty insurance companies are allowed 12 different kinds of deductions, among which are: interest paid; tax-exempt interest; policyholders' dividends, without limitation, partially exempt interest, 85 percent of dividends received, and other trade and business expenditures not specifically allowed elsewhere.

And the law further specifically provides—section 832(c)—that "nothing in this section shall permit the same item to be deducted more than once." Yet, despite this specific provision against multiple deductions, taxpayers under this section are freely permitted to deduct their interest paid.

With no adjustment or reduction for the fact that such obligations may have been met, partly or wholly from tax-free interest, for which 100 percent deduction has already been allowed.

The emphasis here is intended not to suggest that this is improper, but to show the sharp discriminatory contrast with the cited provisions of H.R. 4245, which would deny the same privilege to life insurance companies, and to suggest that, if as much as 70 percent of their exemption for tax-free interest can be arbitrarily taken from the life companies, then the stock casualty companies, and indeed all other investors in municipal securities, may unknowingly be standing next in line.

*2. Regulated investment companies*

Some of the very keenest competitors for the public's investment dollar are the organizations defined in section 851 as "regulated investment companies," commonly called mutual funds.

Section 852(b)(2)D provides that such companies may deduct the full amount of the dividends paid the shareholders, without any deductions for the fact that some or all of the income from which such dividends are paid may have come from tax-free interest, for which 100 percent deduction has already been allowed.

Again, the emphasis is intended not to suggest that this is improper, but to suggest that the sharply contrasting treatment of life insurance companies under the cited sections of H.R. 4245 adds up to an obviously unfair, crippling blow, a truly discriminating burden on over 100 million small savers whose life savings are largely in the life insurance policies they own; and to suggest again that if as much as 52 percent of 70 percent of their tax-free interest can be so arbitrarily taken away from the life insurance companies, then regulated investment companies—and indeed all other investors in municipal securities—may also be standing next in line.

Incidentally there are other unfair aspects of the relative treatment of life insurance companies and other groups of taxpayers relative to treatment of capital gains, etc., which are left out of the discussion in order to stress the manifestly unjust treatment of tax-free income when it happens to be in the hands of a life insurance company, compared to the advantages afforded all other investors.

*3. The individual taxpayer*

The individual taxpayer's net taxable income is determined as follows:

| | | |
|---|---|---|
| Gross income | | $15,000 |
| Deduct tax-exempt interest | | 5,000 |
| Gross taxable income | | 10,000 |
| Deduct: | | |
| Dependents exemption | $4,200 | |
| Charitable contributions | 1,000 | |
| Interest on mortgage loan[1] | 800 | |
| | | 6,000 |
| Net taxable income | | 4,000 |

[1] Not allowable, however, if the loan is made to purchase tax-exempt securities.

But if the philosophy behind the cited section of H.R. 4245 were applied to the individual taxpayer, it would be figured this way:

| | | |
|---|---|---|
| Gross income | | $15,000 |
| Deduct tax-exempt interest | | 5,000 |
| Gross taxable income | | 10,000 |
| Deduct: | | |
| Dependents exemption | $4,200 | |
| Charitable contributions | 1,000 | |
| Interest on mortgage loan | 800 | |
| Total | 6,000 | |
| To avoid "double deduction," add back | 2,000 | |
| | | 4,000 |
| Net taxable income | | 6,000 |

Of course, the add back to prevent double deduction would follow the pattern of H.R. 4245 and be determined in this way:

Divide gross income of $15,000 into total deductions of $6,000 to determine that total deductions were 40 percent of gross income, then to avoid double deduction—

| | |
|---|---|
| From total deductions of | $6,000 |
| Deduct 40 percent of tax-free interest | 2,000 |
| Reducing net deduction to | 4,000 |

Such a procedure seems repugnant and unthinkable. Yet it is the precise method prescribed by H.R. 4245 for stripping the life insurance companies of about 70 percent of their constitutional right to full exclusion of tax-free interest from their tax base.

*Four questions.*—At this point one might ask: If the life insurance companies were given full income tax exclusion on tax-free income—

A. How much less revenue would the U.S. Treasury receive under H.R. 4245?

B. What would be the overall effect on the total tax bill of the life insurance companies?

C. Could the life insurance companies then concentrate on municipal bond investments, and so eliminate much, if not all, income tax liability?

D. How could H.R. 4245 be amended to give the life insurance companies the full exclusion on tax-free income to which they are constitutionally entitled?

A. The answer to the first question is that the revenue to the Treasury, because of life insurance company ownership of these bonds, might rather be increased.

Tax-free income is as yet tax free in the hands of any owner of tax-exempt securities.

As yet, the U.S. Government does not lose anything because of life insurance company ownership of tax-free bonds. But since H.R. 4245 would then impose the corporate tax rate of 52 percent on only the properly taxable income of the life insurance companies, and since the tax rate applying to the traditional holders of these securities is normally much higher, the Treasury should profit to the extent that life insurance company activity in this market might reduce the amounts otherwise available to buyers in the higher tax brackets, who would then invest in taxable securities and so pay income taxes at rates higher than 52 percent.

B. The answer to the second question is that if the life insurance companies enjoyed the full exclusion accorded other taxpayers, instead of only a 30 percent exclusion, then theoretically the revenue to the Treasury could be reduced by about \$32½ million, from the \$563 million which H.R. 4245 would now impose on the 1958 income of the life insurance companies. But actually, for the reason stated above, the total tax take of the Treasury should instead be increased.

It's all a question of what tax rate applies to the individual owner of these securities.

C. The answer to the third question is that just so long as municipal bonds are tax exempt, their purchase and ownership by any investor will serve to eliminate tax liability for those who invest in them, whether individuals or corporations. Even today it would be theoretically possible for mutual funds, stock casualty and fire insurance companies, etc., to invest all their funds in tax-exempt securities. If granted their full constitutional rights, so could the life insurance companies—in theory. Neither the banks and the casualty companies nor the life companies would do so because—

1. it can be proven that it is physically impossible;
2. a little study shows that it would be entirely impractical;
3. it can be demonstrated that it would be a self-defeating plan;
4. even if the life insurance companies were to make such an effort, they could profitably acquire only that portion of the municipals which get into the hands of taxpayers in less than a 50 percent bracket—a group to whom municipals have traditionally never been particularly attractive; and
5. none of these questions bears directly on the real issue: Is tax-exempt income in the hands of the small savers who own life insurance policies to receive the same exclusion from taxes as is allowed any other investor?

D. Subsection 805(e) is the so-called adjustment to prevent double deductions in subpart B, phase I. Subsection 809(f) is similarly labeled in subpart C, phase II. The following changes would amend these subsections so as to eliminate their unconstitutional treatment of tax-free interest, and at the same time leave their intended effect on the treatment of stock dividends unchanged:

Change lines 6 and 7, page 20, to read "(1) the amount deductible under paragraph (7) of section 804(c) by."

In line 21, page 20, change "sum" to "amount."

Strike the dash in line 21 and all of lines 22, 23, and 24, page 27.

Strike all of lines 1 and 2 and "(iii)" from line 3, page 28.

Change line 6, page 28, to "the ratio—."

Change line 7, page 28, to "(A) the numerator of which is the sum of."

Change line 11, page 28 to "(B) the denominator of which is the in-."

Strike "(ii)" in line 16, page 28.

Change line 18, page 28, to "(A), the adjustment under this paragraph shall be."

Change line 19, page 28, to "the deductions provided in sections 243, 244, and 245 (as modified by subsection (e) (7))."

### III. THE END OF TAX-FREE SECURITIES?

Why start with the small saver?

Life insurance is a vehicle through which over 100 million small savers try to shield their wives and children—or widows and orphans—against the sufferings that accompany or follow disability and death; and to assure themselves some self-provided comforts in old age. These are the very people who, over the years, have saved a part of their hard-earned dollars to invest over \$100 billion through their life insurance companies in the national economy while trying to keep themselves and their families off the Government's back.

Most certainly they should not be the very first to be arbitrarily stripped of their constitutional right to exemption from tax on income which they have been told by the Supreme Court was tax-free. And if H.R. 4245 goes unchallenged and unchanged, then inevitably these small savers will not be the last. Tax-free municipal bonds will before long become just a memory.

The long-range implications of this situation have become a matter of grave concern to legislators as well as life insurance company representatives and the insuring public. What follows is quoted from Report No. 34 on H.R. 4245, pages 87 and 88.

"Insufficient consideration has been given to the economic impact of the revenue implications of the bill * * *.

"The new formula imposes a still greater total burden on policyholders savings them * * * the 1942 formula. * * * Both the Treasury Department and the Congress have recognized that the 1942 act * * * would impose an inequitable burden on policyholders savings * * *.

"Over half of the life insurance in force today does not include savings features. Inflation and taxation have influenced this result. The trend toward pure protection and away from savings features is of great economic concern. * * * Healthy expansion of our economy depends in a large measure on the rate of capital accumulation made available through private institutions such as the life insurance companies. Taxes on investment income * * * reduce the interest credited to policyholders savings and such a tax burden further discourages savings through the purchase of life insurance * * *.

"Life insurance companies are already heavily taxed by the States, possibly more heavily than any other industry. These State taxes are unique and have no counterpart in the case of other thrift institutions. * * * In enacting the McCarran Act, Congress * * * evidenced * * * intent to give priority to the States in taxing the insurance business * * *."

Finally, and in a nutshell, having in mind:

1. That the Supreme Court decision herein cited has neither been repealed nor qualified, it is today the law of the land. That the Supreme Court might or might not now reach the same conclusion is beside the point. (See p. 3.)

2. That H.R. 4245 appears to contravene that decision in the same way as did the 1921 law. (See pp. 5-9, 10-11.)

3. That this is not true of the 1942 and the 1950 "stopgap" legislation. (See pp. 7-8.)

4. That we have here, not a question of a double deduction, but a question of one full deduction to over a 100 million small savers. (See pp. 12-16.)

5. That instead of "being better off," the life insurance companies would be stripped by H.R. 4245 of the exemption from tax on 70 percent of their tax-free income, at the same time that the amount of their income taxes would be very substantially increased. (See p. 17.)

6. That, if Congress today can deprive one group of 70 percent of a constitutional right, a future Congress can strip them, and indeed all other investors as well, first of 80 percent, then of 90 percent, and finally of 100 percent of such rights. (See p. 17.)

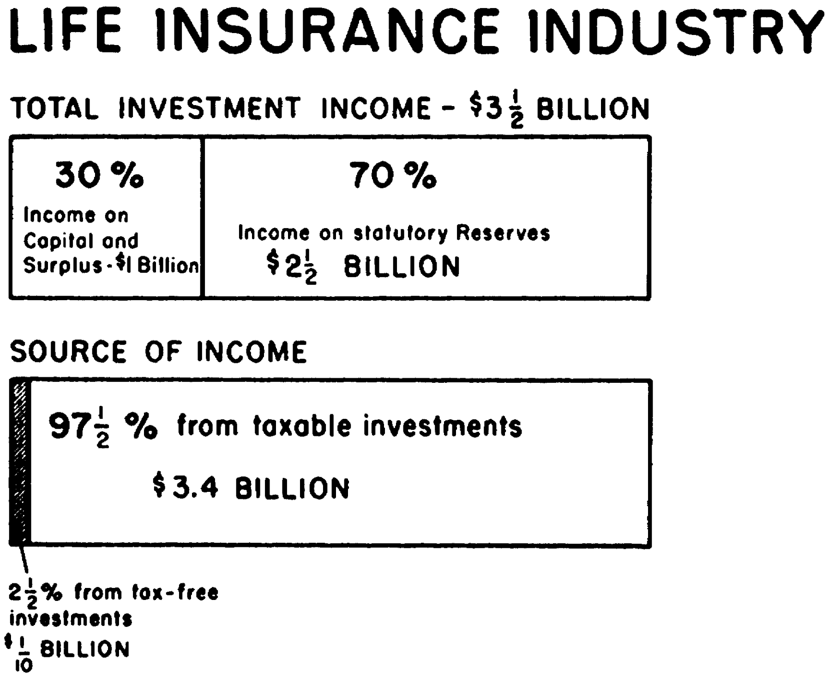
7. That full exclusion from income tax on tax-free income is given other taxpaying groups and individuals. (See pp. 18-20.)

8. That, though allowing life insurance companies the same exclusions as is accorded others might theoretically reduce the proposed $563 million of taxes by $32.5 million, it might more likely increase the total tax take to the Treasury. (See p. 21.)

9. That the law could be rather easily amended to eliminate this injustice. (See p. 22.)

10. Finally, that in addition to the taxes paid the Federal Government, the life insurance companies pay taxes to the States in the approximate amount of about $300 million.

Is it fair or reasonable to deprive over 100 million small savers of their constitutional right to tax-free income, and discriminate unfairly between them and other investors?




ALTERNATE PROPOSED AMENDMENT TO SUBSECTION 809(f) OF H.R. 4245

The proposed changes have bene shown on a separate sheet. Subsection 809(f) is shown below as it would appear after amendment. New material is *italicized;* deleted material appears in black brackets.

"(f) ADJUSTMENT TO PREVENT DOUBLE DEDUCTIONS.—

"(1) AMOUNT OF ADJUSTMENT.—The total of the amounts allowable as deductions under subsection (d) shall be reduced by the [amount determined by multiplying] *sum of—*

"(A) the [sum] *lesser* of—

"[(i) the amount of interest which under section 103 is excluded from gross income] *(i) the excess, if any, of the policy and other contract liability deduction (determined under section 805) over the net investment income (determined under subsection (o) of section 804), and*

"(ii) [the deduction provided by section 242 (as modified by subsection (e)(6)), and] *the amount of interest which under section 103 is excluded from gross income plus the deduction provided by* section *242 (as modified by subsection (e)(6)), and*

"[(iii) the deductions provided in sections 243, 244, and 245 (as modified by subsection (e)(7), by]

"(B) [the ratio] *the amount determined by multiplying the deductions provided in sections 243, 244, and 245 (as modified by subsection (e)(7)), by the ratio—*

"(i) the numerator of which is the sum of the required interest (as defined in paragraph (2)) plus the small business deduction provided by subsection (d)(5), and

"(ii) the denominator of which is the investment yield (as defined in section 805(b)(5)) computed without regard to the limitation in section 804(c)(1) (relating to deduction for investment expenses).

(The balance of the subsection would continue without change from the original bill.)

PROPOSED AMENDMENT TO SUBSECTION 809(F) OF H.R. 4245

The proposed changes have been shown in the memorandum. Subsection 809(f) is shown below as it would appear after amendment. New material is *italicized*, deleted material appears in black brackets.

"(f) ADJUSTMENT TO PREVENT DOUBLE DEDUCTIONS.—

"(1) AMOUNT OF ADJUSTMENT.—The total of the amounts allowable as deductions under subsection (d) shall be reduced by the amount determined by multiplying—

"[(A) the sum of]—

"[(i) the amount of interest which under section 103 is excluded from gross income,

"[(ii) the deduction provided by section 242 (as modified by subsection (e)(6)), and

"[(iii)] the deductions provided in sections 243, 244, and 245 (as modified by subsection (e)(7)), by

"[(B)] the ratio—

"(*A*)[(i)] the numerator of which is the sum of the required interest (as defined in paragraph (2)) plus the small business deduction provided by subsection (d)(5), and

"(*B*)[(ii)] the denominator of which is the investment yield (as defined in section 805(b)(5)) computed without regard to the limitation in section 804(c)(1) (relating to deduction for investment expenses).

If the denominator referred to in subparagraph (B)[(ii)] is less than the numerator referred to in subparagraph [(B)(i)](*A*), the adjustment under this paragraph shall be [the sum determined under subparagraph (A)] *the deductions provided in sections 243, 244, and 245 (as modified by subsection (e)(7))*.

"(2) REQUIRED INTEREST.—For purposes of paragraph (1), the term "required interest" means the total of—

"(A) the sum of the product ascertained under section 805(b)(4)(A);

"(B) the deduction for the investment yield on pension plan reserves (determined under section 805(c)); and

"(C) the deduction for interest paid (as defined in section 805(d)).

D. Subsection 805(e) is the so-called "Adjustment to Prevent Double Deductions" in Subpart B, phase I. Subsection 809(f) is similarly labeled in Subpart C, phase II. The following changes would amend these subsections so as to eliminate their unconstitutional treatment of tax-free interest, and at the same time leave their intended effect on the treatment of stock dividends unchanged.

Change lines 6 and 7, page 20, to read "(1) the amount deductible under paragraph (7) of section 804(c) by".

In line 21, page 20, change "sum" to "amount".

Change lines 20, 21, 22, 23, 24, page 27, and lines 1, 2, 3, 4, 5, and 6, page 28 to read:

"(d) shall be reduced by the sum of—

"(A) the lesser of—

"(i) the excess, if any, of the policy and other contract liability deduction (determined under section 805) over the net investment income (determined under subsection (c) of section 804), and

"(ii) the amount of interest which under section 103 is excluded from gross income plus the deduction provided by section 242 (as modified by subsection (e)(6)), and

"(B) the amount determined by multiplying the deductions provided in sections 243, 244, and 245 (as modified by subsection (e)(7)), by the ratio—"

Change lines 18 and 19, page 28, to read:

"(B)(i), the amount in subparagraph (B) shall be the deductions provided in sections 243, 244, and 245 (as modified by subsection (e)(7))."

NOTE.—Although this change would allow a company to exclude 100 percent of its tax-exempt interest from its taxable investment income, it prevents a company from offsetting any portion of its underwriting gains if its policy and contract liability deduction should exceed its net investment income. This then, is truly the "adjustment to prevent doubt deduction."

PROPOSED AMENDMENT TO SUBSECTION 805(E) OF H.R. 4245

The proposed changes have been shown in the memorandum. Subsection 805(e) is shown below as it would appear after amendment. New material is italicized, deleted material appears in black brackets.

"(e) ADJUSTMENT TO PREVENT DOUBLE DEDUCTIONS.—The adjustment referred to in subsection (a) is the amount determined by multiplying—

"(1) the [sum of the amounts] *amount* deductible under [paragraphs (5), (6), and] *paragraph* (7) of section 804(c) by—

"(2) the ratio—

"(A) the numerator of which is the sum of—

"(i) the deduction for the investment yield on adjusted life insurance reserves,

"(ii) the deduction for the investment yield on pension plan reserves,

"(iii) the deduction for interest paid, plus

"(iv) the small business deduction provided by section 804(c)(9), and

"(B) the denominator of which is the investment yield for the taxable year.

If the denominator referred to in paragraph (2)(B) is less than the numerator referred to in paragraph (2)(A), the adjustment under this subsection shall be the [sum] *amount* determined under paragraph (1).

FORM 1120 L
U. S. Treasury Department
Internal Revenue Service

# U. S. LIFE INSURANCE COMPANY INCOME TAX RETURN

FOR CALENDAR YEAR 1957

**1957**

Do not write in space below

Serial No.

PLEASE TYPE OR PRINT PLAINLY

Name: The Minnesota Mutual Life Insurance Company

Number and Street: Victory Square

City or town, postal zone number, State: St. Paul 1, Minnesota

Date incorporated: August 6, 1880

Place incorporated: Minnesota

1. Was a return filed under the same name for the preceding taxable year? . . . ☒ Yes ☐ No

2. State amount of deferred dividend funds at end of taxable year, exclusive of any amount held for payments in following taxable year $ None

3. Is this a consolidated return?...... ..... ☐ Yes ☒ No
If "Yes," procure from the District Director of Internal Revenue for your district Form 851, Affiliations Schedule, which shall be filled in and filed as a part of this return.

4. If this is not a consolidated return—
(a) did the company at any time during the taxable year own 50 percent or more of the voting stock of another corporation either domestic or foreign?.. ......... ☐ Yes ☒ No
(b) did any corporation, individual, partnership, trust, or association at any time during the taxable year own 50 percent or more of your voting stock?..................... ☐ Yes ☒ No
If either answer is "Yes," attach separate schedule showing: (1) Name and address; (2) percentage of stock owned; (3) date stock was acquired; and (4) the District Director's office in which the income tax return of such corporation, individual, partnership, trust, or association for the last taxable year was filed.

5. Did the company make a return of information on Forms 1096 and 1099 for the calendar year in connection with:
Taxable dividends . . ☐ Yes ☒ No
Other payments . . . . . . . ☒ Yes ☐ No
(See General Instruction H)

6. Did the company at any time during the taxable year own directly or indirectly any stock of a foreign corporation?......... ☐ Yes ☒ No
If answer is "Yes," attach statement required by General Instruction J.

7. Did the company file with the District Director of Internal Revenue a copy of the annual statement for the preceding year as required by General Instruction K?.. ......... ☐ Yes ☒ No
If answer is "Yes," state District Director's office in which statement was filed.

8. If a copy of the annual statement required by General Instruction K does not accompany this return, state reason why the statement is not attached.

9. Is the company a burial or funeral benefit insurance company, engaged directly in the manufacture of funeral supplies or in the performance of funeral services?... ☐ Yes ☒ No
If "Yes," see section 801(e).

## COMPUTATION OF TAX DUE OR REFUND

1. Total income tax (line 42 of tax computation schedule or line 45 of separate schedule NC whichever is applicable) ..... $ 469,674.87
2. Less: Credit for income taxes paid to a foreign country or United States possession allowed a domestic corporation (attach Form 1118) ..... 0
3. Income tax due (line 1 less line 2) ..... 469,674.87
4. Credits for amounts paid on 1957 income tax:
   A. Tax paid with Form 7004 (in case of application for automatic extension of time in which to file) ..... $ 0
   B. Payments and credits on 1957 Declaration of Estimated Tax ..... 96,613.05 ..... $ 96,613.05
5. If tax (line 3) is larger than payments (line 4), the balance is TAX DUE. Enter such balance here → $ 373,061.82
   (See Instruction F.)
6. If payments (line 4) are larger than tax (line 3) ..... Enter the OVERPAYMENT here → $
7. Enter amount of line 6 you want: Credited on 1958 estimated tax ..... $
   Refunded ..... $

## SIGNATURE AND VERIFICATION (See Instruction E)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

June 6, 1958 (Date) — J. S. Hill (Signature of officer) — Second Vice President and Actuary (Title) — CORPORATE SEAL

I declare under the penalties of perjury that I prepared this return for the person named herein; and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

(Date) (Individual or firm signature) (Address)

**FORM 1120 L** 16—73870-1

## GROSS INVESTMENT INCOME

| Line and Instruction No. | | 1. Interest Received | 2. Accrual of Discount | 3. Amortization of Premium | 4.—Total (In Case of Line 1, Column 1 Plus Column 2 Less Column 3) |
|---|---|---|---|---|---|
| 1. | Interest on: | | | | |
| | (a) Wholly exempt obligations. (Attach schedule) Schedule A | $1465801.82 | $ 8,433.15 | $ 34,499.55 | $ 1,439,735.42 |
| | (b) United States Savings Bonds and Treasury Bonds owned in excess of the principal amount of $5,000 issued prior to March 1, 1941 | | | | |
| | (c) Obligations of instrumentalities of the United States issued prior to March 1, 1941 | | | | |
| | (d) Obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. (Attach schedule) B | 217708.10 | 0 | 1,523.00 | 216,185.10 |
| | (e) Loans, notes, mortgages, bank deposits, bonds, debentures, etc C | 5948096.56 | 4,326.92 | 32,820.59 | 5,919,602.89 |
| | Totals | $7631606.48 | $ 12,760.07 | $ 68,843.14 | $ 7,575,523.41 |

| Line | | | Total |
|---|---|---|---|
| 2. | Dividends on stock of: | | |
| | (a) Domestic corporations subject to taxation under Subtitle A of the Internal Revenue Code of 1954 Schedule | | 83,198.10 |
| | (b) Public utility corporations subject to taxation under Subtitle A of the Internal Revenue Code of 1954 | | 399,119.56 |
| | (c) Foreign corporations | | 0 |
| | (d) Other corporations | | 0 |
| 3. | Rents and royalties. (Attach schedule) Schedule E | | 54,807.03 |
| 4. | Income from trade or business other than insurance business | | 0 |
| 5. | Leases, etc. | | 0 |
| 6. | GROSS INVESTMENT INCOME (total of lines 1 to 5) | | $ 8,112,648.10 |
| | **DEDUCTIONS** | | |
| 7. | Interest wholly exempt from tax (line 1 (a), column 4) | $ 1,439,735.42 | |
| 8. | Investment expenses. (Attach schedule) Schedule F | 318,513.35 | |
| 9. | Taxes Schedule G | 33,362.11 | |
| 10. | Real estate expenses Schedule H | 26,144.14 | |
| 11. | Depreciation. (Attach schedule) Schedule I | 35,105.11 | |
| 12. | Depletion of mines, oil and gas wells, timber, etc. (Attach schedule) Schedule J | 1,135.94 | |
| 13. | Trade or business deductions, as provided in section 803 (c) (6). (Attach schedule) | | |
| 14. | Total deductions on lines 7 to 13 | | 1,853,996.07 |
| 15. | NET INVESTMENT INCOME (line 6 less line 14) | | 6,258,652.03 |
| 16. | Less: Net investment income allocable to non-life-insurance reserves (Schedule A) | | |
| 17. | Net investment income allocable to life insurance reserves | | 6,258,652.03 |
| 18. | Less: Reserve and other policy liability deduction (Schedule B) | $ 5,344,854.20 | |
| 19. | Special interest deduction (Schedule C) | | |
| 20. | Total of lines 18 and 19 | | 5,344,854.20 |
| 21. | LIFE INSURANCE TAXABLE INCOME (line 17 less line 20) | | 913,797.83 |

**IMPORTANT NOTE:** If taxpayer is a new insurance company within the meaning of section 818 and the maximum limitation in Schedule B applies, see "Tax Computation" instructions relative to Separate Schedule NC (Form 1120 L)

## TAX COMPUTATION SCHEDULE

### Part I—Computation under Section 802 (a)

| | | |
|---|---|---|
| 1. Life insurance taxable income (line 21 above) | | $ 913,797.83 |
| 2. Non-life insurance taxable income (Schedule D) | | 0 |
| 3. Taxable income (total of lines 1 and 2) | | 913,797.83 |
| 4. Less: Deduction for partially tax-exempt interest (line 7, Schedule E) | | 0 |
| 5. Taxable income for purpose of normal tax (line 3 less line 4) | | 913,797.83 |
| 6. Normal tax (30 percent of amount on line 5) | | 274,139.35 |
| 7. Enter 22 percent of amount on line 3 | $ ~~201,035.52~~ | |
| 8. Surtax (line 7 less $5,500; if the difference is negative, enter zero) | 5,500.00 | $ 195,535.52 |
| 9. Normal tax and surtax (total of lines 6 and 8) | | 469,674.87 |
| **Alternative tax under Section 1201 (a)** | | |
| 10. Taxable income (line 3 above) | | $ 913,797.83 |
| 11. Less: Excess of net long-term capital gain over net short-term capital loss allocable to non-life insurance taxable income computed under section 802 (e) | | 0 |
| 12. Line 10 less line 11 | | 913,797.83 |
| 13. Less: Deduction for partially tax-exempt interest (line 7, Schedule E) | | 0 |
| 14. Line 12 less line 13 | | 913,797.83 |
| 15. Normal tax (30 percent of amount on line 14) | | 274,139.35 |
| 16. Enter 22 percent of amount on line 12 | $ ~~201,035.52~~ | |
| 17. Surtax (line 16 less $5,500; if the difference is negative, enter zero) | 5,500.00 | 195,535.52 |
| 18. Partial tax (total of lines 15 and 17) | | $ 469,674.87 |
| 19. 25 percent of line 11 | | 0 |
| 20. Alternative tax under section 1201 (a) (line 18 plus line 19) | | $ 0 |
| 21. Normal tax and surtax (line 9) | | $ 469,674.87 |
| 22. Income tax (line 20 or 21, whichever is lesser) | | $ 469,674.87 |

16—72870-1

**Part II—Computed under Section 802 (c)**

| | | |
|---|---|---|
| 23. Life insurance taxable income (line 21, top of page 2) | | $ 913,797.83 |
| 24. Less: Deduction for partially tax exempt interest (line 12, Schedule E) | | 0 |
| 25. Taxable income for purpose of normal tax (line 23 less line 24) | | 913,797.83 |
| 26. Normal tax (30 percent of amount on line 25) | | 274,139.35 |
| 27. Enter 22 percent of amount on line 23 | $ 201,035.52 | |
| 28. Surtax (line 27 less $5,500; if the difference is negative, enter zero) | 5,500.00 | $ 195,535.52 |
| 29. First partial tax (total of lines 26 and 28) | | 469,674.87 |
| 30. Gross investment income (line 6, page 2) | | 8,112,648.10 |
| 31. Less: Deduction for wholly tax exempt interest (line 7, page 2) | | 1,439,735.42 |
| 32. Line 30 less line 31 | | 6,672,912.68 |
| 33. Percent non life-insurance reserves are of qualified reserves (line 3, Schedule A) | | 0 % |
| 34. Line 32 multiplied by line 33 | | 0 |
| 35. Net premiums on non life-insurance contracts (computed in the manner described in section 823) | | 0 |
| 36. Dividends to policyholders on non life-insurance contracts (computed in the manner described in section 823) | | 0 |
| 37. Line 35 less line 36 | | 0 |
| 38. Line 34 plus line 37 | | 0 |
| 39. Second partial tax—1 percent of amount on line 38 | | 0 |
| 40. Income tax under section 802 (c) (line 29 plus line 39) | | 469,674.87 |
| 41. Income tax under section 802 (a) (line 22, Part I) | | 469,674.87 |
| 42. Income tax (line 40 or line 41, whichever is greater) | | $ 469,674.87 |

**SCHEDULE A.—COMPUTATION OF NET INVESTMENT INCOME ALLOCABLE TO NON-LIFE-INSURANCE RESERVES**

| | |
|---|---|
| 1. Non life-insurance reserves (as defined in section 804 (d) (2)) | $ NOT |
| 2. Qualified reserves (as defined in section 804 (e)) | |
| 3. Percent line 1 is of line 2 | [redacted] % |
| 4. Net investment income (line 15, page 2) | |
| 5. Net investment income allocable to non life-insurance reserves (line 4 multiplied by line 3) | $ |

**SCHEDULE B**

**Part I—Reserve and Other Policy Liability Deduction**

| | |
|---|---|
| 1. Net investment income allocable to life insurance reserves (line 17, page 2) | $ 6,258,652.03 |
| 2. If amount of line 1 is | |
| (a) Not over $1,000,000— Enter 87½ percent of line 1 | |
| (b) Over $1,000,000— Enter $875,000 plus 85 percent of the excess over $1,000,000 | 5,344,854.20 |
| 3. Deduction under section 804 (a) (line 2 (a) or line 2 (b)) (Enter on line 18, page 2, if less than line 7 below) | $ 5,344,854.20 |

**Part II—Limitation on Amount of Reserve and Other Policy Liability Deduction**

| | | |
|---|---|---|
| 4. (a) Total required interest on life insurance reserves $ ........ (Total of column 8, Schedule G) times 2 | $10,088,742.00 | |
| (b) Required interest on reserves for deferred dividends determined under section 805 (c) (2) | 0 | |
| (c) Interest paid or accrued (line 12, Schedule G) | 770,849.00 | |
| (d) Dividends to policyholders paid or declared (other than dividends on non life insurance contracts referred to in section 804 (d) (2) (A)) | 4,026,985.83 | |
| (e) In the case of a mutual assessment life insurance company or association, an amount equal to two times whichever of the following is the lesser: (1) The amount of the net investment income on life insurance reserves described in section 801 (b) (3) OR (2) 3 percent of the life insurance reserves so described | 0 | |
| 5. Total of lines 4 (a) through 4 (e) | | $14,886,576.83 |
| 6. Less: Adjustments for loans on policies involving life insurance reserves | | |
| (a) Average rate of interest (line 6, Schedule G) | 2.8220 % | |
| (b) Mean of the aggregates of the outstanding policy loans (Section 804 (b) (2) (A)) | $12,233,315.68 | |
| (c) Amount of adjustment (line (a) multiplied by line (b)) | | $345,224.15 |
| 7. Maximum deduction (line 5 less line 6 (c)) (If this line is less than line 3, complete lines 8 and 9) | | 14,541,352.68 |
| 8. Dividends received deduction (line 9, Schedule F) | | $ |
| 9. Total of lines 7 and 8 (enter here and on line 18, page 2) | | $ |

**SCHEDULE C.—SPECIAL INTEREST DEDUCTION**

| | | |
|---|---|---|
| 1. Line 7 plus line 15, top of page 2 | | $ 7,698,387.45 |
| 2. 50 percent of line 16, page 2 | | 0 |
| 3. Adjusted net investment income (line 1 less line 2) | | $ 7,698,387.45 |
| 4. Required interest— | | |
| (a) Total of column 8, Schedule G | $ 5,048,884.00 | |
| (b) Reserves held for deferred dividends described in section 804 (c) (4) multiplied by each rate of interest assumed in computing such reserve | 0 | |
| (c) Interest paid or accrued (line 12, Schedule G) | 770,849.00 | |
| (d) Sum of lines (a), (b), and (c) | | $ 5,819,733.00 |
| 5. Line 3 divided by line 4 (d). Enter percentage | 132 % | |
| 6. Line 17, top of page 2 | | $ 6,258,652.03 |
| 7. Line 18, page 2 | | 5,344,854.20 |
| 8. Line 6 less line 7 | | $ 913,797.87 |
| 9. Special interest deduction—If percentage on line 5 is 105 or more, enter zero. 100 or less, enter 50 percent of line 8. more than 100 but less than 105, enter* ........ % of line 8 | | $ 0 |

* Multiply by 10 the difference between 105 percent and percentage on line 5 and enter percentage thus obtained

## SCHEDULE D.—COMPUTATION OF NON-LIFE INSURANCE TAXABLE INCOME



| | |
|---|---|
| 1. Net investment income allocable to non-life-insurance reserves (line 5, Schedule A) | $ |
| 2. Percent non-life-insurance reserves is of qualified reserves (line 3, Schedule A) | % |
| 3. Net gain from sale or exchange of capital assets. (Attach schedule) | |
| 4. Line 3 multiplied by line 2 | NOT |
| 5. Line 1 plus line 4 | |
| 6. Amount of deduction for dividends received under sections 243, 244, and 245 (line 1 (d), Schedule F) | NEEDED |
| 7. Line 6 multiplied by line 2 | |
| 8. Non-life insurance taxable income (line 5 less line 7) | $ |

## SCHEDULE E.—COMPUTATION OF DEDUCTION FOR PARTIALLY TAX-EXEMPT INTEREST

### Part I—Computation for Purposes of Section 802 (a)

| | |
|---|---|
| 1. Life insurance taxable income (line 21, top of page 2) | $ 913,797.83 |
| 2. Net investment income allocable to non life insurance reserves (line 5, Schedule A) | 0 |
| 3. Line 1 plus line 2 | 913,797.83 |
| 4. Net investment income (line 15, page 2) | 6,258,652.03 |
| 5. Percent line 3 is of line 4 | 14.60 % |
| 6. Amount of the deduction provided by section 242 | 0 |
| 7. Deduction for partially tax exempt interest (line 6 multiplied by line 5) | $ 0 |

### Part II—Computation for Purposes of Section 802 (c) (2) (A)

| | |
|---|---|
| 8. Life insurance taxable income (line 21, page 2) | $ 913,797.83 |
| 9. Net investment income (line 15, page 2) | 6,258,652.03 |
| 10. Percent line 8 is of line 9 | 14.60 % |
| 11. Amount of the deduction provided by section 242 | 0 |
| 12. Deduction for partially tax exempt interest (line 11 multiplied by line 10) | $ 0 |

## SCHEDULE F.—COMPUTATION OF DIVIDENDS RECEIVED DEDUCTION

| | | |
|---|---|---|
| 1. Dividends received deduction— | | |
| (a) Enter 85 percent of line 2 (a), page 2 | $ 70,718.39 | |
| (b) Enter 62.115 percent of line 2 (b), page 2 | 247,913.39 | |
| (c) Enter 85 percent of dividends received from certain foreign corporations | 0 | |
| (d) Total dividends received deduction. Enter sum of (a), (b), and (c) but not to exceed 85 percent of line 15, page 2 (net investment income) | | 318,631.78 |

**Note: Complete remainder of this schedule only if the Limitation on Amount of Reserve and Other Policy Liability Deduction computed on Part II, Schedule B, is applicable**

| | |
|---|---|
| 2. Net investment income (line 15, page 2) | |
| 3. Net investment income allocable to non life insurance reserves (line 5, Schedule A) | NOT |
| 4. Maximum deduction under section 804 (b) (line 7, Schedule B) | |
| 5. Line 4 multiplied by 100/85 | NEEDED |
| 6. Total of lines 3 and 5 | |
| 7. Line 2 less line 6 | |
| 8. Line 7 divided by line 2 | |
| 9. Dividends received deduction under sec. 804 (b) (2) (line 1 (d) multiplied by line 8) (Enter here and on line 8, Sch. B) | $ |

## SCHEDULE G.—DATA FOR RESERVE AND OTHER POLICY LIABILITY DEDUCTION FOR THE SUCCEEDING TAXABLE YEAR

| | 1 Nature of Reserve (Life, Annuity, Etc.) | 2 Assumed Mortality or Morbidity Table | 3 Assumed Interest Rate | 4 Method of Computation (Illinois Standard, Etc.) | 5 Amount of Adjusted Reserve at Beginning of Taxable Year* | 6 Amount of Adjusted Reserve at End of Taxable Year* | 7 Mean of Columns (5) and (6) | 8 Column (3) Times Column (7) |
|---|---|---|---|---|---|---|---|---|
| 1. | | | | | $ | $ | $ | $ |
| 2. | | | | | | | | |
| 3. | | | | SCHEDULE K | | | | |
| 4. | | | | | | | | |
| 5. | Totals | | | | | | $178,754,404 | 5,044,372 |

| | | |
|---|---|---|
| 6. | Average rate of interest assumed in computation of life insurance reserves (total of column 8 divided by total of column 7) | 2.8220 % |
| 7. | 35 percent of line 6 | .9877 % |
| 8. | 2.1125 percent (65 percent of 3¼ percent) | 2.1125 % |
| 9. | Reserve earnings rate (line 7 above plus line 8 above) | 3.1002 % |
| 10. | Total of column 7 multiplied by line 9 above | $5,541,744 |
| 11. | 2 percent of the reserve held for deferred dividends | 0 |
| 12. | Interest paid or accrued — SCHEDULE L | 770,849 |
| 13. | Total of lines 10, 11, and 12 above | $6,312,593 |
| 14. | Net investment income (line 15, page 2) | $6,258,652 |
| 15. | Interest wholly exempt from tax (line 7, page 2) | $1,439,735 |
| 16. | Adjustment for unearned premiums and unpaid losses on non-life insurance reserves (See instructions) | $ 0 |

* In the case of reserves computed on a preliminary term basis, ... [illegible]

## SCHEDULE H.—INVESTED ASSETS BOOK VALUES

(Schedule H need not be filled in if no deduction is claimed for any general expenses that are allocated to investment income)

| | | 1 Beginning of taxable year | 2 End of taxable year |
|---|---|---|---|
| 1. | Real estate | $ 3,354,775.13 | $ 3,519,287.70 |
| 2. | Mortgage loans | 103,982,191.31 | 110,997,678.47 |
| 3. | Collateral loans | 189,500.00 | 214,500.00 |
| 4. | Policy loans, including premium notes | 11,296,486.32 | 12,320,351.87 |
| 5. | Bonds of domestic corporations | 27,093,284.00 | 27,325,932.00 |
| 6. | Stocks of domestic corporations | 9,242,361.00 | 11,464,463.00 |
| 7. | Government obligations, etc. (Submit detailed schedule) | 51,908,625.00 | 57,375,086.00 |
| 8. | Bank deposits bearing interest | 0 | 0 |
| 9. | Other interest-bearing assets. (Attach schedule) | 0 | 0 |
| 10. | Totals of lines 1 to 9 | 207,067,222.76 | 223,217,299.04 |
| 11. | Total of columns 1 and 2, line 10 | | 430,284,521.80 |
| 12. | Mean of the invested assets for the taxable year (one-half of line 11) | | 215,142,260.90 |
| 13. | One-fourth of 1 percent of the mean of the invested assets | | $ 537,855.65 |
| 14. | Income base (line 6, page 2, less the sum of lines 9 through 13, page 2) | | $ 8,016,900.80 |
| 15. | 3¾ percent of line 12 | | 8,067,834.79 |
| 16. | Excess (if any) of line 14 over line 15 | | $ 0 |
| 17. | One-fourth of line 16 | | $ 0 |
| 18. | Limitation on deduction for investment expenses (line 13 plus line 17) | | $ 537,855.65 |

LIFE COMPANIES INTERESTED IN TAX-FREE INTEREST

Acadia Life Insurance Co., Rayne, La.
American General Life Insurance Co., Rusk Building, Houston, Tex.
American Hospital and Life Insurance Co., Pecan and St. Marys Streets, San Antonio, Tex.
American National Insurance Co., Moody Avenue at Market Street, Galveston, Tex.
American Life Insurance Co., American Life Building, Birmingham, Ala.
American United Life Insurance Co., 30 West Fall Creek Parkway, Indianapolis, Ind.
Amiçable Life Insurance Co., Amicable Life Building, Waco, Tex.
Atlas Life Insurance Co., New Orleans, La.
Atlas Life Insurance Co., 212 Florence Trust Building, Florence, S.C.
Bankers National Life Insurance Co., 1 Sunset Avenue, Montclair, N.J.
Bankers Security Life Insurance Society, 103 Park Avenue, New York, N.Y.
Business Mens' Assurance Co. of America, 215 Pershing Road, Kansas City, Mo.
Central Life Assurance Co., Alexandria, La.
Central States Life, Alexandria, La.
College Life Insurance Co. of America, College Square at Central Court South, Indianapolis, Ind.
Colonial Life Insurance Co., 111 Prospect Street, East Orange, N.J.
Columbian Mutual Life Insurance, Co., 805 Main Street, Binghamton, N.Y.
Columbian National Life Insurance Co., 77 Franklin Street, Boston, Mass.
Community Mutual Life Insurance Co., 219 South Boston Avenue, Tulsa, Okla.
Companion Life Insurance Co., 345 Madison Avenue, New York, N.Y.
Continental American Life Insurance Co., 11th and King Streets, Wilmington, Del.
Credit Life Insurance Co., 120 South Simestone Street, Springfield, Ohio.
Delta Life Insurance Co., New Orleans, La.
Dixie Cooperative Life, Bogalusa, La.
Durham Life Insurance Co., 330 Fayette Street, Raleigh, N.C.
Eastern Life Insurance Co. of New York, 306 Fourth Avenue, New York, N.Y.
Empire State Mutual Life Insurance Co., 315 North Main Street, Jamestown, N.Y.
Equitable Life Insurance Co., 816 Fourteenth Street NW., Washington, D.C.
Evangeline Life Insurance Co., 146 West Main Street, New Iberia, La.
Farmers New World Life, 618 Second Avenue, Seattle, Wash.
Fireside Commercial Life Insurance Co., 803 Johnston Street, Alexandria, La.
Federal Life Insurance Co., 6100 North Cicero Avenue, Chicago, Ill.
First National Life Insurance Co., 632–36 Baronne Street, New Orleans, La.
Franklin Life Insurance Co., 812 South Sixth Street, Springfield, Ill.
Great Southern Life Insurance Co., 4310 Dunlavy Street, Houston, Tex.
Gulf Life Insurance Co., 125 West Ashley Street, Jacksonville, Fla.
Hall Life, Monroe, La.
Home Security Life Insurance Co., 111 Corcoran, Durham, N.C.
Independent Life and Accident Co., The, 233 West Duval Street, Jacksonville, Fla.
Insurance Co. of North America, New York, N.Y.
Interstate Life and Accident, 540 McCallie Avenue, Interstate Building, Chattanooga, Tenn.
Jacob Shoen & Son Life Insurance Co., New Orleans, La.
Jeff Davis Mortuary Benevolent Association, Jennings, La.
Jefferson National Life Insurance Co., 241 North Pennsylvania Street, Indianapolis, Ind.
Jefferson Standard Life Insurance Co., Jefferson Square, Greensboro, N.C.
Kansas City Life Insurance Co., 3520 Broadway, Kansas City, Mo.
Kilpatrick Life, Shreveport, La.
Lafond Life Insurance Co., Opelousas, La.
Lafourche Life Insurance Co., Raceland, La.
Lamar Life Insurance Co., The, 317 East Capitol Street, Jackson, Miss.
Laughlin Industrial Life Insurance Co., New Orleans, La.
Leitz-Egan Life Insurance Co., New Orleans, La.
Liberty Life Insurance Co., Liberty Life Building, Greenville, S.C.
Liberty National Life Insurance Co., Liberty National Life Building, Birmingham, Ala.
Lincoln National Life Insurance Co., 1301–27 South Harrison Street, Fort Wayne, Ind.

Lincoln Income Life Insurance Co., 981 South Third Street, Louisville, Ky.
Life Insurance Co. of Georgia, 573 West Peachtree Street NE., Atlanta, Ga.
Life Insurance Co. of Virginia, The, Capitol and Tenth Streets, Richmond, Va.
Magnolia Life Insurance Co., Lake Charles, La.
Midland National Life Insurance Co., 104 South Maple Street, Watertown, S. Dak.
Melancon Industrial Insurance Co., Carencro, La.
Midwest Life Insurance Co. of Lincoln, Nebraska, 500 South 16th Street, Lincoln, Nebr.
Minnesota Mutual Life Insurance Co., The, Victory Square, St. Paul, Minn.
Monarch Life Assurance Co., The, Victory Square, St. Paul, Minn.
Monarch Life Assurance Co., The, 215 Portage Avenue, Winnipeg, Canada.
Monumental Life Insurance Co., Charles and Chase Streets, Baltimore, Md.
Mother Life Insurance Co., New Orleans, La.
Mulhearn Protective Association, Monroe, La.
National Equity Life Insurance Co., 209 West Capitol Avenue, Little Rock, Ark.
National Old Line Insurance Co., Capitol Avenue at Wood Lane, Little Rock, Ark.
National Reserve Life Insurance Co., 515 South Main Avenue, Sioux Falls, S. Dak.
Nationwide Life Insurance Co., 246 North High Street, Columbus, Ohio.
National Life Insurance Co., 246 North High Street, Columbus, Ohio.
North American Life Insurance Co. of Chicago, 36 South State Street, Chicago, Ill.
North American Reassurance Co., 161 East 42d Street, New York, N.Y.
Northern Life Insurance Co., Third Avenue at University Street, Seattle, Wash.
Occidental Life Insurance Co. of North Carolina, Cameron Village, Raleigh, N.C.
Ohio National Life Insurance Co., The, 2400 Reading Road, Cincinnati, Ohio.
Old Line Life Insurance Co. of America, The, 707 North 11th Street, Milwaukee, Wis.
Olympic National Life Insurance Co., 915 Second Avenue, Seattle, Wash.
Orleans Insurance Co., New Orleans, La.
Pan-American Life Insurance Co., 2400 Canal Street, New Orleans, La.
Paul Revere Life Insurance Co., The, 18 Chestnut Street, Worcester, Mass.
Peninsular Life Insurance Co., 645 Riverside Avenue, Jacksonville, Fla.
Pelican State Life, Jonesboro, La.
Peoples Life Insurance Co., 1343 H Street NW., Washington, D.C.
Philadelphia Life Insurance Co., 111 North Broad Street, Philadelphia, Pa.
Pilot Life Insurance Co., Box P, Greensboro, N.C.
Poole Funeral Benefit Association, Bogalusa, La.
Postal Life Insurance Co. of New York, 511 Fifth Avenue, New York, N.Y.
Protective Life Insurance Co., Protective Life Building, 2027 First Avenue North, Birmingham, Ala.
Provident Life Insurance Co., Provident Life Building, Bismarck, N. Dak.
Rabenhorst Industrial Life, Baton Rouge, La.
Ramson Industrial Life, New Orleans, La.
Republic National Life Insurance Co., 3988 North Central Expressway, Dallas, Tex.
Security Benefit Life Insurance Co., 700 Harrison Street, Topeka, Kans.
Security Life Insurance Co., Donaldsonville, La.
Security Industrial Insurance Co., Donaldsonville, La.
Security Life & Accident Co., Security Life Building, Denver, Colo.
Southeastern States Life Insurance Co., 2728 Agnes Street, Corpus Christi, Tex.
Southern National Life Insurance Co., 516 Florida Street, Baton Rouge, La.
Southwestern Life Insurance Co., Southwestern Life Building, Dallas, Tex.
Standard Life Insurance Co. of Indiana, Washington and Fall Creek Boulevards, Indianapolis, Ind.
Sun Life Insurance Co. of America, 109 East Redwood Street, Baltimore, Md.
Thomas Life Insurance Co., Hammond, La.
Travelers Insurance Co., The, 700 Main Street, Hartford, Conn.
Union Life Insurance Co., Union Life Building, Little Rock, Ark.
Union Mutual Life Insurance Co., 396 Congress Street, Portland, Maine.
Union National Life Insurance Co., 1020 Florida Street, Baton Rouge, La.
United Fidelity Life Insurance Co., 1029 Elm Street, Dallas, Tex.
United Life & Accident Insurance Co., 2 White Street, Concord, N.H.
United Life Insurance Co., Bastrop, La.
United States Life Insurance Co. in the City of New York, The, 84 William Street, New York, N.Y.

Universal Life Insurance Co., 480 Linden Avenue, Memphis, Tenn.
West Coast Life Insurance Co., 605 Market Street, San Francisco, Calif.
Western Life Insurance Co., 604 Park Avenue, Helena, Mont.
Willet Industrial Life, Plaquemine, La.
Wisconsin National Life Insurance Co., 77-81 Washington Boulevard, Oshkosh, Wis.
Woodmen Accident & Life Co., 1526 K Street, Lincoln, Nebr.

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

Mr. CUMMINGS. Thank you, sir.

The CHAIRMAN. The committee will now recess to 2:30 this afternoon.

(Whereupon, at 1 p.m., the committee recessed, to reconvene at 2:35 p.m. this same day.)

AFTERNOON SESSION

Senator KERR. Mr. John A. Kendrick, Quaker City Life Insurance Co.

## STATEMENT OF JOHN A. KENDRICK, OF THE FIRM OF BURTON, HEFFELFINGER, McCARTHY & KENDRICK, WASHINGTON, D.C., APPEARING ON BEHALF OF QUAKER CITY LIFE INSURANCE CO. OF PHILADELPHIA, PA.

Mr. KENDRICK. Mr. Chairman, I am John A. Kendrick, member of the law firm of Burton, Heffelfinger, McCarthy & Kendrick, having offices in the Investment Building, Washington, D.C. My firm is legal counsel for Quaker City Life Insurance Co. of Philadelphia, Pa., which is licensed in 20 States as an industrial life insurance company, with assets of approximately $20 million and insurance in force of approximately $254 million.

As the committee knows, on February 18, 1959, this House of Representatives passed the bill which is presently before the committee. It is expected to produce income to the Treasury of approximately $545 million for the taxable year 1958, with the resultant increase in the life insurance tax revenue of approximately 70 percent in 1 year. This company, Quaker City Life Insurance Co. of Philadelphia, recognizes the need for a permanent and equitable tax formula for the life insurance industry that will increase the revenue to the Federal Government.

However, our interpretation of the life insurance company tax bill would indicate an increase of approximately 600 percent of our tax paid in 1958 on 1957 operations. We expect an increase in tax. However, management believes that such a drastic increase in tax may jeopardize the solidarity not only of Quaker City Life Insurance Co., but also many other competing companies.

The new tax bill is based on assumptions. Projections were made by the industry, but the final 1958 earnings were not known at the time this bill was drafted. Since the earnings of the industry are now available, we ask would it not be prudent to reinvestigate the effect this bill will have on the industry?

Quaker City Life Insurance Co. is a relatively small industrial insurance company which has been operating for 40 years. The nucleus of the policyholders are the low-income group. The average policy is less than $500, and there are aproximately 700,000 policies in force, the majority of which have been issued on a permanent plan of life insurance. All of these contracts must be honored. All policies have been issued on a nonparticipating basis. Consequently, there is no dividend scale to be adjusted nor is there any contractual provision for assessments. The only logical conclusion is an inevitable increase in premium rates which must be borne by all new policyholders. It seems unfair that they must bear this burden to the benefit of all present policyholders.

The life insurance industry has been taxed not only by the Federal Government, but also by each individual State. The life insurance industry has already had imposed upon it taxes far greater than any other known industry on the State level. During recent years there have been State governments that have enacted additional legislation increasing the revenue from life insurance companies. Since taxes on premiums paid to State, county, and municipal governments will be a deductible item in the life insurance Federal tax return, this bill opens an avenue for future increased-tax legislation.

During the past 4 years the capital, surplus, and voluntary reserves of this company have increased $700,000. The new proposed life insurance tax would equal approximately half of this amount in 1 year. This example certainly justifies that the smaller companies should receive substantial assistance in the final tax formula. It is definitely unfair to increase the industry level by 70 percent and this company's by 600 percent. The future policyholders should not be adversely penalized to the benefit of the present policyholders, nor should all the gains of the past 4 years be reduced by one-half in the proposed 1-year tax increase. The entire formula should be reappraised, and some consideration for individual exceptions to companies like Quaker City Life Insurance Co. that may be penalized by excessive tax increases.

Senator KERR. Mr. Kendrick, you say that your tax for 1958 would be up 600 percent from what it was in 1957.

Mr. KENDRICK. Yes, sir.

Senator KERR. Do you have the financial statement for your company for 1957?

Mr. KENDRICK. I do not with me, Mr. Chairman. I would like the opportunity, particularly in view of the fact that I understand there will be some additional hearings held on the 17th, to produce any additional information requested by the committee——

Senator KERR. Would you look at this and see if that is it, and if it gives information pertinent to your company?

Mr. KENDRICK. Is that Best's? I am sure it is, sir.

Senator KERR. Does that show the profit of your company in 1957?

Mr. KENDRICK. I believe this is correct; yes, sir. I have not compared it with our own statement, but I am sure it is correct.

Senator KERR. What does that show it to be in 1957?

Mr. KENDRICK. As to the profit itself, sir?

Senator KERR. Yes.

Mr. KENDRICK. It shows a decrease in surplus, but I do not see the profit figure right offhand.

Senator KERR. Isn't there an item there "Gains for operations"?

Mr. KENDRICK. There is a net operating gain figure.

Senator KERR. Would that have any relationship to profit?

Mr. KENDRICK. Not to be facetious, Senator——

Senator KERR. I am not being facetious.

Mr. KENDRICK. No; I know you aren't.

Senator KERR. I am just a child in the woods in these financial statements. I am just asking you to lead me, guide me.

Mr. KENDRICK. I know you are not being facetious, sir. I was saying that by way of predicating my following remarks, that yesterday afternoon I arrived just as the committee had adjourned for the evening and I said to your aid here, "Does anybody ever invoke the fifth amendment before this committee?" He said in a horrified tone, "No, they don't."

I am not invoking the fifth amendment but I am saying I am ignorant of these facts. I am merely giving this statement for the president of the company who was here up until this morning and then had to leave. That is why I asked permission of the committee to subsequently introduce additional information which has been requested by the committee.

Senator KERR. Well, you make a statement that you are going to have to pay 600 percent more taxes, and for that to have the significance to me that I think you want it to have—for me and other members of the committee—we would have to know what your profit was in 1957, what it will be in 1958; what your taxes were for 1957, what they will be for 1958.

Mr. KENDRICK. Right, sir, and I will be glad to supply that information.

Senator KERR. What does that show as dividends paid in 1957?

Mr. KENDRICK. $468,000.

Senator KERR. You wouldn't pay $463,000 in dividends when you had a net loss, I don't suppose.

Mr. KENDRICK. No. There is not a net loss. There is shown a net operating gain.

Senator KERR. Of how much?

Mr. KENDRICK. According to the book that you have handed me.

Senator KERR. Well, now, that is not my book. I just——

Mr. KENDRICK. No. And I subscribe to its accuracy. I think it is correct.

Senator KERR. I am not even in a position to do that.

Mr. KENDRICK. Right.

Senator KERR. Does that show the taxes paid by your company?

Mr. KENDRICK. I am sure it does. There is a figure here of taxes. It does not state whether this is to the Federal——

Senator KERR. Well, we really would need to know, wouldn't we?

Mr. KENDRICK. Yes, sir. And we will be glad to supply that information, sir.

Senator KERR. All right. Then supply for the record the profit for 1957, the Federal taxes for 1957, the net gain from operations in 1957, and the same figures for 1958.

Mr. KENDRICK. Right, sir.

Senator KERR. Thank you very much.

(The material referred to was not supplied at the time the hearings were printed.)

Senator KERR. Are there any other questions?

Senator CARLSON. Mr. Chairman, I have a statement of an insurance company in the State of Kansas, the Central Plains Life Insurance Co., which might bear out some of the figures that have just been submitted by Mr. Kendrick for his company. It discloses the fact that the taxes set up for 1958 based on 1957 and previous years' earnings, were $6,500. The total tax, income tax under the proposed legislation would be $36,554, or a difference of $30,054.

Senator KERR. On what earnings?

Senator CARLSON. For 1958, Central Plains Life Insurance Co.; net investment income, $29,180. Operations net income, $153,865. The total net income, $183,045.

Senator ANDERSON. I think the record will show they made about $24,000 in investment income and $200,000 income from operations.

Senator KERR. Net gain from operations.

Senator ANDERSON. We took the investment income and figured what amount they would pay on this, and $2,000 would be right, $2,000 or $3,000.

Senator KERR. I guess we would have to be confronted with the question as to whether or not $6,000 taxes on $200,000 net gains from operations was extraordinarily—was adequate. Well, that will be some of the matters that we are going to have to make some kind of a decision on.

All right, Mr. McClatchey.

## STATEMENT OF DEVEREAUX F. McCLATCHEY, GENERAL COUNSEL, THE NATIONAL ASSOCIATION OF LIFE COMPANIES, ACCOMPANIED BY DeWITT ROBERTS, EXECUTIVE SECRETARY, THE NATIONAL ASSOCIATION OF LIFE COMPANIES

Mr. McCLATCHEY. Mr. Chairman, gentlemen of the committee, my name is Devereaux F. McClatchey. I am general counsel of the National Association of Life Companies, a trade association organized under the laws of the State of Georgia, with a membership of more than 120 small and medium sized life insurance companies in 25 States.

I am accompanied here today by Mr. DeWitt Roberts, who is executive secretary of the association, and I would like, if I may, to refer any technical questions to him and I respectfully say that almost any questions are technical on this subject in my opinion.

Senator KERR. I would say that is a profound conclusion.

Mr. McCLATCHEY. This appearance before the Senate Finance Committee is to express our viewpoint on H.R. 4245, a bill relating to the taxation of the income of life insurance companies, and to save time I would like to omit portions of my printed statement and to some extent talk from it rather than to read it, if it pleases the committee.

Senator KERR. The entire statement will be made a part of the record and you may make such observations as you see fit.

Mr. McCLATCHEY. While we recognize the writing of either a satisfactory or durable tax measure in the field of life insurance presents unusual difficulties, we are convinced that this pending measure is a bad bill that should be either rewritten in its entirety or substantially amended.

I would like to call attention to the fact that so far in these hearings no witness has supported the present bill as now drawn without amendments.

Senator KERR. Say that again.

Mr. McCLATCHEY. So far in these hearings no industry witness has supported the present bill as now drawn without suggesting substantial amendments.

Senator KERR. Have you figured up the sum total of the deductions that would be obtained if all of the amendments were adopted?

Mr. McCLATCHEY. No, sir, I have not, Mr. Chairman.

Senator KERR. I am going to ask somebody that is an expert in that field to do it for me when the hearings are over and see if the bill then as amended by the suggestions would add to the surplus or the deficit. [Laughter.]

Senator ANDERSON. I am prepared to say the Senator from Oklahoma, as near as I can see, came out with a new term known as the "negative."

Mr. McCLATCHEY. I may also remark that the bill in my opinion as now drawn is so confusing and complicated that at the least it is bound to result in very extensive litigation.

We are making our criticism of this measure in the face of a hammer over the heads of the industry in that we are told in effect either take this bill or pay under the 1942 act, which is admittedly a challenging set of alternatives.

First, we think that this bill is excessive for the present earnings of the industry. The gains from operations of the industry I have been reliably informed will amount to approximately $1¼ billion for 1958 before any taxes, Federal, State or local, are deducted.

Senator ANDERSON. Where do you get that figure?

Mr. McCLATCHEY. I believe that came—Mr. Roberts can give you that information.

Mr. ROBERTS. Those were the figures used by the Treasury from some estimates I think from the Institute of Life Insurance.

Senator KERR. I believe that was the estimate Mr. Lindsay gave us.

Mr. McCLATCHEY. State taxes will amount to about $300 million leaving a balance of $950 million from which under this bill the Treasury would take in excess of 58 percent without any allowance for tax-exempt interest.

We believe that this is obviously an excessive amount. There are probably other witnesses who have developed or will develop the thesis of excessive taxation as it affects the economy of the country and the people who are dependent upon the institution of life insurance for their welfare.

We will talk predominantly about the competitive aspects of this measure, and I would like to omit the portions of my talk which deal with the history of life insurance taxation since that is well within the knowledge of the committee.

The present bill is a hodgepole of previously abandoned and unworkable laws. It discriminates in our opinion very heavily against small companies in competition for reasons we will give, and we feel that it discriminates against stock companies, as compared to mutual companies, and that it destroys the historic competitive relationship within the industry.

Further, it exempts broad segments of the industry from any tax whatsoever. It allows some companies an artificial deduction based on industry averages not practically available to other companies. And finally, while it cannot go off the board as rapidly in a time of declining interest rate as the 1942 bill did, it can in fact cease producing revenue and is unstable as a permanent tax bill.

As a competitive weapon against smaller companies, it provides the large mutual companies with special exemptions that can reduce their taxes by a third and does reduce their taxes under the bill as now drawn beginning in 1959 very appreciably.

Against the stock companies it adds an additional tax that mutual companies do not have to pay.

An examination of the five largest companies writing pension plans and the five largest companies not writing pension plans will show at a glance the disadvantage which those not in the pension business will face under this bill. Further, an examination of this proposed law and the 1956 stopgap as applied to 1947 and 1948 will show that this bill in those years, would have produced almost nothing against very substantial sums under the measure in effect in 1957 which would have been produced during those 2 years.

This association recommends that in view of these criticisms, instead of this measure with its ramifications and involvements which we submit it would take a carload of skilled actuaries to interpret, that the Mills stopgap be enacted into law as permanent legislation at a rate that will reflect accurately and fairly a tax upon the profits of the industry and satisfy the needs of the Treasury and at the same time furnish a simple and clear bill.

This association three times has maintained this position in these hearings, and we still maintain this position. First, an investment income approach is the only method that preserves the competitive relationships between all kinds of companies, big and small, stock and mutual, participating and nonparticipating.

Two, the Treasury will never develop and cannot develop a workable true corporate total income measure, and this measure we feel does not fulfill this requirement.

Three, while the Mills-Curtis stopgap in our opinion is the best piece of legislation yet devised in this field, we recognize it does not meet the Treasury requirements for production of revenue at this time. Estimating that the true 1958 profits after State and local taxes of life companies——

Senator KERR. May I interrupt you right there?

Mr. McCLATCHEY. Yes, sir.

Senator KERR. I don't ordinarily do it and I don't want to. I have just been advised that the Treasury said that gains from operations in 1958 will amount to $1,250 million after and not before deduction of State and local taxes.

Mr. McCLATCHEY. Well, I had the figure the other way. We would add $300 million to what I stated to get the correct figure, then, yes, sir.

Senator KERR. I believe a representative of the Treasury is right here. Will you identify yourself for the record?

Mr. WOODWARD. Mr. Slitor.

Senator KERR. Here he is right here. What is your name?

Mr. SLITOR. Richard Slitor, tax analysis staff, Treasury Department. I think the correct figure is about $1,200 million after deduction of all State and local taxes.

Senator KERR. I knew you would want that information.

Mr. McCLATCHEY. Yes, sir. My figures, then, are about $300 million off to that extent. I did not take the taxes off.

Senator ANDERSON. Would that be a correct statement? If the Treasury figure is correct—and I am calling on my memory, aren't the State taxes and other taxes about $300 million, then? Don't you have to add another $250 million for Federal taxes to get up to this figure? I thought that the $1.2 billion was a net figure and your statement doesn't read it as a net figure. It could be regarded as gross income. The Treasury statement for 1958 described the industry as having had net investment income of $3.75 billion, total income from premiums and investments of around $20 billion, and a net operating gain of $1.2 billion. Now, that is after taxes and dividends, isn't it?

Mr. McCLATCHEY. I had been given the figure the other way, Senator. If I am in error, I apologize for the figure.

Senator ANDERSON. I am not asking for an apology. I am merely trying to get the record straight on it. I am informed that I am wrong, that it is State and local taxes only.

Senator KERR. After State and local taxes.

Senator ANDERSON. And before Federal taxes. But it is after dividends, is it not?

Mr. McCLATCHEY. It would be a very substantial percentage of the revenue for taxes.

We propose a measure that we feel would yield, if our recommendation is adopted as to the pensions, which I will come to in a moment, we propose a measure that would yield $450 million on 1958 income on a basis of taxing 10 percent of the investment income up to $250,000, 15 percent of the next $1,250,000, and 22 percent of the excess, taxing every dollar of investment income, whether from the reserves, based on the quota of industrial policyholders, or the millions in pension funds.

We submit that that plan is the fairest that can be adopted. But if the Congress finds that this is still not enough yield, they can adjust that formula, for example, to 10, 16, and 22 percent and obtain a yield in excess of $500 million.

If the Senate, if this body decides that it is necessary or advisable to proceed by amending the present measure rather than following our first recommendation, that is rather simple. It could be done by substituting for part 1 as now drawn a Mills-type formula at 10, 16, 22 level or at the larger formula if deemed advisable, exempting no reserves whatsoever, and thereby eliminating the $60 million tax rebate to a handful of large companies provided in the bill in the pension deduction as well as eliminating the 10 percent or more rebate to a group of large companies provided by use of the industry average as a tax base instead of their own figures as has already been discussed by other witnesses. And this would produce out of part 1 we estimate a yield of $470 million.

The small company deductions should then be adjusted approximately in part 2 to avoid small companies paying a tax in part 2 as a result of the deduction afforded them in part 1.

The Treasury has decided just before this measure was adopted in final form that it could forego in future years the $60 million in review from taxation on pensions, and despite that, we feel that the burden of taxation in the industry ought to be spread over all forms of life insurance and not be exclusively imposed upon those contracts that protect families from destitution. We feel that if an item is life insurance, it ought to be taxed as such. We take the position that if pensions are not insurance, life insurance companies ought not to write them. If they are properly insurance contracts, they should be taxed like other insurance contracts. And that was the view that this Senate took when the Mills-Curtis stopgap came to this body, and struck out these exemptions after you saw the figures on the tax reduction that would be given to a handful of big companies while the taxes were going up on their smaller competitors.

Competitively in our view the exemption of pensions from taxation means that the enormous profits in this field can be used and would be used to destroy competitors in other lines of business. They can take the money that they save from those exemptions and use it to increase dividends on other insurance contracts. They can use this free grant to promote their sales. They can tie tax-free pensions in with group and group-accident-health contracts, package deals that will eliminate forever small competition in the group business.

It seems most inequitable to us that the taxes of the largest companies in America should be actually reduced under this bill when full effect is given to this pension deduction while their smaller competitors have a tax increase of 70 percent or more.

We also ask that the Senate consider other implications. To succeed in this pension field, a company must be large. As a practical matter it must also be licensed in New York State. Of 604 companies with less than $50 million assets, all of whose reports are available in Best's, only five are engaged in any way in the pension business. Almost no companies in the South, the Southeast, the Mountain States or the Far West are engaged in these operations. It is, practically speaking, confined to five Eastern States.

The geographic impact upon the economy of the country ought not to be disregarded for the small regional companies which we think are necessary to an orderly decentralization of industry and finance as Congress has repeatedly approved as a desirable public policy and essential to the national welfare and defense.

We believe sincerely that the elimination of the tax on pension annuities together with similar exemptions which could logically be pressed along this line and which, as a matter of fact, have already been pressed and suggested by some witnesses along the same line, if adopted, would be the death knell in fact of small companies throughout the Nation which are not in a position to write pension business.

Then, there are revisions we recommend in part 2. The first is an obvious recommendation to permit companies to carry over the deduction from part 1 upon the basis of the maximum rate so that the differential for small companies will not be lost. And this parallels and ought to be a substitute for the small-business deduction provided in part 2 of the bill as now presently written.

Then there is another suggestion in part 2 which we feel was an oversight in the bill as now drawn. The special reserve or surplus provision for group insurance or group-accident and health insurance of 2 percent is provided among the deductions in part 2. Apparently by inadvertence a similar provision for other accident and health insurance not of a group character was not made. We feel that this was an oversight since provision was made for noncancellable and guaranteed renewable accident and health contracts. It is equally necessary in our view that provision be made for individual accident and health of all kinds, whether cancellable or term.

We recommend that since it is desirable to reach the sometimes exceptional profits of specialty companies that sell almost nothing but term contracts and windfalls that occasionally occur in individual companies, a section be provided that will guarantee an appropriate tax from such companies under such conditions. This can probably best be done by relating operating gains to investment income.

Several other methods have been suggested. I believe Mr. Curtis suggested two or three methods in the House testimony, and we feel that this method is preferable for arriving at this result without going into this very complicated and involved method which is presented in the pending bill.

During all the prolonged discussions of a Federal income tax for life insurance companies, there was never an intimation that the Treasury would seek to tax stock companies more heavily or in any way differently from mutual companies. In the original printed draft of the House measure there was no part 3. It was first presented very recently and there were no hearings in the House on the bill as it has been passed.

We submit that part 3 ought not to become the law. We think, our association does, that it is contrary to nearly 50 years of policy on the part of the Treasury and the Congress and we believe it is unsound as a matter of theory and that it is a penalty against the public policy in favor of making dividend distributions.

We feel that is establishes a very dangerous precedent. It is conceded, I believe, that it is not expected to raise more than a very small amount of money. A hasty estimate shows that in our group of companies we feel that it will be a very long time before any of our companies will probably be called upon to pay a tax under this section. As a tax measure it seems that it will reach only a few companies in the entire Nation which can in our view be better reached by other devices.

Nevertheless, we feel that it totally confuses the accounting procedures of a life insurance company. It might prove an effective bar or at least an impediment to sales, liquidations, reinsurance, or mutualizations of such companies. It almost inevitably requires some form of regulation by the Federal Government of life insurance, which is a policy the Congress has decided that it does not want to go into.

Now, as to the respective yields of these measures. According to the Treasury estimates, 4245 would yield $545 million in 1958. I think it is fairly clear that this estimate has to be reduced about $35 million to provide fully for tax exempt interest due to the testimony of the witness this morning which I feel this committee will find to be a necessity.

On the basis of the 1958 income this amount will drop further $20 million yearly because of the exclusion of pension fund reserves from the tax to be achieved over a three-year period beginning in 1959.

And that the measure by the end of the fourth year might drop down, probably will drop down to $450 million.

This $60 million deduction for pensions, as already remarked, will be distributed among a very few of the large companies in the business. We recommend a measure, as already stated, which would produce the same amount of money without any preference to any company, large or small, because of such special exemptions. A larger rate could be adopted as already suggested according to the formula going down to 18 percent which would go above $500 million in each of those 4 years. And that is without considering that the industry will grow. If the projection of the growth of the industry which has been made is correct, this 4245 presumabily would yield some $650 million in 1961, but the revised measure with our amendments with the Mills formula in part 1 would yield $750 million, according to the expected growth of the industry.

We do not believe, gentlemen, that with the measure in its present form it will produce the yield that theoretically it should. We think that the more stable total investment income approach would show the same steady climbing yield that it has shown in the past years. We have not gone into the probable effect of this measure upon Government financing. It is the considered opinion of those who have advised us in this field that the heavy premium it puts upon ownership by life insurance companies of municipals and other tax exempts will result in drastic changes in the portfolios of life companies, and that in consequence the cost of financing the Federal debt will be substantially increased.

Since our experts disagree, as all experts do, as to the extent of the increase, we will make no statement along that line. However, the shift to high interest rate mortgages on the one hand and low yield tax exempts on the other in a ratio calculated to eliminate all tax under part 2 of the proposed measure may be expected on the part of many prudent managers. They would be unfair to their policyholders and their stockholders if their investment portfolios did not produce the best results for the company. There is no such premium upon tax exempts under the Mills-Curtis type of formula. There will be certain advantages both in certainty of tax yield to the Government and in the avoiding of dislocation of the present competitive relationships within the industry.

We feel that these more than cancel out the possible problematic highly speculated graded yield under the proposed measure even though it should be fairly and reasonably amended. Thank you.

Senator KERR. Thank you, Mr. McClatchey.

Now, we talk about the exemption of pensions from taxation. Am I correct in assuming or understanding that you are referring to the existing tax on pension plan income to life insurance companies?

Mr. McCLATCHEY. Yes, sir.

Senator KERR. Not on the pensions.

Mr. McCLATCHEY. No, sir. It is on the income of the insurance companies from pensions.

Senator KERR. Now, what tax rate do trust companies handling these pension plans now pay on their properties?

Mr. McCLATCHEY. The banks and trust companies themselves pay a regular corporate tax, Mr. Chairman. The plans are themselves tax exempt. However, it is our position, sir, that there are many things a life insurance company can do that a bank cannot do, and that there are banks and that there are insurance companies.

Senator KERR. Well, is the tax on a trust company, as to its profits in handling one of these pension plans, the same today as it was with reference to a life insurance company?

Mr. McCLATCHEY. The plan itself——

Senator KERR. I am talking about the tax on the trust company on the one hand and the tax on the insurance company on the other.

Mr. McCLATCHEY. Sir, I believe the fee the bank would get for handling it would be subject to a regular corporate tax.

Senator KERR. Well, now, you are talking about the exemption of $60 million in taxes. I gathered from your statement that that is the amount that without this bill the insurance companies would pay.

Mr. McCLATCHEY. Yes, sir. This bill when given full exemption——

Senator KERR. What does that come out of?

Mr. McCLATCHEY. It is a deduction which companies which write group insurance annuities are permitted to take under this bill.

Senator KERR. Deductions from what?

Mr. McCLATCHEY. From their investment income.

Senator KERR. From their tax liability?

Mr. McCLATCHEY. It would be a tax liability without the deduction in the bill, yes, sir.

Senator KERR. Well, then, if it becomes a reduction, it is a reduction of tax liability, isn't it?

Mr. McCLATCHEY. Yes, sir. That is correct.

Senator KERR. Now is that tax liability currently on the insurance company?

Mr. McCLATCHEY. Yes, sir.

Senator KERR. Well, what source of money is subjected to that tax?

Mr. McCLATCHEY. I didn't understand.

Senator KERR. What source of revenue or money, assets, is it that is taxed to that extent under current law?

Mr. McCLATCHEY. It is the insurance companies' income from writing group annuities.

Senator KERR. Now you mean—is your term "group annuities" the same as the term "pension plans" that you did use?

Mr. McCLATCHEY. Yes, sir.

Senator KERR. Don't shift on me like that. You lose me, sir.

Mr. McCLATCHEY. All right. May I ask permission to ask Mr. Roberts—I know he is a little more familiar with that than I.

Mr. ROBERTS. Strictly speaking, Senator Kerr, group annuities and pension plans are not identical because group annuities are a form of paying pensions. But there is also another insurance company use method of handling pension funds that is the positive agreement type where——

Senator KERR. Which one is he talking about?

Mr. ROBERTS. Both of them are treated the same under H.R. 4245 and have been treated the same under past laws. They have been—the presumed profits of the life insurance companies, from the handling of these funds, have been treated just like any other presumed profits of life insurance companies and are subject to tax. The proposal is to exempt an amount of interest from taxation equal to the amount of interest on the reserves held for that purpose which amounts to an exclusion of any tax upon pension funds, and it is the position outlined by Mr. McClatchey that we do not think that if the pension business, that is to say group annuity or deposit type, is an insurance business, then it ought to be taxed as insurance. If it is not an insurance company, insurance companies ought not to write it.

There is a profit to it from the company, and that profit has been reached in all previous bills. In fact, the Senate amended the so-called Mills-Curtis stopgap in 1956 to strike out the pension exemptions because they felt at that time—and the House accepted that view—that there were profits to the insurance industry from pensions, from the handling of pension business. To exempt them, of course, might create an imbalance elsewhere, though we are not precisely concerned with that. But other institutions operating on a fee basis do pay a tax on the profits they deprive from handling pensions, although the actual interest on the pensions is tax free.

However, that is the situation, for example, about the purchase of a fixed rate policy of pension insurance which is a group annuity, annuities matured from trusteed plans or anything else, let us assume, say, at 3 percent. If the company has a greater yield than 3 percent, obviously the surplus or excess interest is that much profit to the company just as it would be in any other form. And many companies do write guaranteed plans of that kind. In fact, most of them do. In fact, all of them do. I don't know of one that writes any other type.

Trustee plans, of course, depend on entirely different factors. The reason one goes to an insurance company is because an insurance company guarantees, whereas a trustee plan cannot guarantee to the same extent.

Senator KERR. I am sure that the statement you have made is responsive to my question, but with my limited knowledge I haven't figured out the connection between the two.

Mr. ROBERTS. We are merely seeking, Senator Kerr, to pay taxes on the money that we make out of pension plans.

Senator KERR. Well, I thought you said that you didn't write any. I thought the witness said that you didn't write any.

Mr. McCLATCHEY. We are seeking for all forms of life insurance to be taxed, Senator, without special deductions for——

Senator KERR. What did you say about writing——

Mr. McCLATCHEY. I said there are only a few very large companies that, in fact, do write them. There are no companies——

Senator KERR. Who did you say you were representing?

Mr. McCLATCHEY. An association of small- and medium-sized life insurance companies, some 120 life insurance companies.

Senator KERR. Now how many of them write these——

Mr. McCLATCHEY. Not any of them, sir.

Senator KERR. Well, if you don't write any of it out, how are you in competition with these fellows that do?

Mr. McCLATCHEY. We are in competition with all life insurance companies in other fields, and this exemption unfairly discriminates, in our view, in that they have a deduction in their business which we do not have. They are enabled—they pay less tax according to their income and according to their insurance than we have to pay.

Senator KERR. I am going to have trouble following you if you don't address yourself to my questions, see? And if you leave that—it is wonderful. I know it is informative, but in trying to keep my mind on the question and then reaching out there at the same time, I am worse than the fellow riding two horses going in different directions, in following you and thinking about my question. And if you would just answer my question, it would be very helpful.

You said competitively the exemptions of pensions from taxation means that the enormous profit from this field can be used and would be used to destroy competitors in other lines of business.

Now I take it that you are referring there to something in this bill that frees from taxation some revenue now being derived by somebody.

Mr. MCCLATCHEY. That is correct.

Senator KERR. And I asked you what was the comparison between the status of the ones you are talking about here and others engaged in the same business, which I thought I knew but which I am not right sure now that I do after your expert's answer there, and that is, the writing or handling of these pensions. Name them for me.

Mr. ROBERTS. You want the names of companies primarily writing pension business?

Senator KERR. No; for the moment I want to know what it is they write. What is it that produces this enormous profit?

Mr. ROBERTS. Well, there is a very considerable profit derived from pension business.

Senator KERR. Are you familiar with this statement?

Mr. ROBERTS. Yes. There are—in the pension business now——

Senator KERR. The enormous profits from this field. I am just trying to get down here on a piece of paper what the field is.

Mr. ROBERTS. Let me give you an illustration from one company, then, Senator.

Senator KERR. Let us name the field.

Mr. ROBERTS. The pension field earned for one company on its operating statement——

Senator KERR. You know you are trying to filibuster me. You are not trying to answer my question.

Mr. ROBERTS. I am trying to answer your question.

Senator KERR. What is the field you are speaking about?

Mr. ROBERTS. Pensions, pension plans as written by life insurance companies.

Senator KERR. Pension plans. What is it? Just name it briefly.

Mr. ROBERTS. Pension plans written by life insurance companies.

Senator KERR. Stop right there while I write it down.

Now, is the situation one that here are 120 companies that can't write them?

Mr. ROBERTS. As a practical matter, sir, very few small companies can compete in the pension plan field, but they do compete with the large companies that write pension plans in the group field, and if pensions are exempt, they can be packaged in a group.

Senator KERR. Let us talk about the pension plans.

Mr. ROBERTS. As a practical matter small companies can't go into the pension field.

Senator KERR. Now, who else is in that field?

Mr. ROBERTS. In the pension field there are individual trusteed plans that handle pensions in a different fashion from life insurance companies, but they do handle pension plans.

Senator KERR. There have been witnesses here, and I am sure you have heard them, that talked about losing business in this field to trust companies. Now, were they talking about something else or did I get the wrong impression of what they were talking about when I thought they were talking about the same thing?

Mr. ROBERTS. Well, sir, there are also trust companies that lose business to insurance companies in the pension field. It is a highly competitive field and both of them make money out of that.

Senator KERR. That wasn't the question I asked you, was it?

Mr. ROBERTS. I thought so.

Senator KERR. No; I asked you if that is what they were talking about losing business on.

Mr. ROBERTS. Yes, sir.

Senator KERR. And you said there are trust companies that lose business to life companies.

Mr. ROBERTS. Yes, sir. Both ways. There are always changes in the field and it is intensely competitive every day. I do not think as a whole that one is losing to the other percentagewise very much.

Senator KERR. Now, do the life insurance companies now pay tax on the profits they make on the pension plans written by life companies?

Mr. ROBERTS. Yes, sir.

Senator KERR. Do the trust companies pay any Federal tax on the profits they make on pension plans written by trust companies?

Mr. ROBERTS. Yes, sir.

Senator ANDERSON. What is that?

Senator CURTIS. Would you yield right there, Mr. Chairman?

Senator KERR. Yes.

Senator CURTIS. Do the banks and trust companies pay a tax on the interest increment of the trust fund?

Mr. ROBERTS. No, sir.

Senator CURTIS. Now, if the insurance company exemption is not placed in the bill, will the interest increment for the benefit of the pensioners be taxed?

Mr. ROBERTS. I do not think so because you buy an annuity contract whether it is group or individual just as you buy any other insurance contract, and the company makes a profit on it. That would be true under any circumstances. Pension trust funds, many of them, eventuate in the purchase of individual annuities to insurance companies, but they don't pay any tax on the interest at any time, but the trustee pays a tax on the profits he makes.

Senator KERR. Now, without this exemption the insurance companies would not be paying any interest on the interest growth of that pension reserve they have?

Mr. ROBERTS. Senator, I am not sure that I quite understand that, Senator Curtis.

Senator CURTIS. Is it your contention that without this amendment the insurance companies would not be paying a tax——

Mr. ROBERTS. On their profit, no, sir.

Senator CURTIS. On the interest increment to the trust fund reserves? To the pension reserves?

Mr. ROBERTS. I still do not understand the Senator's question.

Senator CURTIS. All right. Is it true that money placed in one plan—its growth by reason of interest would be taxed——

Mr. ROBERTS. No, sir.

Senator CURTIS. If it is handled by an insurance company and the growth by reason of interest if it is trusteed would not be taxed without this amendment.

Mr. ROBERTS. May I assume a case to make it clear? An insurance company guarantees to pay a fixed return on which the annuity is based. It receives a fixed premium. The money goes into the general reserves of the company and might be invested, for all I know, fully in tax exempts. The trustees' funds are held together in one pot. All of the interest—if the interest rate drops below 3 percent, then the person using the trustee plan must make up the difference. If he is dealing with an insurance company, he would not have to make up the difference because the insurance company is guaranteeing the contract.

On the other hand, the trustee does not receive any excess interest whereas the insurance company would receive excess interest developing between his assumed rate and the rate that he actually received on the interest. That is where excess interest is created in an insurance company.

Senator CURTIS. That is all, Mr. Chairman.

Senator KERR. I would like to have the contribution of the Treasury representative, Mr. Slitor, to this question. We are talking, as I am sure you have gathered, about pension plans written by life companies and similar business transactions by trust companies.

Now, I have gathered from what I have been told and heard that certain profits made on that operation by the life insurance companies currently are being taxed while those by the trust companies are not being taxed. Now, either confirm that or correct it and enlighten me on it.

Mr. SLITOR. It is true that under present law the net investment income of a life insurance company from all sources and allocable to any type of business is taxed after——

Senator KERR. I am addressing myself solely to pension plans written by life companies and similar plans written by competitors.

Mr. SLITOR. Yes, sir. And I am trying to point out that the net investment income, the entire net investment income including that part attributable to pension plan business is taxed in the same manner. It is subject to——

Senator KERR. You mean in a life insurance company.

Mr. SLITOR. In a life insurance company. It is taxed after a deduction in 1958 under prevailing law of about 75½ percent. So that about 24½ percent of that net investment income is subject to the regular corporate rate of 52 percent.

Senator KERR. Now, what about the same gain in the hands of a trust company?

Mr. SLITOR. The net investment earnings of a qualified pension trust would be entirely exempt.

Senator KERR. If a trust company had it.

Mr. SLITOR. Yes.

Senator KERR. Now, that is true today everywhere, any trust company in the United States?

Mr. SLITOR. If the pension plan is a qualified plan. If the pension trust is qualified.

Senator KERR. Well, now, is that rule of eligibility applicable to the insurance company operation under current law and under the proposed bill, H.R. 4245?

Mr. SLITOR. Well, under current law there is no distinction in the tax treatment of this net investment income whether it relates to a qualified plan or any other plan or any other type of insurance business. Under the bill the proposed exemption is limited to the net investment income which is allocable to the reserves under qualified pension plans.

Senator KERR. Which would be identical with those now being handled by trust companies.

Mr. SLITOR. And which are exempt; yes, sir.

Senator KERR. But still identical to those now being handled by trust companies.

Mr. SLITOR. Yes, sir.

Senator KERR. And since they are under current law exempt in the hands of trust companies, the principle in this bill is to bring about a situation in a period of 2 or 3 years where they will be treated identically if in the hands of an insurance company?

Mr. SLITOR. Yes, sir.

Senator KERR. Mr. Witness, do you accept that?

Senator GORE. Mr. Chairman, would you yield for a question there?

Senator KERR. Yes.

Senator GORE. The same would prevail with respect to a bank that was trusteed, is that true? Would a bank that is trusteed be in the same position as a trust company?

Mr. SLITOR. Yes, sir.

Senator GORE. Thank you.

Senator KERR. What was the answer to the Senator's question?

Mr. SLITOR. Yes.

Senator KERR. Now, does the witness accept the statement made by the representative of the Treasury as accurate?

Mr. ROBERTS. That statement is accurate.

Senator KERR. Stop right there.

Mr. ROBERTS. That statement is accurate but the profits or the fees paid to banks or trust companies are subject to tax. There are no such fees that I know of paid to insurance companies on the premiums, and——

Senator KERR. Now, does the "but" that you gave me change the verification of the accuracy of the statement by the representative of the Treasury?

Mr. ROBERTS. To a very slight extent, sir. The banks pay a tax on the profits derived from handling pension business. Under this law insurance companies would pay no tax upon the profits, or very slight tax upon the profits of handling the business.

Senator KERR. Well, now, don't the insurance companies get any fees?

Mr. ROBERTS. They receive premiums. The premium represents the fee and the amount that goes into the reserve, the amount that goes into contingency funds, and everything, they use an element of profit in the premium that is paid them. Banks receive a flat fee.

That fee is taxed. The tax under the previous formula assumed that a profit on pension plans was approximately the profit on the other forms of life insurance, and that is one of the objections we have basically to this new type bill, that it does distinguish between different kinds of insurance and makes you have to plow around to see where the profit was here and there, whereas the flat formula basis inevitably reached all the profit very readily without quite so much difficulty.

Senator KERR. Well, I want to tell you that that difficulty is remote compared to the difficulty I have in following your answer. [Laughter.]

Mr. ROBERTS. Sorry.

Senator KERR. Now let's get back to the question I asked you. Do you accept the accuracy of the statement made by the representative of the Treasury?

Mr. ROBERTS. Oh, certainly.

Senator KERR. All right. Now just stop right there. Now, even if this bill is enacted, is it not possible or probable that after this exemption to which the witness has referred becomes fully effective there will still be money made by the insurance company that will be captured in step 2 of this bill with reference to the pension plans?

Mr. ROBERTS. It is possible to capture some of that profit in part 2.

Senator KERR. Wait a minute. Isn't it possible that there will be profit in that operation which will be made subject to taxes by reason of being captured by step 2 in the bill?

Mr. ROBERTS. Yes, sir.

Senator KERR. Now, then, with reference to a similar situation handled by a trust company, the only tax they pay is on the fee that is paid them for handling it.

Mr. ROBERTS. On the profit they made from handling it, yes, sir.

Senator KERR. Well, is the answer yes or no?

Mr. ROBERTS. "Yes," sir.

Senator KERR. The only tax in their hands is on the fee they charge for handling it.

Mr. ROBERTS. Yes; that is correct.

Senator KERR. The profit they make on it is added to the asset of the trust itself and becomes the profit of the ones for whom it is established.

Mr. ROBERTS. The profit the firm makes, not the profit that the institution makes.

Senator KERR. That is what I was talking about.

Mr. ROBERTS. Yes, sir.

Senator KERR. Now, in the hands of the insurance company the profit they make on it goes to pay the guaranteed amount which they have agreed to pay to the trust?

Mr. ROBERTS. Yes, sir.

Senator KERR. Now, they have told us here that their competitive position is adversely affected and we have had evidence to the effect that as of 1950 insured reserves and trust funds of private pension plans were in about the same amounts, that is, insured reserves in the hands of insurance companies, $5,575 million; trust funds, $5,750 million, with the ratio of 49.23 on the one hand and trusteed in the amount of 50.77; that in 1957 it had grown to where the ratio was

40.84 in the insured portion and 59.16 in the trusteed, percentagewise, and I have been advised that Mr. Natrella of the Securities and Exchange Commission in 1957 estimated this proportion will be 20 percent in the insured and 80 percent in the trusteed by 1965.

Are you sufficiently familiar with the facts and the statistics to tell me whether those statements are valid and worthy of acceptance?

Mr. ROBERTS. I wouldn't undertake to discuss the validity of the projection. The figures quoted for prior years are correct.

Senator KERR. Now, is the statement of witnesses here that the growing—the increasing percentage of these funds that are trusteed as compared to those that are insured is due to the tax feature incident to the insurance company operation not applicable to the trusteed operation?

Mr. ROBERTS. I do not think so, sir. Let me give—let me say that trustee plans may make investments that may not be made by insurance companies. For example, a very large part of the funds for Sears employees, just to be illustrative, is invested in Sears stock which would not in that percentage be a valid investment for life companies. Because of the limitation on life insurance company investments, trustee funds can usually earn more. The advantage of an insurance type plan is that it has a guarantee backed by the great solvency of the company, that more than makes up for the slightly higher yield that may be obtained. That is largely for smaller plans. In the very large plans where there is a very heavy investment in common stocks, not permissible for life insurance companies, they can earn more money through the trustee plan. I think that is why so many of the very large plans are trusteed. They can make much broader investments. They are not limited to certain types of stocks, bonds, and mortgages at low valuation bases.

Senator KERR. Low return bases.

Mr. ROBERTS. Relative low return bases.

Senator KERR. In other words, then, you do not think the argument that the tax differential having contributed to this increased disparity is valid.

Mr. ROBERTS. I do not think that it contributes to it, Senator.

Senator KERR. You see, I find some statements here by the witness which, based on information before me, is subject to correction, and having found some of them of that kind, naturally I wonder if maybe other statements with reference to which I don't know might also be subject to correction.

For instance, in speaking of part 3, the witness said:

> The Treasury concedes that the Treasury can raise almost no money.

Now the statement of the Treasury was that it would raise $50 million a year, was it not?

Mr. SLITOR. Are you referring to step 3 of the bill?

Senator KERR. Yes, sir.

Mr. SLITOR. The Treasury has not indicated a firm estimate of the revenue under that part of the bill in future years. We have indicated a range of which $50 million is the upper limit.

Senator KERR. On the basis of current earnings?

Mr. SLITOR. On the basis of current income levels.

Senator LONG. What is the lower limit of that range?

Mr. SLITOR. I suppose the lower limit is zero.

Senator LONG. Zero, yes; I just wanted to get that straight.

Senator KERR. You say:

We recommend that this measure be junked and that the Mills-Curtis stopgap be enacted into law as permanent legislation at a rate that will reflect accurately the tax upon the true profits of the industry.

What rate of taxation does the Mills-Curtis stopgap provide with reference to investment income?

Mr. ROBERTS. The present bill is 12.5 percent on the first——

Senator KERR. Is that the present Mills-Curtis stopgap?

Mr. ROBERTS. Yes, sir, and 15 percent thereafter, and therefore 20 percent of the top bracket of the bill would increase the yield precisely a third.

Senator KERR. I am not talking about what something would do.

Mr. ROBERTS. The present one is 12.5, 15, Senator Kerr.

Senator KERR. Let's stay with that. Now that is with reference to investment income, is it not?

Mr. ROBERTS. Yes, sir.

Senator KERR. What rate of taxation does it apply to underwriting profits?

Mr. ROBERTS. It was the assumption of both the previous stopgap and the Mills-Curtis stopgap that the total profits, not investment profits, under the 1942 tax law went into what is excess interest, Senator Kerr. The theory behind the Mills-Curtis stopgap and behind the earlier stopgap was that the total profits were measurable by a formula based on total investment income, and they fixed, frankly, too low a rate, as we said here 12 months ago.

Senator KERR. Well, now, a member of the staff tells me that the Mills-Curtis stopgap provided no tax rate on any——

Mr. ROBERTS. It has no direct tax upon underwriting; no, sir, except a very limited tax on companies less than 10 years old.

Senator KERR. Well, now, the information I get from him is that it has no tax on anything but investment income.

Mr. ROBERTS. I think that their prescribed theory, Senator Kerr, was that they measured profits through investment income. I think that is kind of beating the devil around the bush, but they assumed——

Senator KERR. Well, now, they didn't beat him very hard if they only beat him around the bush. [Laughter.]

Mr. ROBERTS. I don't think so, because a year ago, Senator, when we appeared here, we said very frankly, this association did, that the taxes on the industry were somewhat too low, and we said so at the House hearings.

Senator KERR. Aside from what it did to the devil, what did it do to underwriting profits?

Mr. ROBERTS. Underwriting profits, as such, have not been taxed in the life insurance industry since either 1918 or 1919, because it was discovered by the Treasury at that time that a total income approach bill could not be written. We said here a year ago they couldn't write a total income approach bill, and they can't write one, I do not think.

So they went at that time to what they called the excess interest measure, which is a form of investment income approach, and they have used that in every year starting with 1920.

Senator KERR. Then, is it a fact that the Mills-Curtis stopgap does not place any tax on underwriting profits?

Mr. ROBERTS. It does not place a tax on underwriting profits, as such.

Senator KERR. Does it place a tax on underwriting profits?

Mr. ROBERTS. I think it does, Senator. Because it places a tax upon insurance companies, that is estimated to be a tax upon their profits.

Senator KERR. Well, it applies only to investment income.

Mr. ROBERTS. Yes, sir, it applies to investment income, however, as a measure—of profits.

Senator KERR. What would that do to a company that had no reserves?

Mr. ROBERTS. That is what caused us——

Senator KERR. I say, what would that do to a company that has no reserves?

Mr. ROBERTS. There are few companies of that kind, but it gives them a free ride.

Senator KERR. What would that do to a company that has no reserves?

Mr. ROBERTS. It would give them a free ride.

Senator KERR. They would have no tax?

Mr. ROBERTS. I am afraid it would have almost no tax.

Senator KERR. Well, you are afraid it would have almost no tax. Would it have any?

Mr. ROBERTS. Well, they would have some investments as required by law for capital surplus, but investments are very negligible and there are perhaps 20 such companies in the country.

Senator KERR. Then the recommendation that the witness has made would be that there would be no tax on that company?

Mr. ROBERTS. No, sir. We have recommended that there be a provision under the law to catch the so-called specialty companies, and also to catch some companies that may have windfalls, and while I know of no windfall cases that have occurred in the last 2 or 3 years, there were windfall cases in the late thirties in a good many companies, large and small, and we think they ought to be taxed, and by relating operating gains to investment income you catch them.

Senator KERR. He says:

The National Association of Life Companies has a recommendation. We recommend that this measure be junked and that the Mills-Curtis stopgap be enacted into law as permanent legislation at a rate that will reflect accurately the tax upon the true profits of the industry.

I must say to you that I understand that——

Mr. ROBERTS. Senator, we state:

We recommend that——

Senator KERR. Just go along with me.

Mr. ROBERTS. Yes, sir.

We recommend that, since it is desirable to reach the sometimes exceptional profits of specialty companies that sell almost nothing but term contracts, and windfalls that might occasionally occur in individual companies, that a section be provided that will guarantee an appropriate tax from such companies under such conditions; this can probably best be done by relating operating gains to taxable investment income.

Senator KERR [reading]:

> * * * this can probably best be done by relating operating gains to taxable investment income.

Does this mean by limiting the tax to taxable investment income?

Mr. ROBERTS. No, sir. It means that if—let me illustrate, please, Senator.

If the investment income of the specialty company subject to tax was, say, $10,000 or $12,000, which it well might be, and the company made $300,000 or $400,000, we would propose that they be taxed upon a very large section of the excess of their operating gains over the taxable investment income.

It is true that in a normal company operating gains do not always very accurately reflect profits, but in a specialty company the difference between operating gains and true profits is very negligible, and it is fair to take them on that basis, in our judgment.

Senator KERR. What rate would you apply to them?

Mr. ROBERTS. There have been several formulas suggested.

Senator KERR. What rate would you apply to them?

Mr. ROBERTS. However——

Senator KERR. What rate would you apply to them?

Mr. ROBERTS. I think that they should be taxes—there is a little bit more problems, perhaps, than ordinary corporations. I would say ury feels that it needs will, in itself, when that additional special proably 30 to 35 percent on their operating gains. That is only a suggestion. However, lower rates have beeh suggested, and I am not familiar with their specific problems, because I have none among our membership.

Senator KERR. We tax them under this bill on 50 percent of the net gains from operation in excess of their investment income, at the regular corporate rate currently, and then thereafter when either of two contingencies arise, one being that their total gain equals 25 percent of their reserves, the other when their total gain equals 60 percent of their premium, but in any event at such time as any part of that net gain from operation on which taxes have not been paid is passed out to the stockholders in the form of a dividend, or when a compony voluntarily transfers an amount from the policyholders' surplus account, shareholders' surplus account, when a company no longer meets the definition of a life insurance company, in the event of a distribution of debts, shareholders followed by a subsequent retirement of the debt, when a company mutualizes or a stock company becomes a mutual company, or when there is a payment in redemption of stock of one or more stockholders to the extent in excess of the balance in the shareholders' surplus account.

I so say it was a limited endorsement, Senator.

That is all.

Senator Long.

Senator LONG. I found this proposal in this new bill that the Treasury brought before us extremely complicated.

It occurs to me there may be a considerable possibility of loopholes in this thing, because it is so terribly complicated that I can't understand it. I understand that those who speak for a number of companies have attempted to compute their liabilities. If they assign two different accountants, each one comes out with different results, or if they assign three, all three come out with different results.

Is that your experience trying to account for the liability under the proposed bill?

Mr. ROBERTS. I am not an accountant, sir, but I had two actuaries run off roughly the liabilities of one company and they came out pretty far apart, and I then asked two excellent actuaries to work on the tax-exempt problem for me, and I am sorry to say that while they agree with the fine witness of the Minnesota Mutual, there was a tax exemption, they disagree as to whether it was 50 percent or 78 percent, and I have no idea which of their computations is correct, because I got confused somewhere midway between the second and third denominator.

Senator LONG. Let me just ask you this:

Do you know of any instance in which two accountants could sit down with the books of a company and come out with the same results based on this bill, if they are working in different rooms?

Mr. ROBERTS. I doubt it very seriously, Senator Long. I don't think that two accountants or two actuaries could conceivably come out with the same results working from this bill.

Of course, that is perhaps a little unfair, because they have had to work from the bill, and not from Treasury forms, which might simplify, and in a very simple company it could happen once out of a hundred times, maybe.

Senator LONG. Well, from the information I got in Louisiana, the executives of our companies met and had someone explain the bill. They had a big blackboard and diagrams and signs. They tried to work it out, and asked questions, and nobody understood what it was all about by the time they got through explaining it.

So it seems to me the bill proposed is so complicated that if we are going to have something that the people can understand, we need to work from a simpler basis.

What you are suggesting here, at least insofar as it goes, is something we can understand. You simply tax investment income.

Mr. ROBERTS. Well, now, that is what we prefer. However, Senator Long, there is—we have always contended that investment income could be made a measure of the profits of a company. Now that is on a formula, but it can be made a fair formula.

However, there are many people who claim that that is an unfair way to reach it.

Therefore, we have alternatively suggested a part 1 and a part 2 bill, which is very simple. That is to say, the taxing of investment income in part 1, and an effort to reach the gains from underwriting in part 2 by using a lower part 1 than we propose in a single part bill.

I think that a single part bill with a rider to catch the specialty companies, and also to catch the windfalls, is very desirable, because I don't think the specialty companies will be a problem for too many years. The windfalls will be with us always. But it would at least be simple, and this is the most complex piece of tax legislation that I have ever seen.

I haven't seen as much, of course, as the chairman of the committee, who I think said yesterday it was the most complex piece of tax legislation he had seen during his service in the Senate.

Senator LONG. Well, you say here:

> There are certain revisions we recommend in part 2. The first revision that we recommend in part 2 is obvious.

Well, it is not obvious to me, and therefore I would like for you to explain that—

and it is to permit companies to carry over the deduction from part 1 upon the basis of the maximum rate, so that the differential for small companies will not be lost.

Would you try to illustrate that by showing how that would work?

Mr. ROBERTS. Yes, sir.

Senator LONG. So I can put it down here on a pad.

Mr. ROBERTS. Yes, sir.

In the present bill here, Senator, the deduction for small companies occurs in part 1, but because it would result in a balancing of it in part 2, it is taken off again.

Senator LONG. Now, you see that just becomes words to me, which go in one ear and out the other, unless you give me something in terms of dollars and cents to show how it would work.

Mr. ROBERTS. Yes, sir.

Senator LONG. Suppose you assume $100,000 of income, or just any particular figure.

Mr. ROBERTS. Let us assume there is $100,000 of taxable income after you applied either the formula in H.R. 4245 and as we propose, and that the small company——

Senator LONG. You propose that you simply tax investment income without going into the complicated formula?

Mr. ROBERTS. That is true; we would prefer that. We have a phase 2, but if you simplify part 1 it doesn't make any difference. It is very obvious if you have a two-part bill, if you deduct from the taxable income the small business deduction then when you come down and make your deduction for the parts you paid taxes on in part 2, they will lose that deduction, because it will go back into their underwriting profits.

So you have to take it off twice. That is provided in the present bill, but it is necessary, if you use a flat rate to do it in a different fashion. It is relatively simple.

If you tax on 10, 15, 20, for example, when you came down to make your deduction in part 2, you would have to make your deduction all the way across on a 20 basis. That would be the only thing. Otherwise, they would lose their deduction in part 1.

Senator LONG. Well, I believe I understand what you are talking about, but I would just like to try to get that in terms of dollars and cents.

You are saying in part 1 if you had $100,000 of taxable income——

Mr. ROBERTS. Yes, sir.

Senator LONG. You would pay the tax on 24.5 percent of it, if I recall correctly, under the existing law.

Mr. ROBERTS. Something like that; yes, sir.

Senator LONG. And you would pay a 52-percent tax on that part, which would be about 13 percent on the total taxable income, so you would pay a tax of about $13,000, if I understand correctly, under part 1.

Mr. ROBERTS. Yes, sir.

Senator LONG. Now, you say that under part 2——

Mr. ROBERTS. You deduct the part that was taxed from your operating gain.

Senator LONG. You deduct the $100,000 that was taxable, or $13,000 tax that you paid.

Mr. ROBERTS. No; the $100,000 is taxable.

Senator LONG. Yes.

Mr. ROBERTS. And since that would contain the benefit of about $15,000 smaller business deductions, you have to bring down not $100,000, but $115,000, or you would be paying in part 2 tax, too, the $15,000, that was the intention of the bill to exempt. That is provided in the bill, but since we propose a flat-rate formula instead of a more complicated one, it would be necessary to compute it across. It can be done in several other ways, however.

Senator LONG. Those are all the questions I have. Thank you very much.

Senator ANDERSON (presiding). I want to come back to this pension plan a little bit. The statement, I believe, says:

> If an item is life insurance, it ought to be taxed as life insurance.

Will you give us the reverse, if it is not life insurance, do you think it ought to be taxed as life insurance?

Mr. ROBERTS. Yes, sir; if it is life insurance, that is, if it is a business that a life insurance company should be in——

Senator ANDERSON. No, no; if it is life insurance, it ought to be taxed as life insurance. There is a reverse to it, if it is not life insurance it should not be taxed as life insurance.

Mr. ROBERTS. Quite right, Senator, and life insurance companies shouldn't sell it.

Senator ANDERSON. Should not sell it?

Mr. ROBERTS. Not if it is not apropos to the life insurance business.

Senator ANDERSON. Is credit insurance life insurance?

Mr. ROBERTS. Yes, sir.

Senator ANDERSON. Then you don't believe in any life insurance company selling credit insurance?

Mr. MCCLATCHEY. It isn't.

Senator ANDERSON. Oh, no; if it isn't life insurance then we shouldn't sell it, let's be consistent.

Mr. ROBERTS. By credit insurance, you mean life insurance on a debtor.

Senator ANDERSON. Is health insurance life insurance?

Mr. ROBERTS. Accident and health insurance is not life insurance.

Senator ANDERSON. And no life insurance company should sell it?

Mr. ROBERTS. Most life insurance companies sell——

Senator ANDERSON. No, no; you say——

Mr. ROBERTS. Or sell health insurance.

Senator ANDERSON. You said they shouldn't sell it if it wasn't life insurance. Now, do you stand by that, or don't you?

Mr. ROBERTS. I would say that it was a trifle oratorical, Senator. [Laughter.]

Senator ANDERSON. Well, you recognize that this pending situation has some very interesting implications, does it not?

Somebody gave a statement, and I think you were the one, that said that the great growth in these trusteed plans was because they could buy common stock. You used Sears as an example, didn't you? I think nearly all of the pension fund of Sears is in Sears stock, isn't it?

Mr. ROBERTS. I mentioned that in passing; yes, sir.

Senator ANDERSON. And that couldn't happen to a life insurance company.

Mr. ROBERTS. They do, of course, buy——

Senator ANDERSON. But he couldn't buy all of it.

Mr. ROBERTS. Buy Sears stock, but they couldn't heavily overinflate their portfolio with one company's stock.

Senator ANDERSON. Well, when the life insurance people come around to examine us, they take a pretty good look at things like that.

Mr. ROBERTS. That is where life insurance companies have yields of about 3.5 percent, whereas many other companies investing money have much higher yields.

Senator ANDERSON. Now, you thought, though, that the reason that the trusteed funds grew as against the insurance funds was because of this ability to buy common stock in large proportions.

Mr. ROBERTS. I think to a very great extent that is true, Senator.

Senator ANDERSON. Now in 1950, could they still buy common stocks?

Mr. ROBERTS. In 1950 the trusteed plans could, in many instances, buy common stocks.

Senator ANDERSON. There has been no change in what they could buy since 1950, has there?

Mr. ROBERTS. There has been a little change, however, in the economic horizon, I think, and also——

Senator ANDERSON. Wait, now.

Mr. ROBERTS. And also the trusteed plans have grown more rapidly than the insurance plans now. The plans themselves, Senator, I mean, and not the investment.

Senator ANDERSON. I understand thoroughly, but you were trying to say that the reason the trusteed plans grew is because they could buy common stocks.

Mr. ROBERTS. I think that is true.

Senator ANDERSON. They could buy them in 1950, couldn't they?

Mr. ROBERT. Yes.

Senator ANDERSON. All right. In 1950 it was 50–50, wasn't it? You are familiar with the statistics. This is from what was filed before the House of Representatives at least, and it showed 50 billion 575 million in insured reserves, and 50 billion 750 million in trust funds.

That is pretty even, isn't it?

Mr. ROBERTS. Yes.

Senator ANDERSON. By 1957, with exactly the same rights, they had gone to 40 percent for the insured reserves, and nearly 60 percent, 59 plus, for the trust funds.

Had there been any change in the legal obligations during that period?

Mr. ROBERTS. I know of none.

Senator ANDERSON. Therefore, it wasn't the fact they could buy common stocks, was it?

Mr. ROBERTS. I still think so, sir.

Senator ANDERSON. All right.

Now, if you still think so, does it have any relation, you think, to yield? Let me give you some yields.

In 1951 the tax-exempt corporate funds yielded a net of 3.09 percent, and after Federal tax, the life insurance companies plans yielded 2.98. That is within eleven one-hundredths of 1 percent of every other, and a man could reasonably perhaps figure that he was going to pay that for the sake of the insurance that it would be definite and specific.

But by 1957 the yield was 3.84 on trust-exempt funds, and 3.44 on the insurance companies' program. That is forty one-hundredths of 1 percent, isn't it?

Mr. ROBERTS. Almost one-half of 1 percent.

Senator ANDERSON. You don't think that had anything to do with it, do you?

Mr. ROBERTS. I think that that contributed to it, yes, and I think the difference in investment portfolio has a great deal to do with that.

Senator ANDERSON. Surely. Have you looked at the numbers that were insured? I have here a study made by the Bankers Trust Co. of New York, and it said that of the new plans adopted between 1953 and 1955, covering 66 plans with at least 200 life plans, the average size of the group annuity cases was 660 employees, and for the trusteed plans was 3,400.

Does that indicate to you as to whether the large companies, because of their very large reserves, can make use of the trusteed plans but small business has to depend upon the insured plan?

Mr. ROBERTS. I think, in general, small business prefers the insurance plan in many cases.

Senator ANDERSON. And you want to cut them out from that or tax them for the sake of small business, is that right?

Mr. ROBERTS. I do not think it has that effect. I merely want the insurance companies engaging in the pension plans to pay the same kind of taxes that all life insurance companies pay, so that in dealing with other lines of insurance they will not be able to shift their large profits from pension plans into other fields, pay dividends, well, to expand business or to tie together several different kinds of contracts in one premium package, and thereby swamp the small companies that may be engaged and are engaged in group that do not find it feasible to be in the pension business.

Senator ANDERSON. We have a Small Business Committee in the Congress that constantly tries to look out for small business. Now, if you do not tax this type of business, the comparison between the tax-exempt corporate pension fund is 3.84 percent against 3.75, and small business can avail itself under that circumstance. But you want to tax the insurance companies so that the small company gets only 3.44, isn't that the net of your argument?

Mr. ROBERTS. In many instances, Senator, he does not get 3.4, as a majority, a majority of plans, I would assume, that annuity assumptions are somewhat nearer 3 percent than 3.4.

All we are seeking to tax——

Senator ANDERSON. Annuities——

Mr. ROBERTS. Are the profits of insurance companies. We are not trying to tax the policyholder, we are not trying to tax the ultimate pension. We merely want companies who compete with our companies to pay their share of taxes, and we feel the Treasury can ill afford to lose $60 million from one source and then make it up on the little fellow.

Senator ANDERSON. If they were making it up; yes. Have you got anything to show that the pension plan will not take the course, as the Security Exchange Commission that is an agency of this Government, says that it is headed toward? It says it is going down to 20 percent. Your theory is if it could all go out it would be a good thing and put all pension plans under the bank trusteed forms. But a great many businesses need it.

It just happens that many of us come up against this problem. I was once associated with a little business and tried to buy a group pension plan on them recently. As I related earlier, I ran immediately into the situation where the local bank suggested that maybe I should buy a bank trusteed plan instead of an insured plan. I don't think I have that many employees, or the firm does, and I thought this was a good avenue. However, the theory seems to be that the insured plan is a bad thing to be done for them, and you want to drive them out of the business by putting a heavy tax on them. I don't understand it.

Mr. ROBERTS. Let me then say that we merely wish the large companies to pay the taxes on their profits that the small companies pay; we would be quite content with that; but the prospect of being driven out of business by a $60 million tax forgiveness is not appetizing to small companies which are competing with the large ones, and which would find it very difficult to compete with such things as one large company's withdrawing $15 million from its pension reserve strengthening fund, and dumping it into surplus and ultimately into, and I suppose, competitive features in, I believe it was 1955, freeing any element of a business from its share of taxation, Senator Anderson, we feel is merely a subsidy that could be employed against competition.

Because a drug store incidentally sells other things does not mean it is entitled to perhaps the license rate that some other kind of business enjoys.

Senator ANDERSON. Just one question, you draw attention to the fact that while 16 New York companies are authorized to do business in Texas, not a single Texas company is authorized to do business in New York.

How has the experience been with the two States?

Mr. ROBERTS. What was that, sir?

Senator ANDERSON. How has the experience been with the solvency of companies in the two States?

Mr. ROBERTS I am informed that in the entire history of Texas life insurance companies through the year 1957, which is the latest for which I have complete reports, a total sum of $500 has been lost to policyholders through Texas life insurance companies, which compares very favorably with any other State's experience.

Senator ANDERSON. Did I misread the Ben-Jack Cage and all the rest of those stories?

Mr. ROBERTS. No policyholder lost a nickel, Senator Anderson.

Senator ANDERSON. Is the only purpose of regulating businesses to be served if the policyholders lose? Don't you sometimes have good rules for the people who invest?

Mr. ROBERTS The policyholders came out all right. The stockholders really were fixed up in two or three of those cases.

Senator ANDERSON. Is that the reason maybe why some companies are not registered in New York? Aren't the New York laws pretty good? What kind of a fire policy does nearly everybody use? The New York fire policy?

Mr. ROBERTS. I think generally so. Their fire policies have been excellent. There has been some degree of criticism of the New York life insurance provisions, but they are suitable for New York and I think admirably fitted for New York needs. It is the extraterritorial features that are generally complained of by companies elsewhere.

Senator ANDERSON. I can only say that in the little tiny segment of business that I got into, some of us are very happy that New York holds up the standard that helps us in other parts of the world. I think so, at least.

Mr. ROBERTS. I think generally, Senator, North Carolina, Louisiana, are supposed to have the best and fairest codes and are held up rather as models in the industry, but with those things it is always a matter of opinion.

Senator ANDERSON. Senator Carlson.

Senator CARLSON. I have no questions.

Senator ANDERSON. Senator Douglas.

Senator DOUGLAS. No questions.

Senator ANDERSON. Senator Talmadge.

Senator TALMADGE. I would like to say that I am sorry that I could not be here for the beginning of Mr. McClatchey's testimony. Both of these witnesses happen to come from Georgia and are longtime friends of mine. Mr. McClatchey is one of the most able lawyers in the city of Atlanta.

Unfortunately two of my committees are in session today, and in trying to go from one to the other I find it rather difficult to be in two places at one time.

I agree with the witness that I find this bill quite complicated. I have been wrestling with it now for some weeks, and I still have not thoroughly understood it.

As I understand, the purport of your testimony is that you would prefer existing law to this recommended bill.

Mr. McCLATCHEY. That is correct, sir.

Senator TALMADGE. You realize, of course, the existing act would be the act of 1942, and not the Mills stopgap act.

Mr. McCLATCHEY. Yes, sir. I believe we would prefer even 1942 to the present law.

Senator TALMADGE. I see that you make several suggestions here. One I believe is a recommendation that profits of an insurance company be taxed exclusively on investment income on a graduated basis.

Mr. McCLATCHEY. That is correct.

Senator TALMADGE. On that graduated basis you would use something of the type of tax plan that is applicable to individuals and not corporations. Of course, a graduated base on corporations, as I understand it, is 30 and 52 percent.

Mr. McCLATCHEY. Yes, sir, in respect to giving small companies a larger deduction, that is correct.

Senator TALMADGE. But with individuals, I believe graduation begins at 20 percent and goes up somewhere around 92 percent.

Mr. McCLATCHEY. Yes, sir.

Senator TALMADGE. You still believe that a graduated basis would be more favorable than any overall approach in trying to tax both investment income and so-called operating profits?

Mr. McCLATCHEY. That is our view, Senator.

Senator TALMADGE. I see that in the so-called specialty companies that have no reserves or very little, if any, you use a different approach to tax so-called operating profits.

Mr. McCLATCHEY. Yes, sir, we would use something of the nature of the part 2 in the present bill. We would concede that you would need to have a device to catch those companies that had a very small amount of investment income.

Senator TALMADGE. Are there some insurance companies that deal in life insurance requiring reserves and also specialty insurance that would not require reserves?

Mr. McCLATCHEY. I believe they would all require some reserves, Senator, but there are certain types of companies, I am informed, that require a much smaller proportion of reserves than normal life insurance companies.

Senator TALMADGE. How would you approach the taxation of a company, for instance, that writes several types of insurance policies, some requiring large reserves, and others of a specialty policy type that require little or no reserves?

Mr. McCLATCHEY. I say there have been several suggestions. I think Mr. Curtis in the House suggested that you might segregate certain types of life insurance that were peculiar in respect of not requiring reserves.

Our suggestion here is rather that there be a modified part 2 which would provide a tax of a stated amount in the event the gain from operations as filed with the insurance department in the State exceeded a certain stated proportion of the investment income.

That is complicated to state, Senator, and we would be glad to undertake to furnish such a suggested form if the committee would like.

Senator TALMADGE. I would appreciate it if you would.

Mr. McCLATCHEY. Yes, sir.

Senator TALMADGE. I would appreciate it if you would submit for the record the recommendations——

Mr. McCLATCHEY. Yes, sir.

Senator TALMADGE. To go with a draft form of such amendments as you would propose.

Mr. McCLATCHEY. All right, sir.

Senator TALMADGE. There are one or two other things that I would like to ask you about.

Of course, one of the problems that lies in taxing the insurance industry is the charge that there have been vast loopholes in the taxation of insurance.

You realize that any corporation that makes in excess of $25,000, pays a 52 percent tax on the excess. The insurance industry, as you know, does not, and insofar as I know, it is the only profit organization that doesn't pay a 52 percent tax on its income after certain exemptions and deductions.

There have been charges, for instance, that insurance companies own and operate radio and television stations, and get favorable insurance tax rates rather than the normal 30–52 percent rate that they would have to pay if they were operating those stations without the aid and benefit of having an insurance company as a holding company.

How would you approach such a problem as that?

Mr. McClatchey. Well, that is a similar problem, it seems to me, Senator, if I have gotten your question, to the one we discussed just a moment ago as to the specialty company. I am not sure that I understood clearly.

Perhaps you understood, Mr. Roberts, what the question is?

Mr. Roberts. Since all that would go into the category of intercorporate profits, it would be pretty well reached by either the formula that parallels part 1 of the present bill, or if it overflowed into an excess amount, and I think in most of the cases the Senator has in mind, if it overflows very considerably it would be caught by our proposal to catch specialist windfalls.

Mr. McClatchey, in drafting his suggestion he is going to file, I know, in the suggestion we make, that it will be aimed not merely at specialties because they are necessary, but it also would be aimed at windfalls. That is to say, exceptional profits that do arise from time to time in individual companies that greatly exceeded their reasonable profit which is to be anticipated from their business, and I think that would very likely reach these unusual conditions.

There are not too many States in which these rather exceptional investments are permissible, anyway.

Senator Talmadge. As I understand your testimony, you would eliminate entirely the so-called phase 3 part of this tax bill.

Mr. McClatchey. Yes, sir.

Senator Talmadge. How would you ultimately get a tax on all earnings of an insurance company if you adopt an investment type approach, plus your specialty company feature, if you do not have some ultimate means of taxing the profit of an insurance business at the time that it declares dividends to stockholders?

My question is, how are you going to nail down a tax bill and say that from henceforth on there will be no escape provisions for insurance companies so that every dollar will be taxed by the Federal Government?

Mr. McClatchey. As we discussed with Senator Kerr awhile ago, I believe it was, this goes back to the difficulty over 50 years in trying to devise a fair tax measure that would do just as you state.

Our view is, sir, that the investment income approach, when placed at a rate, at a schedule that will produce the revenue which the Treasury feels that it needs will, in itself, when that additional special provision is put on, will in itself measure the entire income of the company even though you do not, as such, go down and tax down at the end, that the tax you put on the investment income is itself a measure of the true income.

That was the theory of the Mills-Curtis bill, sir, as I understand it.

Senator TALMADGE. Why would you disregard completely the so-called underwriting profits or operating gains?

Mr. MCCLATCHEY. As I understand it, the reason that has been disregarded, not gone into in the past, has been the difficulty of determining what actually was underwriting gains, and I think under——

Senator TALMADGE. That difference would be, of course, your insuring the contingency that may arise 50 years hence.

Mr. MCCLATCHEY. That is correct, sir.

Senator TALMADGE. You don't know whether there will be any profit on that particular transaction unless the contingency arises, do you?

Mr. MCCLATCHEY. That has been the theory on which the past bills have gone, yes, sir.

Senator TALMADGE. I would appreciate it very much if you would prepare a memorandum outlining in detail your suggestion, what your method of taxation will be, an estimate on the amount of revenue it would raise for the Government, and prepare the necessary amendments for the consideration of this committee.

Thank you.

(Mr. McClatchey subsequently submitted the following for the record:)

EXPLANATION OF THE PROPOSED AMENDMENT TO THE INTERNAL REVENUE CODE WITH RESPECT TO THE TAXATION OF LIFE INSURANCE COMPANIES

The attached draft of the proposed amendment to the Internal Revenue Code is designed as a substitute for the provisions of H.R. 4245, dealing with the taxation of life insurance companies for the years subsequent to 1957.

Under the proposed substitute, the 1942 formula would be permanently eliminated and the current stopgap measure or Mills law would be made permanent with two modifications.

The first of these modifications would be to institute an overall decrease in the deduction provided against net investment income. Under the present law, insurance companies are allowed to deduct 87½ percent of the first $1 million of investment income and 85 percent of the remainder. Under the proposed new formula, a deduction of 90 percent would be provided against the first $250,000, 84 percent against the next $750,000 and 78 percent against all investment income over a million. This new formula contains a slight additional break for small companies by increasing the deduction rate on the first $250,000 of income. However, on all amounts of investment income above $250,000, the deduction rate is substantially decreased and the yield of the proposed bill would be $172 million greater than under the law in effect for 1957.

The second modification to the Mills law suggested is the tax on specialty company income. One of the defects in the present Mills formula is that certain specialty companies, primarily those virtually exclusively engaged in writing credit life insurance, have little investment income but substantial and easily ascertainable underwriting profits. The present formula misses this income almost completely. Accordingly, it is proposed that a new category of income be established—namely, "specialty company income." A specialty company would be defined as a company whose net gains from operations after dividends to policyholders exceeds three times its investment income and non-life-insurance income. In the case of such a company, 25 percent of such excess would be considered as specialty company income and subject to tax at the regular corporate rates. Net gains from operations is defined as that figure set out in the annual report of life insurance companies as net gain from operations after dividends to policyholders. This is a standard widely recognized figure which is computed in the same manner by all companies on a form approved by the National Association of Insurance Commissioners. An earlier Treasury Department recommendation in this area was based on using the same figure to determine total income on all insurance companies.

AMENDMENT TO H.R. 4245

Strike out all after page 1, line 5, and insert the following:

"1. Section 802 of the Internal Revenue Code of 1954 is amended to read as follows:

"SEC. 802. TAX IMPOSED. A tax is hereby imposed for each taxable year beginning after December 31, 1954, on the income of every life insurance company. Except as provided in subsection (c), such tax shall consist of a normal tax (computed under section 11(b)) and a surtax (computed under section 11(c)) on the sum of—.

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

"'(2) the nonlife insurance taxable income (as defined in subsection (f)) plus

"'(3) the specialty company income (as defined in section 808).

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

"'(1) the net investment income allocable to nonlife insurance reserves (determined under section 804(d)),

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

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

"'(c) ALTERNATIVE TAX IN THE CASE OF COMPANIES HAVING NONLIFE INSURANCE RESERVES.—

"'(1) IN GENERAL.—In the case of a life insurance company which has nonlife-insurance reserves, the tax imposed by subsection (a) of this section for any taxable year beginning after December 31, 1954, shall be the tax computed under such subsection (or under section 1201(a) if applicable) or the tax computed under paragraph (2) of this subsection, whichever is the greater.'"

NOTE.—Remainder of section to be reenacted without amendment.

"2. Section 804(a) of the Internal Revenue Code of 1954 is amended to read as follows:

"'(1) 90 per centum of so much of such excess as does not exceed $250,000;

"'(2) 84 per centum of so much of such excess as exceeds $250,000 but does not exceed $1,000,000; and

"'(3) 78 per centum of so much of such excess as exceeds $1,000,000.'

"3. Section 804(b)(3) is amended to read as follows:

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

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

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

"'(i) the net investment income allocable to non-life-insurance reserves, and

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

bears to the net invested income.'"

NOTE.—Remainder of section to be reenacted without amendment.

"4. Section 805(a) of the Internal Revenue Code of 1954 is amended by eliminating therefrom the following:

"'(and the tax imposed by section 811)'".

"5. The Internal Revenue Code of 1954 is amended by adding a new section 808 to read as follows:

"'SEC. 808. SPECIALTY COMPANY INCOME.

"'(a) GENERAL RULE.—In the case of a life insurance company whose net gains from operations during the taxable year exceed three times the aggregate of the life insurance taxable income and the non-life-insurance taxable income for such year, then 25 per centum of such excess shall be considered as its "specialty company income" for the taxable year.

"'(b) DEFINITION.—For the purposes of this section the term "net gain from operations" shall be the "Net Gain From Operations After Dividends to Policyholders" computed in the manner required for the purposes of the annual statement for the taxable year on the form approved for life insurance companies by the National Association of Insurance Commissioners, except that no deduction shall be made for any Federal income tax.' "

"6. Sections 811, 812, 813, 816, and 817 of the Internal Revenue Code of 1954 are deleted."

Senator LONG. Might I ask just one more question, Mr. Chairman?

Senator ANDERSON. Surely, Senator Long.

Senator LONG. The statement is made that you would recommend taxing on the Mills-type formula. You use this language: "* * * exempting no reserves whatsoever from taxation."

Now, what type things do you have in mind that are exempted from taxation as of now, or would be exempt under this bill?

Mr. MCCLATCHEY. We were referring to the pension matter, Senator that we have discussed.

Senator LONG. Is that the only thing you had in mind when you say, "exempting no reserves whatsoever from taxation"?

Mr. MCCLATCHEY. Yes, sir.

Senator LONG. As I understand it, and please correct me if I am wrong, the bill we are considering would give the 85 percent dividends credit on stockholdings by an insurance company when it received dividends in those stocks. The Mills-Curtis stopgap formula does not do that, if I understand it correctly.

Mr. ROBERTS. It was our contemplation, Senator, that if a single phase, plus a specialty company rider were adopted, that the normal dividend credit on stockholders' dividends from insurance companies would not be allowed, the reason for that being that you must reach certain profits that are nebulous, that can't be found, and also a very practical reason that that catches the balance of the money that the captive companies own.

Now, in at least one instance of the so-called captive companies, I am informed, I haven't run it down myself, but I think the information is correct, that although the company, that is to say the life company, that is a specialty company, will pay a greatly enhanced tax, the combined tax of the life company and the company that owns it will be decreased about $200,000 as a result of the bill by virtue of the dividend credit that is provided in it. They pay some $3 or $4 million in dividends to their holding company, and this was immediately subject to, since it made a very large profit, to 52 percent corporate tax, so that they really, instead of having a free ride, paid about $1,700,000 in ultimate taxes, although the specialty company didn't pay them, and we feel that when we have a flat formula you ought to get a dividend credit, we don't ask for too much.

Senator LONG. Of course that is where some of this confusion arises. In other words, you would advocate taxing 100 percent of the dividends that the insurance company receives at a rate between 10 and 22 percent, as compared to a proposal of taxing 15 percent at 52 percent. By the time you get through with those multiplications you finally come out to about the same thing one way or the other.

Mr. ROBERTS. I think you usually, on tax matters, you always come out very much the same. It is just a matter of distribution on those kinds of operations.

Senator LONG. You say that "thereby eliminating the $60 million tax rebate to a handful of companies in this bill," and I would ask you in that respect if you are referring to the insurance pension system? You are referring to that, are you not?

Mr. ROBERTS. I am referring to the fact that approximately 9 or 10 companies monopolize the pension field, have about 90 percent of the pension reserves, and we do point out, incidentally, that in one of them, if pensions are exempt from taxation they should certainly be exempt, their reserves should be exempt from qualifying the company as a life company, that one of them would be perilously close to not being a life insurance company any more.

Senator LONG. As I understand it, the argument in favor of exempting the pension part of this matter from taxes is that their competitors are not paying taxes on the pension part of their program; is that correct?

Mr. ROBERTS. Well, we apprehend that if the pension fund or pension reserves are exempt from taxes there would be large profits that could be used to the disadvantage of other companies competitively. There is a profit in handling the pension business.

The difference between the flat formula basis and the other in the treatment of pensions is that actually there is no unfairness under the flat formula.

I can conceive of an unfairness to pension funds under this very complicated one, if it would be put back in, because you would not nearly get the profits on it. You would actually get something else.

It is rather like the situation that developed on tax exempts; you are paying twice.

Senator LONG. You feel if pension funds are to be eliminated, they ought to be required to handle those funds separately so they would not get some tax advantage incidentally that was never intended?

Mr. ROBERTS. That is right.

Senator LONG. But you do see the problem that either corporations that set up their own pension funds for their employees or banks that handle pension funds for employees are competitive with the insurance companies, and they apparently do not pay taxes on those pension funds they handle.

Mr. ROBERTS. Senator, that is why we—one of the additional reasons why we—are strongly against this vastly complicated bill.

The formula based on investment income alone reaches nothing except the profits of life insurance companies, and I think some Senators feel that it does not reach all of those. But it does not tax anything but the profits; whereas the strange three-pronged bill before you, I am afraid, perhaps, imposes an unfair tax upon similar categories of insurance and, perhaps, pensions among them; and that is why we think that a one-phase tax program such as we have had since 1920, and such as we have had under a different theory and under the same theory that we have proposed since 1951, will hit nothing in pensions except the profit derived from them.

I do admit if you took pensions out of the present House bill you might be unfairly taxing something, I do not know how much.

Senator LONG. In your statement you go on to say, "as well as the 10 percent or more rebate to the same companies, provided by their use of the industry average as a tax base instead of their own figures."

Now, could you help me to understand that statement?

Mr. ROBERTS. Senator Long, I doubt that I could help you to understand it because I hope that we are right about the 10 percent which we arrived at by taking a typical company that has approximately reserves on an average of 2.3.

Senator LONG. 2.3 what?

Mr. ROBERTS. Reserves on an average of about 2.3 percent.

Senator LONG. Interest?

Mr. ROBERTS. The industry average is almost 2.8; that is the Treasury's announcement of averages, I believe, which is 2.78.

That leaves you a difference of one-half of 1 percent.

If you come on down——

Senator LONG. Let me ask you this, does that industry average mean the weighted average or does it mean the average——

Mr. ROBERTS. No; it is not a weighted average, Senator. A company——

Senator LONG. Because here is a point that appears to me if you are trying to arrive at an industry average. One company might have $1 million of insurance outstanding, and another might have $100 million.

If you just averaged the interest that those two were receiving you would not allow for the fact that one is 100 times as large as the other.

So, does the industry average mean the weighted average?

Mr. ROBERTS. It is not the average of companies, but it is the average of sums held at different rates. It is probably a weighted average, I am sure.

Senator LONG. That would be a weighted average; yes.

Mr. ROBERTS. But the denominators and numerators are so numerous in part 1 of the bill that I do not think I could follow them at the moment.

But, at any rate, a company reserving on a 3 percent basis does not have the advantage of charging off some extras because, unfortunately, it is reserving above the average of the industry.

But if you have a reserve basis more than the average, why, you get the advantage of the industry's average.

Now since, in general, the small companies and most stocks reserve on a 3 percent basis, and the large companies strengthened their reserves with windfalls during a period around 1943 and soon, they have an advantage that is represented by some figure between five-tenths of 1 percent, divided by something which works out, I am told, that it is somewhere between 10 and 12 percent average across the board; that is to say, on the average, they pay 10 percent less on phase 1 than a company reserving at the 3 percent level would.

Senator LONG. So your feeling is that this does tend to discriminate against, in general, small companies when you use the industry average?

Mr. ROBERTS. It unquestionably does; yes, sir.

Senator LONG. Thank you.

Senator ANDERSON. We are going to Senator Carlson in a moment. But I would like to ask, you did make a statement about this company that had large returns from something else, and had to pay 52 percent on it. Not wishing to air business out in public, I wish you would furnish us with a memorandum on that because we have been checking up here, and we do not quite find how that is possible if dividends received by corporations are administered the way the law says they are administered. Will you please furnish us that information and the device?

Mr. ROBERTS. You are referring to my reference to the holding company?

Senator ANDERSON. In the case of the corporation other than a small business investment company operating under Small Business Investment Act of 1958, it states:

"There shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends other than dividends described in paragraph (1) of section 244 relating to dividends on a preferred stock of a public utility from a domestic corporation which is subject to taxation under this chapter," and it would be subject to taxation under the chapter, as we see it.

If so, would you please give us the situation that would let us trace that case down?

Mr. ROBERTS. I would be glad to, sir.

Senator ANDERSON. Senator Carlson?

Senator CARLSON. Mr. Chairman, I want to ask one question.

Senator ANDERSON. May I be the first to congratulate you. [Laughter.]

Senator CARLSON. Mr. McClatchey, you have done a good job here this afternoon expressing your views on H.R. 4245.

Mr. McCLATCHEY. Thank you.

Senator CARLSON. Now, the stopgap formula which you are advocating has been referred to by insurance people and many individuals as an excise tax because it taxes the same percent of investment income of all companies, ignoring the variations in their contractual obligations.

Now, do you have any comment on that?

Mr. McCLATCHEY. I believe that there is in the measure a provision for young companies of 10 years or less, as I recall it, which ameliorates the tax if there is a loss to those companies.

Now, it would be our view that if a company is older than that and has investment income which would make it subject to tax under the Mills formula, and also has a loss that it is a matter usually that the company is undertaking to expand or is deliberately using its receipts from its investments with anticipation of a loss, if it does not make a profit.

In other words, there would be surely some cases where the tax would not be fair and equitable as they are, I believe, sir, in all tax bills.

But, on the whole, the bill would generally tax insurance companies fairly.

Senator CARLSON. Don't you believe, Mr. McClatchey, that the smaller companies that you first referred to would be rather exceptional cases?

Mr. McCLATCHEY. Yes, sir; I suppose they would.

Senator CARLSON. That is all, Mr. Chairman.

Senator KERR. (presiding). Are there further questions?

All right, Mr. McClatchey.

Mr. McCLATCHEY. Thank you, sir.

(Mr. McClatchey's prepared statement in full is as follows:)

STATEMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES BY DEVEREAUX F. MCCLATCHEY, GENERAL COUNSEL

My name is Deveraux F. McClatchey. I am general counsel of the National Association of Life Companies, a trade association organized under the laws of the State of Georgia, with a membership of more than 120 small- and medium-sized life insurance companies in 25 states.

This appearance before the Senate Finance Committee, and the viewpoint expressed upon H.R. 4245, a bill relating to the taxation of the income of life insurance companies, is directed by a unanimously adopted resolution of the convention of the association, after exhaustive study of the subject by the association's staff and its committee on taxation.

While we recognize that the writing of either a satisfactory or a durable tax measure in the field of life insurance presents unusual difficulties, we are convinced that this pending measure is a bad bill, that should either be rewritten in its entirety or substantially amended.

The criticism of this measure is made in the face of a hammer held over the heads of the members of the life insurance industry by the Treasury Department. The industry was told, in effect: "Either take this bill or pay under the 1942 act."

Despite that danger, of which members of this association are conscious, we find H.R. 4245 a bad tax measure.

First, it seems to us to be excessive for present earnings of the industry. The gains from operations of the entire industry will amount to approximately $1,250 million for 1958, before any taxes, Federal, State, or local, are deducted. State taxation amounts to about $300 million, leaving a balance of $950 million from which the Treasury seeks in excess of 58 percent, with no allowance for tax-exempt interest. While we suggest that this is an excessive amount, decision on this question is one that addresses itself to the judgment of the Congress so entirely that we do not propose to dwell upon it. There are probably others among the witnesses who will develop the thesis of excessive taxation of the life insurance industry as it affects the economy of the country and the people who are dependent upon the institution for their welfare.

We intend to talk about the competitive aspect of this measure.

There are two kinds of life insurance companies, stocks and mutuals. Since the first income tax act they have been taxed in the same way. Theoretically, this should not be so, but the reasons why it must be so were set out very cogently by a distinguished former member of this committee at the hearings here a year ago. When Senator Flanders of Vermont came to the Senate, he resigned every directorship that he held, except as a director of National Life Insurance Co. Throughout the hearings from 1919 to the present day, there have been long technical discussions explaining why mutual and stock companies must be taxed in the same way. The explanation that Senator Flanders gave took very few words and was stripped of all technicalities. As it is found on page 14 of the hearings, I quote it to you:

"* * * far as the mutuals go. There is no company to be taxed. There are only individuals scattered all over the country to be taxed.

"Now, when it comes to the stock companies, there is a company to be taxed. There are certain stockholders whose earnings are affected as the company is taxed. But here the situation, Mr. Chairman, seems to me to be on all four feet with the mutual company to this extent and for this reason, that the stock companies are in constant and severe and unremitting competition with the mutual companies, and they cannot get far out of line without going out of business."

As a necessary preliminary to discussing what this proposed bill will do to competition in the life insurance industry, it will be necessary to review very briefly the four previous types of legislation in this field.

From the enactment of the first income tax act until 1920, the total income approach, or general corporate method of taxation, was followed. This did not produce any significant revenue and during World War I, a small excise tax was also imposed, but eliminated after the war.

In 1920 the excess interest approach was devised by the Treasury. There is no such thing as excess interest, but it was a useful fiction to employ in providing a workable tax bill. In spite of the battle of 1932 between the American Life Convention and the Life Presidents Association, representing, respectively, the small and the large companies, the measure, though frequently revised, especially following the decision in the National Life Insurance Co. case in 1928, remained until the enactment of the 1942 bill. The excess interest approach was then junked because it did not work and because it did not produce much money. A tax bill based on industrywide averages, but tied to the excess interest theory, was passed. This bill produced satisfactory revenue until there was a decline in investment income during the war. It went off the board. It produced not a dime for the Treasury in 1947 and 1948. In 1950 another similar monstrosity was enacted that did produce some revenue, but that proved on test to be unsatisfactory to the Treasury and inequitable within the industry.

Then came the total investment income approach, written into law first in 1951 and revised and greatly improved in 1956.

It is based on the theory that since mutual companies have no income except that from investments, and since that income should be taxed at a rate other than the corporate rate, a device measuring the true profits of companies, stock and mutual, through a tax on investment income, can be applied.

The present bill is a hodgepodge of the laws applicable in 1942 plus the abandoned 1932 measure. It discriminates heavily against smaller companies in competition and against all stock companies as compared to mutual companies. It destroys the historic competitive relationships within the industry. It exempts broad segments of the industry from any tax whatsoever. It allows companies an artificially contrived deduction based on industry averages but denies that tax abatement to other companies.

Finally, while it cannot go off the board as rapidly in a time of declining interest rates as the 1942 bill did, it can do so and is unstable as a producer of revenue.

As a weapon against the smaller companies, it provides the very large mutuals with special exemptions that can reduce their taxes by a third and does reduce their taxes beginning in 1959 very appreciably.

Against the stock companies, it adds an additional tax that mutual companies do not have to pay.

It destroys the historic competitive relationships. An examination of the five largest companies writing pension plans and the five largest companies not writing pension plans will show at a glance the disadvantage which those not in the pension business would face.

An examination of this proposed law and of the 1956 stopgap as applied to the years 1947 and 1948 will show that this miracle bill that the Treasury has devised would have produced almost nothing in either of those years, against very substantial sums under the measure we paid taxes under in 1957.

The National Association of Life Companies has a recommendation. We recommend that this measure be junked and that the Mills-Curtis stopgap be enacted into law as permanent legislation at a rate that will reflect accurately the tax upon the true profits of the industry.

Three times at hearings on income tax measures for life companies, the National Association of Life Companies has said these same three things:

1. A total investment income approach is the only method that preserves the competitive relationships between all kinds of companies, big and small, stock and mutual, participating and nonparticipating.

2. The Treasury will never develop and cannot develop a corporate total income approach measure. They have promised to do so every year since 1954. They promised here, in this hearing room, before this committee, that they would have the outline of such a bill before the Congress 10 months ago, so that the industry and the technical staff of the Ways and Means Committee and the Senate Finance Committee could study it. They did not do so. They could not do so. They cannot do so today.

It is possible that they were deterred from doing so by the fact that a total income approach bill could not possibly yield more than $425 million in revenue for 1958, while the plan advocated by the National Association of Life Companies would yield approximately $450 million.

3. We have said, and we say again, that while the Mills-Curtis stopgap is the best piece of legislation yet devised, it did not produce enough revenue. Estimating as we did that the true profits after State and local taxes of life companies with an adjusted but not a full deduction for tax-free investment income approximated $900 million, we proposed a measure that would yield $450 million in 1958 on a basis of taxing 10 percent of the investment income up to $250,000,

15 percent of the next $1,250,000, and 22 percent of the excess, and taxing every dollar of investment income whether from the reserves based on the quota of industrial policyholders or the millions in pension funds. We submit today that this investment income plan is the best, the fairest that can be adopted, and if the Congress finds that a greater yield is absolutely necessary they can make an up-to-date adjustment to 10, 16, 22 percent and obtain a yield of considerably greater amount.

But, if it is the wish of this body to disregard this recommendation and to undertake to repair this present measure, that can be done fairly simply. We would then recommend that part 1 of H.R. 4245 have substituted for the existing language a Mills-type formula at a 10, 16, 22 level, exempting no reserves whatsoever from taxation, and thereby eliminating the $60 million tax rebate to a handful of large companies that is provided in the bill, as well as the 10 percent or more rebate to these same companies provided by their use of the "industry average" as a tax base instead of their own figures. This would produce a yield of $470 million. The small company deduction should then be adjusted appropriately in part 2, to avoid small companies paying a tax in part 2 as a result of the deduction afforded them in part 1. Although the Treasury reversed itself just before this measure was drafted in final form and decided that it did not need the $60 million in revenue from taxation on pensions, we feel that the burden of taxation in the industry ought to be spread over all forms of life insurance and not exclusively imposed upon those contracts that protect families from destitution. If an item is life insurance it ought to be taxed as life insurance. Last month these same companies that want a $60 million annual subsidy from the Treasury to use to plow under the competition from small energetic companies endeavored to obtain permission from the State of New York for segregating pension funds and acting as trustee for such funds in an obvious bid for tax avoidance. The State of New York took the position that insurance companies must stay in the insurance business. NALC takes the position that if pensions are not insurance, life insurance companies ought not to write such contracts; if they are proper insurance contracts, they should be taxed as other insurance contracts. This was the view that the Senate took when the Mills-Curtis stopgap came to this body. They struck out these exemptions after they saw the figures on the tax reduction that would be given a handful of big companies while the taxes were going up on their smaller competitors.

Competitively the exemption of pensions from taxation means that the enormous profits from this field can be used and would be used to destroy competitors in other lines of business. They can take the money and use it to increase dividends on other insurance contracts. They can use this free grant from the U.S. Treasury to expensively promote sales. They can tie tax free pensions in with group and group accident health contracts, package deals that will eliminate forever small competition in group business.

It seems most inequitable to us that the taxes of the largest companies in America should be actually reduced while their smaller competitors have a tax increase of more than 70 percent.

We also ask that the Senate consider other implications. To succeed in the pension field a company must be large. As a practical matter it must also be licensed in New York. But we draw to your attention the fact that while 16 New York companies are authorized to do business in Texas, not a single Texas company is authorized to do business in New York. Seventeen New York companies are entered in Tennessee, but no Tennessee company is licensed in New York. Seventeen New York companies are licensed in Indiana, but no Indiana company is licensed in New York. Fifteen New York companies are licensed in Georgia, but not 1 of Georgia's 32 companies can do business in New York.

Of 604 companies with less than $50 million assets, all whose reports were available in Best's at the time, only five are engaged in any way in the pension business. Almost no companies in the South, the Southeast, the Mountain States or the Far West are engaged in these operations. It is confined to five Eastern States. The geographic impact upon the economy of the country ought not to be disregarded for the small regional companies are necessary to that orderly decentralization of industry and finance that Congress repeatedly has approved as a desirable public policy and essential to the national welfare and defense.

The elimination of the tax on pension annuities ultimately would be the death knell of small companies throughout the Nation. They have grown and prospered under the investment income tax system, where all types of insurance paid their share of the tax bill. To use an illustration from my native State, since 1941 the assets of all life insurance companies increased 215 percent; the assets of Georgia companies increased 1,438 percent. No wonder the mammoths think it is time to trample down the mice.

There are certain revisions we recommend in part 2.

The first revision that we recommend in part 2 is obvious. It is to permit companies to carry over the deduction from part 1 upon the basis of the maximum rate, so that the differential for small companies will not be lost. This parallels and should be a substitute for the small business deduction provided in part 2 of the bill as now presently written.

The second revision is to correct an obvious oversight. The special reserve or surplus provision for group insurance or group accident and health insurance of 2 percent is provided among the deductions in part 2. Apparently by inadvertence a similar provision for other accident and health insurance was not made. That this was an oversight, we feel sure, since provision was made for noncancelable and guaranteed renewable accident and health contracts. It is equally necessary that provision be made for individual accident and health, of all kinds, whether cancelable or term, and we ask that this oversight be remedied.

We recommend that, since it is desirable to reach the sometimes exceptional profits of specialty companies that sell almost nothing but term contracts, and windfalls that might occasionally occur in individual companies, that a section be provided that will guarantee an appropriate tax from such companies under such conditions; this can probably best be done by relating operating gains to taxable investment income.

This recommendation was made necessary by our final recommendation to this committee.

During all the prolonged discussions of a Federal income tax act for life insurance companies, there was never an intimation that the Treasury would seek to tax stock companies more heavily or in any way differently from mutual companies. In the original printed draft of the House measure there was no part 3. We ask that part 3 be stricken in its entirety. It is contrary to nearly 50 years of policy on the part of the Treasury and Congress. It is theoretically unsound. It has never been advocated so far as we know for any other enterprise in America. It establishes a bad and a dangerous precedent. The Treasury concedes that it will raise almost no money. We know of no company in our group that in 1958 or the foreseeable future will ever be called upon to pay a tax under this section. As a tax measure it will reach only 8 or 10 companies in the entire Nation, and these can be better reached by other devices. But it confuses totally the accounting procedures of the companies. It might prove an effective bar to the sale, liquidation, reinsurance or mutualization of any company. It creates a kind of surplus wholly unknown to the industry and almost inevitably requires a reversal by the Congress of the national policy of State rather than Federal regulation of the insurance industry. So confident are we that this committee will recommend elimination of section 3, and so obvious do these stated reasons seem to us that we do not intend to expand the argument on section 3 further.

Now as to the respective yields of the three measures that we have discussed.

According to the Treasury's estimates, this measure, H.R. 4245, would yield $545 million in 1958. On the basis of 1958 income, this amount would drop $20 million yearly (because of the exclusion of pension fund reserves from tax, to be achieved under this bill over a 3-year period beginning in 1959) until it would produce only $485 million by the end of the fourth year. Almost all of this $60 million reduction is distributed among a few of the largest companies in the business. The measure that the National Association of Life Companies recommends would produce approximately $450 million in each of the 4 years with no preferential reductions to any company, large or small. H.R. 4245, as we suggest it be amended, would produce $520 million in each of the 4 years. These figures are based upon the assumption that there will be no growth in the industry; that is, we have assumed a continuation for 4 years of the 1958 figures; upon that basis, H.R 4245, as it passed the House, would yield $2,060 million. The measure that we propose would yield $1,800 million. H.R. 4245, if amended as we propose, would yield $2,080 million and would not discriminate in favor of the few giant companies with untypical reserve rate structures or those engaged in the pension field.

If the Treasury's projection of the growth of the industry is correct, however, the difference is more striking and we think that, in fairness, we should draw attention to it. H.R. 4245 would presumably yield $665 million in 1961; the measure that we propose would only yield $510 million in that year, and the revised measure, following the amendments that we have suggested, would yield $750 million. However, while the need for revenue to the Government is acute, a sound tax system is also necessary.

We do not believe that with the measure in its present form or as projected with the amendments we suggest would produce the yield that theoretically it should. We do think that the more stable total investment income approach would show the same steady climbing yield that it has shown in the past years. We have not discussed and we will not endeavor to speculate upon the probable effect of the present measure upon Government financing. It is the considered opinion of our best advisers in the field that the heavy premium put upon ownership by life insurance companies of municipals and other tax-exempts will result in drastic changes in portfolios and that, in consequence, the cost of financing the Federal debt will be substantially increased; since our experts disagree, as all experts do, as to the extent of the increase that would probably result, we do not wish to comment upon it. However, the shift to high interest rate mortgages on the one hand and low-yield tax-exempts on the other, in a ratio calculated to eliminate all tax under part 2 of the proposed measure, may be expected on the part of many prudent managements. They would be unfair to their policyholders and their stockholders if their investment portfolios did not produce the best results for the company.

There is no such premium upon tax-exempts under the Mills-Curtis type formula and there will be certain advantages both in certainty of tax yield to the Government and in the avoiding of dislocation of the present competitive relationships within the industry. We feel that these more than cancel out the possible, the problematic, the highly speculative greater yield under the proposed measure, even though it were fairly and reasonably amended.

Senator KERR (presiding). Mr. Slater, Robert E. Slater.

## STATEMENT OF ROBERT E. SLATER, VICE PRESIDENT, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., ACCOMPANIED BY B. FRANKLIN BLAIR, ACTUARY, PROVIDENT MUTUAL

Mr. SLATER. Mr. Chairman, my name is Robert E. Slater. I am vice president of the John Hancock Mutual Life Insurance Co. of Boston, Mass.

Associated with me is Mr. Franklin Blair, actuary of the Provident Mutual. We are both actuaries by profession. I appear as a representative of the temporary committee on the taxation of mutual life insurance companies.

The work of that committee is supported by 23 mutual life insurance companies, listed in exhibit 1. These companies are operated solely in the interests of more than 20 million policyholders. These companies are widely diversified as to size and location. They pay approximately 20 percent of the total tax burden of the life insurance industry.

Our committee has spent more than 3 years in study of this problem, seeking sound principles for taxation of life insurance. We submitted statements of our findings at the recent hearings of the Ways and Means Committee. We continue to adhere to the principles expressed to that committee, and wish to incorporate that testimony, by reference, into the record of this hearing.

A mutual life insurance company consists of a group of individuals associated to provide life insurance for themselves at as low a cost as possible. Premium deposits and the income from the investment of the deposits are held for the exclusive benefit of the policyholders and their beneficiaries. Consequently, any tax levied on a mutual company must be borne by the policyholders or their dependents and no one else.

Most policyholders of life insurance companies are people of modest means. The John Hancock, for instance, with approximately 11 million policyholders, is one of the largest life insurance companies. However, the average size of our policies is only $1,290, and the average reserve held on such policies (which represents the extent of savings involved) is only $233. In many instances, these people have no other form of savings for the protection of their families.

Our primary concern with H.R. 4245, the bill now before you, is the amount of taxes imposed on the policyholders of mutual companies. The tax on the mutual companies would be over $50 million greater than a straight 52 percent tax on their gain from operations before the usual adjustments allowed to corporations generally.

Under this bill, mutual companies would pay 69.4 percent of the tax, although they have only 63 percent of the insurance in force, only 61 percent of the surplus funds and only 58 percent of the gains from operations. It has been estimated that for 1958 this latter percentage would be down to 55 percent. In light of these figures it is difficult to see how anyone can maintain that mutual life insurance companies have any competitive tax advantage over stock life insurance companies.

The impact of these taxes is of concern, not only to these policyholders directly, but also to everyone else in the United States. The assets of life insurance companies constitute this country's greatest source of capital for long-term investment. The premium deposits of policyholders flow into investments of almost every conceivable nature in every part of the land. For example, since the end of World War II, life insurance funds have provided over $35 billion for mortgages, more than half of which went into FHA and VA loans. Each year, life companies, through mortgage loans, help about 400,000 families to buy their homes. Life companies also have $44 billions invested in industry. The savings of individuals, accumulated through life insurance, are not only important to the expansion of our economy, but are also one of the most effective deterrents to inflation and to further erosion in the purchasing power of the dollar. We feel this aspect of the situation has not yet received adequate attention—therefore we ask your serious consideration of it.

In spite of the fact that the tax laws prevailing over the last several years have made life insurance the most heavily taxed form of institutional savings, this bill levies a further 70 percent increase in Federal taxes for 1958. We know of no other industry that has ever been subject to such an increase in its tax burden in a single year. This is just too much, too fast.

The higher taxes rise, the more the American people will be discouraged from endeavoring, through their own efforts, to protect their families against the hazards of death, disability and old age. These are reasons why the people through savings institutions like life insurance should not be called upon to bear a heavy burden of taxes.

Life insurance has been looked upon as a business relegated to the States for taxation. The business pays special State premium taxes, amounting to about $300 million. Together State premium taxes and the Federal income tax total over $850 million. The extra heavy burden of State taxes cannot be ignored in determining the proper level of Federal taxes upon the policyholders.

For all the reasons I have discussed, we cannot endorse the level of taxes imposed by the bill under consideration. However, of the possible alternatives remaining to us, it is our conclusion that this bill, with suitable amendments, should be enacted into law without undue delay. Even if that cannot be done until after March 15, we feel the new law, whenever passed, should be applied to 1958 operations, and that the outmoded and inequitable 1942 law should not be permitted to become operative.

Among the defects of the 1942 law, and there are many, is its failure to make provision for the smaller companies. The role of life insurance is so vital to the American economy that it needs a thrust of new companies penetrating new areas. We have always advocated lenient tax treatment of bona fide new companies. In H.R. 4245 we favor a longer period over which new companies can charge losses and also a larger deduction from investment income in phase 1.

We would recommend four amendments to H.R. 4245. Of these, the first two are of basic and fundamental importance, and the other two involve refinement of principles already incorporated in the bill.

Our first recommended amendment relates to the computation of the "policy and other contract liability deduction." We believe this deduction should be based on the individual company's actual earned interest rate for the taxable year. Because the life insurance business has been told that the use of this rate would not produce the amount of revenue desired, we would urge the use of a 5-year individual company average to maintain a level of income rather than the artificial "mean" now provided.

This proposed amendment has been presented to you during these hearings by several witnesses. It would be needlessly repetitive for me to review the reasons for the amendment. However, I would like to make it clear that our companies not only endorse it, but consider it essential if this bill is to become law.

We strongly recommend a second amendment, which relates to the limitation on the deduction of dividends to policyholders in calculating taxable income. Under the bill as drawn, the amount of dividends to policyholders which may be deducted in calculating the gain from operations is limited arbitrarily to the amount which would reduce this gain to the level of the taxable investment income. Because of this limitation, the bill does not, in effect, permit any reduction in the tax for mutual companies when the gain from operations is less than the taxable investment income. Not to allow such a reduction results in an excessive tax, and discriminates against the policyholders of participating insurance because it results, in effect, in a tax on part of dividends to policyholders.

Let us consider, for a moment, the true nature of dividends to policyholders. In a mutual company, the experience on each class of policy is determined each year. When this experience establishes a cost of insurance which is less than the cost provided for in the premium, the unused portion of the premium is returned to the policyholder. This adjusts the premium to the actual cost of insurance. While these returns are usually referred to as "dividends," they are actually refunds of excess premiums paid by the policyholders, and should not be considered as part of income subject to taxation.

Clearly, there is ample justification for deducting 100 percent of premium refunds in computing taxable income. However, as a practical matter, we are suggesting that the bill be amended to allow 50 percent of the refunds now disallowed. In justice, at least this much should be allowed, particularly since companies issuing only nonparticipating insurance are permitted to deduct 100 percent of any excess of taxable investment income over gain from operations from taxable investment income.

The accompanying exhibit 2 gives an example of how this bill discriminates against the policyholder having participating insurance. Two companies are illustrated, both of which have the same taxable income and the same gain from operations after the deduction of dividends to policyholders. Company A issues participating insurance but company B does not. Despite the fact that their operations are identical except in this one respect, the tax base of company A is $500,000 larger under H.R. 4245 than that of company B. Even under our proposed amendment the tax base for company A would be $250,000 greater than that for company B. Thus it is clear that this amendment only reduces but does not eliminate the discrimination against the holder of participating insurance.

In calculating the gain from operations, for tax purposes, a full 100 percent deduction is given for all but one of the major items entering into the computation of the gain from operations in the company's official annual statement. This statement is prepared on a form prescribed by the National Association of Insurance Commissioners. The one major item whose deductibility is limited for tax purposes is dividends to policyholders. This singling out of one item for special treatment seems artificial and arbitrary and creates a serious tax burden on the millions of people who own participating insurance. It is inequitable to determine by formula a result from operations and then ignore it.

It has been stated that the limitation in this bill on the deductibility of dividends is desirable "to prevent mutual companies from depriving an undue tax or competitive advantage by deducting policy dividends." Even with a 100 percent deduction, instead of the recommended 50 per cent, mutual companies would not derive any competitive advantage. In order to derive a tax advantage a company would have to sell insurance at less than cost. No company can engage in such a practice and stay in business for long.

The third amendment we recommend relates to pension plans.

The report of the Committee on Ways and Means states that deduction of part of the investment income attributable to pension plans is necessary in order—

* * * to equate the treatment provided the smaller employers who cannot establish separate trusteed pension plans.

The committee is to be commended for establishing this principle and for seeking to eliminate this discrimination against insured pension plans. However, the investment income credited to qualified pension plans is exempted only in part by this bill. If the desire is to equate fully the treatment of insured pension plans with the advantages now accorded plans administered by banks and other trustees, the following steps should be taken:

(1) Include all qualified pension plans by broadening the definitions.

(2) Exempt from taxation all investment income allocated to the pension plan lines of business.

(3) Treat capital gains and losses allocated to pension plans the same as investment income allocated to those lines of business.

(4) Exclude amounts allocable to pension plans from the calculation of phase 2.

The fourth amendment we recommend is that individual annuities, including supplementary contracts with life contingencies, be given similar treatment to that accorded contracts under qualified pension plans.

At the present time, a life insurance company is required to pay an income tax on its investment earnings on individual annuity business. In addition, the annuitant generally is required to pay income taxes as he receives the annuity. There is thus a double application of taxes on investment income earned for annuitants.

Such double taxation in our opinion should be eliminated. Moreover, common fairness would seem to require that a person who buys an individual annuity should not be taxed more heavily than one who has an annuity under a qualified pension plan.

If all four of these amendments are adopted, we estimate that revenue under the amended bill would be $480 million for 1958, which is only 2.5 percent less than would be produced by the 1942 law. But it would be an increase of 64 percent over the amount actually paid for 1957, and an increase of 50 percent over the amount that the stopgap law would produce for 1958. The details of these revenue estimates are given in exhibit 3, attached.

After 1958, as additional provisions of the bill become effective, and due to the growth of the industry's assets through continued payment of premiums, the revenue should be $500 million a year or more.

Your responsibility for legislating a tax increase of this magnitude is great. We, however, have a responsibility to our policyholders for bringing this to your attention.

There are other aspects of this matter which are important but which we have subordinated to the apparent realities. With the two basic amendments which have been outlined we are prepared to try to accommodate ourselves to the levies imposed. We believe, however, that further reduction of the tax, even beyond the amendments urged by us, would be of benefit to our country as a whole.

Thank you.

Senator KERR. Thank you, Mr. Slater.

I yield to the Senator from Nebraska.

Senator CURTIS. May I say to you, Mr. Slater, I have to leave to attend another meeting, and I appreciate, Mr. Chairman, your yielding for this observation.

I followed your statement very closely, and I think it is excellently put forth.

Mr. SLATER. Thank you, sir.

Senator CURTIS. I merely wanted to comment on the fact that the list of companies that are part of your committee includes a very fine Nebraska company, and I would like to show my interest in that company.

Senator KERR. Would the Senator give us its name?

Senator CURTIS. It is the Bankers Life Insurance Co. of Nebraska.

Mr. SLATER. It is the first one.

Senator CURTIS. It is the first comaker or endorser or whatever you wish to call it; Mr. George B. Cook, president, Bankers Life Insurance Co. of Nebraska, 14th and N Streets, Lincoln, Nebr.

Senator KERR. I thought that was an opportunity for a commercial that I would not want to deprive the Senator of. [Laughter.]

Senator CURTIS. You are very gracious, and I thank you.

Senator KERR. I know I would have wanted to have done that had it been an Oklahoma company.

(The exhibits previously referred to follow:)

EXHIBIT 1

SUPPORTERS OF THE TEMPORARY COMMITTEE ON THE TAXATION OF MUTUAL LIFE INSURANCE COMPANIES, 1740 BROADWAY, NEW YORK 19, N.Y.

George B. Cook, president, Bankers Life Insurance Co. of Nebraska, 14th and N Streets, Lincoln 8, Nebr.

W. Rankin Furey, president, Berkshire Life Insurance Co., 7 North Street, Pittsfield, Mass.

Everett H. Lane, president, Boston Mutual Life Insurance Co., 156 Stuart Street, Boston 6, Mass.

Charles J. Zimmerman, president, Connecticut Mutual Life Insurance Co., 140 Garden Street, Hartford 15, Conn.

Ellsworth A. Roberts, president, the Fidelity Mutual Life Insurance Co., Parkway at Fairmount Avenue, Philadelphia 1, Pa.

Norman O. Houston, president, Golden State Mutual Life Insurance Co., 1999 West Adams Boulevard, Los Angeles 54, Calif.

James A. McLain, chairman of board, the Guardian Life Insurance Co. of America, 50 Union Square, New York 3, N.Y.

Wm. P. Worthington, president, Home Life Insurance Co., 256 Broadway, New York 8, N.Y.

Mr. Paul F. Clark, chairman of board, John Hancock Mutual Life Insurance Co., 200 Berkeley Street, Boston 17, Mass.

James P. Fordyce, chairman of board, Manhattan Life Insurance Co., 120 West 57th Street, New York 19, N.Y.

Walter G. Voecks, president, Lutheran Mutual Life Insurance Co., 201-211 First Street, SE., Waverly, Iowa.

O. R. Tripp, president, Ministers Life & Casualty Union, 3100 West Lake Street, Minneapolis 16, Minn.

Harold J. Cummings, president, Minnesota Mutual Life Insurance Co., 1006 Victory Square, St. Paul 1, Minn.

H. Bruce Palmer, president, the Mutual Benefit Life Insurance Co., 300 Broadway, Newark 4, N.J.

Louis W. Dawson, president, Mutual of New York, 1740 Broadway, New York 19, N.Y.

O. Kelley Anderson, president, New England Mutual Life Insurance Co., 501 Boylston Street, Boston 17, Mass.

T. S. Burnett, president, Pacific Mutual Life Insurance Co., 523 West Sixth Street, Los Angeles 55, Calif.

Malcolm Adam, president and trustee, Penn Mutual Life Insurance Co., 530 Walnut Street, Philadelphia 5, Pa.

Alexander Mackie, president, Presbyterian Ministers Fund, Rittenhouse Square, Philadelphia 3, Pa.

Thomas A. Bradshaw, president, Provident Mutual Life Insurance Co. of Philadelphia, 4601 Market Street, Philadelphia 1, Pa.

Richard E. Pille, president, Security Mutual Life Insurance Co., Box 351, Binghamton, N.Y.

Garnett E. Cannon, president, Standard Insurance Co., 812 Southwest Washington Street, Portland 7, Oreg.

H. Ladd Plumley, president, State Mutual Life Assurance Co. of America, 340 Main Street, Worcester 8, Mass.

EXHIBIT 2

*Examples of effect of limitation on deductibility of dividends*[1]

| | Company A (participating) | Company B (nonparticipating) |
|---|---|---|
| ASSUMED DATA | | |
| Taxable investment income | $8,000,000 | $8,000,000 |
| Dividends to policyholders | 1,000,000 | None |
| Net gain from operations after full deduction of dividends to policyholders | 2,500,000 | 2,500,000 |
| RESULTING NET GAIN FROM OPERATIONS | | |
| As defined in H.R. 4245 | 3,000,000 | 2,500,000 |
| If H.R. 4245 is amended as proposed | 2,750,000 | 2,500,000 |
| TAX BASE | | |
| As defined in H.R. 4245 | 3,000,000 | 2,500,000 |
| If H.R. 4245 is amended as proposed | 2,750,000 | 2,500,000 |

[1] These examples have been simplified by omitting such features as the capital gains tax, et cetera, but they illustrate the basic principles involved.

EXHIBIT 3

*Estimates of revenue for 1958 on various bases*

[In millions]

| | | |
|---|---|---|
| Revenue under H.R. 4245 | | $558 |
| Reductions in 1958 resulting from proposed amendments: | | |
| Amendment 1: 5-year Average | $44 | |
| Amendment 2: Dividends to policyholders | 34 | |
| Amendment 3: Pension plans[1] | 0 | |
| Amendment 4: Individual annuities[1] | 0 | |
| Total reductions | | 78 |
| Revenue under H.R. 4245 after amendments | | 480 |
| Revenue under 1942 law | | 402 |
| Revenue under stopgap law | | 319 |

[1] Becomes effective gradually over a 3-year period beginning in 1959, when other provisions which increase the revenue become effective.

Senator KERR. Mr. Slater, I am going to ask you a very unusual question, and you do not have to answer it if you do not want to.

As a predicate for it I want to make this statement: So far as I am concerned and, speaking for myself only, I hope this committee will bring a bill out of here that is equitable not only from the standpoint of the Government to a group of taxpayers—and I want to say that it is a group that I regard very highly—but also equitable as between the great number of taxpayers who will be affected by this bill.

We do not have any mutual company in Oklahoma that I know of, which is domiciled in Oklahoma.

I think it is an opportunity that the mutual companies have failed to take advantage of, and which does not reflect too highly upon the very highest possible degree of intelligence that they could use, but then nevertheless I speak of reality and not of a hope.

We do have quite a number of stockholders.

Many of them tell me, and have told this committee, that they feel that this bill, as written, will be discriminatory against the stock companies; that either amendment to which you refer, and most of them have been presented by others—I believe there are one or two that are presented by you for the first time——

Mr. SLATER. I do not think that is so, sir. I think about everything except No. 4 has been covered here, sir.

Senator KERR. Well, No. 4 was the one I had in mind.

If I am not mistaken that certainly is the first time that I have seen it to recognize it.

Mr. SLATER. It is similar to item 3, sir, similar to the pension plans. It only applies to individuals rather than to qualified pension plans.

Senator KERR. It may have been included in the recommendation which others have made with reference to pension plans, but if it was they did not go into detail in it to the extent that you have gone.

But, at any rate, representatives of the fine stock companies in Oklahoma have told me that the bill, as written, discriminates against them; that either of these amendments would increase the discrimination.

Now, you have convinced me, No. 1, that you know what you are talking about.

Mr. SLATER. I trust I do, sir.

Senator KERR. Well, you have convinced me that you do; that you are an expert on the provisions of this bill.

From the standpoint of a stock company, if it should be your lot to be designated to come now and advise this committee from their viewpoint, would you be able either to establish the principle that the bill, as written or with these amendments, does discriminate against our companies or does not?

As I said, you do not have to answer that question if you do not want to.

Mr. SLATER. Senator Kerr, as I understand it, in the first part of my statement I stated, the first paragraph, on the level of taxes, I said that the tax on the mutual companies would be over $50 million greater than a straight 52 percent tax on their gain from operations before the usual adjustment allowed to corporations generally.

Senator KERR. Yes. I heard that, and I underscored it here on my paper.

But with knowledge of that, and having some comprehension of its significance, I still ask you the question.

Mr. SLATER. Well, sir, I believe that the statement that we have presented for mutual companies would indicate that the mutual companies are being discriminated against, the policyholders of mutual companies are being discriminated against, and I could not, as an actuary if I worked for a stock company, or at least I do not know how I could, come here and make a statement to the effect that stock companies are being discriminated against by this bill.

Senator KERR. Of course, the statement that you made there is based upon a recognition or an assertion that all dividends to policyholders should be taken into account as reductions of taxable income.

Mr. SLATER. We believe, sir, that——

Senator KERR. I say, this statement is based upon that assertion.

Mr. SLATER. That is correct. That is after deduction of dividends to policyholders; that is correct.

Senator KERR. So if you were representing a stock company here you could not take and establish the premise that the bill, as written, is discriminatory against you?

Mr. SLATER. No, sir; I could not do that.

I have stated, I believe, that it is discriminatory in the other direction.

Senator KERR. In reference to your recommended amendment No. 3, you make statements which, if I understand them, indicate or set forth your conviction as of now the tax structure, as provided in this bill, to begin with, and in current law without this bill, discriminates against insurance companies as compared to trust companies in the handling of what have been referred to here as pensions plans written by life companies.

Mr. SLATER. That is correct, sir; I do believe that.

Senator KERR. It is your premise that the law, as now in effect, discriminates against the insurance companies?

Mr. SLATER. Yes, sir; I believe that to be the fact.

Senator KERR. I want you to tell me in language, as I told one witness here today, that a sixth grader could understand how you arrive at that conclusion.

Mr. SLATER. Well, I arrive at that conclusion in this way, sir: In a life insurance company the total investment earnings of that company today, under the stopgap law that was in effect in 1957, we paid a tax of 7.8 percent of our net investment income or 52 percent on 15 percent of our investment earnings, and that was deducted on all lines of business, including the pension plan line of business.

Now, similar plans in trust companies, banks, privately trusteed and so on and so forth, do not pay any tax on investment earnings that they earn on the funds invested.

Senator KERR. I wonder now if, in order to be accurate, you should address your remarks to the effect of the 1942 act in view of the fact that it is the law today.

Mr. SLATER. Well, the same thing would apply, sir, to the 1942 law. The investment earnings of a life insurance company are taxed at a higher rate than the 1955 stopgap law.

Senator KERR. Well now, you see that is a general statement, and I assume that you are presuming that I can apply it to the question I have asked you.

What I would like for you to do is to address yourself strictly to the question I asked you.

You know, I asked another witness to do that, and I am not right sure but that he eventually did, but by that time I was mentally fatigued to where I could not fully recognize it, and I just assumed he did.

Mr. SLATER. All right, I will try to limit my remarks as they refer to pension plans.

Under the 1942 law we pay a tax on the net investment income of the investment earnings allocated to that line of business.

What I would like for you to do is to address yourself strictly to the earnings.

Mr. SLATER. Those are the earnings of the funds.

Senator KERR. Well now, was that your company earnings?

Mr. SLATER. That is right.

Senator KERR. That is what I want to know.

Mr. SLATER. That is correct, sir.

Senator KERR. Is there a difference in the amount of the earnings which this trust fund accumulates in your hand from what it would be in the hands of a trust company?

Mr. SLATER. Well, the earnings are the investment earnings on the funds that are deposited with the company.

Senator KERR. With the insurance company?

Mr. SLATER. Yes. We pay a tax on them. A trust company does not.

Senator KERR. Those are not your funds, are they?

Mr. SLATER. No, sir; they are—well, I do not want to get into legal complications here.

Senator KERR. You are a trustee of them.

Mr. SLATER. We do not trustee them in the sense that a bank trustees them, but we do have obligations under those funds to pay them out.

They are not funds that are the property of the corporation. The earnings are credited to the——

Senator KERR. They are not given to you for your benefit, are they?

Mr. SLATER. No, sir; they are not. They are for the benefit of the employees of the employer.

Senator KERR. Then does not that more or less create a situation of a trustee?

Mr. SLATER. I do not think it does in the strict sense, but I think among us sixth graders it probably does. [Laughter.]

Senator KERR. In general. I want to tell you that is what you are dealing with.

Mr. SLATER. Well, I am, too, sir.

Senator KERR. You and I will get along. What I am trying to figure out is this: How can you get any business in the matter of a pension fund if you are going to keep out of the profit on it which would be subject to taxation or not? It does not make any difference to the fellow who puts his money there, does it——

Mr. SLATER. That is correct.

Senator KERR (continuing). As to whether you get part of the profit or you and the Government get it; it does not make any difference to him.

Mr. SLATER. Your question is how can we get any new business, sir. I think that the answer is we are not getting very much.

Senator KERR. I am asking you how you can get any business. If you and the Government get part of the profit of the operation in your hands, but where nobody but the fellow that is being handled gets the profit, if it is in the hands of the trust company, how can you get any business?

Mr. SLATER. Well, the only place we can get any business, sir, is with the very small employer who cannot afford to have a spread of risk that a large corporation can have, and he must come to a life insurance company and, therefore, the provisions in the bill discriminate against the small employer.

I think Senator Anderson pointed that out here before; this discriminates primarily against the small employer.

Senator KERR. You mean the 1942 act with reference to this and a portion of the——

Mr. SLATER. I think this bill does also, sir. I think H.R. 4245 discriminates against the small employer because, if I remember Mr. Slitor's figures correctly, 75 percent of the investment income and not the full 100 percent of the investment income——

Senator KERR. I want to say this: That if the present law is wrong, and there is indication that the Ways and Means Committee and the

House thought it was, because they make provision to remove it in steps, and if it is wrong to where it should be removed at all, I think it ought to be removed immediately.

Mr. SLATER. I agree with that.

Senator KERR. But what I am trying to find out is whether or not it is wrong, you see. That is what I am asking you now—to tell me how it discriminates.

Mr. SLATER. Well, the way it discriminates is this, sir: We earn, say, something on the order of 3½ percent on our investments.

We then pay a Federal income tax on that of, say, something on the order of 30 points, so that——

Senator KERR. Let us go back now to that 3½ percent that you earn on this money of these people that have this pension program.

Mr. SLATER. That is correct.

Senator KERR. To what extent do they get that 3½ percent?

Mr. SLATER. In a mutual life insurance company we credit all of that to their accounts, except what we have to pay in Federal taxes, and that will be something on the order of 30 points off that, so that if it were 3.5, it would be reduced to something on the order of 3.2 that we would be allowed to credit.

Senator KERR. Is that more than this bill provides an exemption for?

Mr. SLATER. This bill would allow us three-quarters of the 30 points which would be roughly 20-some-odd points.

In other words, instead of crediting 3.5 as the trust company could, we would be allowed to credit 3.4; so that the discrimination, we believe, still exists in there to this part.

Senator KERR. You say pay the rest of it to the Government?

Mr. SLATER. We pay roughly 0.30 percent—30 points—of our net investment income to the Government in Federal taxes.

Senator KERR. Do you allocate any of that profit to your surplus account?

Mr. SLATER. In a mutual company, sir, we do not have profits in the sense that you are referring to, and all of our funds are allocated to our policyholders.

Senator KERR. Well, you do have a surplus; do you not?

Mr. SLATER. We do have a surplus account, but when policyholders terminate, that part of the surplus that is determined to be theirs goes with them.

Senator KERR. Would that be true in a stock company?

Mr. SLATER. Well, no, sir. When a policyholder terminates in a stock company he does not get settlement dividends as we pay in a mutual life insurance company.

Senator KERR. The witness that was here awhile ago said in his judgment he was convinced that there was not a discrimination in this matter in the present law, and that the attempt to relieve you of some taxes in this program of a certain amount of it each year, rather than removing a discrimination, created one.

Mr. SLATER. Well, if I understood him correctly, and I listened to him, and I would have to interpret what I thought he said, and if I understood him correctly, Senator, he implied that if the taxes on pension plans were reduced we could then take that money, that savings on the pension plans, and use it in other lines of business.

This, of course, cannot be done.

Senator KERR. Why?

Mr. SLATER. Well, for three reasons.

Senator KERR. You understand I am not arguing with you any more than I was with the other witness. I am trying to get the facts in this record.

Mr. SLATER. For three reasons: One is that the employers we do business with know that the taxes have been eliminated on pension plans, and I think you can rest assured that they will make sure they get it.

Secondly, management would do it as we maintain equity.

Thirdly, regulation 33 of the New York Insurance Department would require that any savings in taxes on pension plans would be allocated to that line of business and not other lines of business.

I agree with Senator Anderson that the laws of New York State are very commendable.

Senator KERR. If we adopted the second amendment recommended by you, if we took care of this fourth part of your amendment No. 3, would that do what you are talking about? Would that accomplish the result that you seek?

Mr. SLATER. I think that you would have to eliminate all investment income.

Senator Kerr, if you just eliminate all the investment income and do not eliminate it from phase 2, you cause the tax to fall in phase 2 that did not occur in phase 1.

Senator KERR. Is it not eliminated in phase 2 by policyholder dividends?

Mr. SLATER. No, sir; because companies do need to maintain, especially for small employers, contingency reserves to offset the improving mortality that occurs with annuities.

Senator KERR. I wonder if you would submit the amendment that you think would effect the elimination of this discrimination.

Mr. SLATER. Senator Kerr, we will be glad to, but Mr. Warters, who has been a previous witness, has submitted amendments that would take care of this provision 4.

Senator KERR. And your recommendation to be carried out would be by the acceptance of those amendments?

(The proposed amendment referred to appears in Mr. Warters' statement at p. 205.)

Mr. SLATER. That is correct, sir.

Senator KERR. Any questions, Senator Long?

Senator LONG. Yes.

You have the recommendation here that you ought to be allowed a deduction from dividends to policyholders.

Do I understand that you are urging that that should be deducted from the taxable investment income?

Mr. SLATER. That is from phase 1; that is correct.

As I understand the tax law, Senator Long, it is a total income approach, a total receipts tax.

It is split in two categories, I believe, approximately: one, it tries to determine the so-called net investment income tax, and the second place, the so-called gains from operations, and if we are not allowed to carry back, and we are only asking for half a carryback, it means that a tax calculated under phase 1 that is excessive, and for mutual companies is a tax on the policyholders. If that tax is excessive, we are not allowed to carry it back to reduce the tax on the policyholder.

Senator LONG. You state in your analysis here that they are actually refunds of excess premiums.

Mr. SLATER. That is the dividends; yes, sir.

Senator LONG. Now, it seems to me that with regard to your dividends, as one who does not understand your business very well, that if you receive, let us say, $1 million which you are going to hold for a year to see how the business goes, and to keep it, if you have to, and to return it if you did not need it, that you should not be entitled to deduct it unless you include it in your income to begin with.

If you put it in there, I can see that you ought to be entitled to take it back out as a deduction, but if you did not include that $1 million as income, I cannot see that you are entitled to deduct the full million.

Mr. SLATER. Well, the dividends, sir, are included with the premiums initially, and deducted as a dividend to policyholders, so they have been included with the premiums.

Senator LONG. The full million?

Mr. SLATER. All dividends to policyholders have been included in the accounts above in premium income.

Senator LONG. Well now, is that full million dollars reflected as a part of the total investment income or only part of it against which you would like to make the deduction?

Mr. SLATER. Sir, you are referring to $4 million. I do not seem to have that figure.

Senator LONG. $1 million. Is that $1 million—in your illustration in exhibit 2, I believe you undertook——

Mr. SLATER. Exhibit 2; yes, sir.

Senator LONG. Yes, exhibit 2. You undertook to illustrate how that would work out in company A and company B, being two parallel companies.

What I had in mind is if you refer to $1 million there of dividends to policyholders, well now, is that full $1 million, 100 percent of it indicated in that $3 million of total investment income?

Mr. SLATER. Well, the investment income on that is in the taxable investment income, that is correct, sir.

The investment income earned on the $1 million is in the $3 million above.

Senator LONG. Yes.

But now the point I have in mind is if you earn, let us say, $40,000 of income on that $1 million you would not claim the right to deduct the $1 million because you earned $40,000 on it, would you?

Mr. SLATER. No, sir. But in the item below in determining the $2½ million figure, the dividends, the $1 million figure is included in premiums and deducted as a dividend.

The question of deductibility of dividends does not take place in phase 1 but is in the second phase, which is a so-called total receipts approach.

Senator LONG. Offhand it would just seem to me that the logical way to handle that as a return of premium is to more or less try to account for that on the side, just not charge you for it in the first instance. If you were not charged for it, you would not have any deduction; if you put it in, you would be entitled to take it out again.

Mr. SLATER. We are, in effect, charged for it in one side, but not allowed to take credit for it when a negative item shows up.

Senator LONG. Well, the only thought that occurs to me is that it should not work out as a double deduction.

Mr. SLATER. It is not a double deduction, sir.

Senator LONG (presiding). Senator Carlson?

Senator CARLSON. No questions.

Senator LONG. Senator Gore?

Senator GORE. No questions.

Senator CARLSON. Mr. Chairman, if we are about to conclude our hearings I would like to say that we are very fortunate in having able men like Mr. Slater to come before the committee and help us on this very complicated problem.

Senator LONG. Let us wait just 1 minute until Senator Kerr returns.

Mr. SLATER. There are two statements we would appreciate, if it is agreeable with you, to add in the record: One a statement on the subject of competition, and another a statement on dividends as a reduction of premiums.

Senator LONG. Yes. They will be included in the record.

(The statements referred to follow:)

STATEMENT ON DIVIDENDS AS A REDUCTION OF PREMIUMS BY ROBERT E. SLATER, VICE PRESIDENT, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., BOSTON, MASS., ON BEHALF OF TEMPORARY COMMITTEE ON THE TAXATION OF MUTUAL LIFE INSURANCE COMPANIES

A mutual company's primary concern, with respect to premiums, is to receive from its policyholders net payments sufficient to cover the cost of insurance. Initially it sets its premium rates higher than these minimum amounts, contemplating that it will return the unnecessary amounts as dividends. It has the problem, however, of determining an appropriate amount of extra initial charge for each type of policy and age at issue. The logical approach to this problem is to compute an initial premium using conservative assumptions as to mortality, interest, and expenses, thus allowing for an adverse future trend in any or all of these elements which determine the cost of insurance.

The mutual company then later faces the second problem of determining an equitable refund to each policyholder in the normal instance in which the adverse experience provided for in the premium does not, in fact, develop. The computation of the dividend must involve measurements of experience on mortality, interest, and expense against the premium assumptions since these same differences determined the amount of conservatism originally built into the premium. The end result, however, is obviously a simple return to the policyholder of the overcharge made to him.

With respect to policies that become paid up, a special situation arises. The original premium contains conservative provision for mortality, interest, and expense experience not only during the premium paying period but also during the later paid-up period. At the end of the premium paying period a mutual company retains a fund sufficient not only to cover minimum anticipated costs but also to cover some adverse development of experience. Consequently, here also, if the adverse experience does not develop, further refunds to the policyholders can be made.

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STATEMENT ON COMPETITION BY ROBERT E. SLATER, VICE PRESIDENT, JOHN HANCOCK MUTUAL LIFE INSURANCE CO., BOSTON, MASS., ON BEHALF OF TEMPORARY COMMITTEE ON THE TAXATION OF MUTUAL LIFE INSURANCE COMPANIES

The attached table illustrates premium rates currently being charged and net payments after dividends anticipated for five mutual companies and five stock companies. The five mutual companies chosen are representative companies, all of whom support the work of our committee. The five stock companies are representative of the nonparticipating part of the industry generally.

Three conclusions may be drawn from these data:

One. The gross premiums charged by mutual companies are indeed redundant and the dividends which return the unnecessary portion of those premiums do, in fact, reduce the net payments required from the policyholders to the same order of magnitude as nonparticipating premiums.

Two. Any competitive advantage of mutual companies over stock companies is not of great significance. The variations between companies and by plan of insurance are larger than the average differential between stock companies and the mutual companies. In an individual sales situation it would appear that particular plans of insurance, the exact nature of policy benefits, and other similar factors, including the ability of the salesman, would have more effect than any theoretical advantage of a mutual company over a stock company.

Three. Nevertheless, it is generally true that the net payments required of mutual policyholders are somewhat lower than the nonparticipating premiums of stock companies over the 20-year period illustrated (these same differences would probably not exist over a shorter period, and the opposite would be true, certainly, for the first year of insurance.

With regard to the general question of competitive advantage between mutual companies and stock companies it is obvious that a mutual company needing to cover only the cost of insurance should require smaller net payments from its policyholders than would a stock company operated with equal efficiency and under similar circumstances. This follows from the fact that the stock company must cover not only the cost of insurance but also some increment of profit for its stockholders. While we believe that any competitive advantage resulting from this fundamental distinction in the nature of these two types of companies is a small one, we also feel it would be grossly inequitable to impose upon the mutual companies an extra tax burden with the simple objective of raising the cost of insurance in those mutual companies to what that cost would be if they too needed to earn some profit for stockholders.

*Current net premiums for typical mutual and stock companies*

[Stated per $1,000 of insurance for a $5,000 policy issued at age 35]

5 TYPICAL MUTUAL COMPANIES

| | Whole life policy | 20-pay life policy |
|---|---|---|
| Gross premiums: | | |
| Company A | $26.68 | $38.13 |
| Company B | 24.64 | 39.10 |
| Company C | 28.58 | 38.98 |
| Company D | 26.40 | 40.14 |
| Company E | 24.39 | 38.56 |
| Average | 26.12 | 39.60 |
| Gross premiums less dividends (average over 20-year period): | | |
| Company A | 20.06 | 30.50 |
| Company B | 19.60 | 30.72 |
| Company C | 18.41 | 29.81 |
| Company D | 20.25 | 31.59 |
| Company E | 18.66 | 28.92 |
| Average | 19.38 | 30.31 |

5 TYPICAL STOCK COMPANIES

| | Whole life policy | 20-pay life policy |
|---|---|---|
| Nonparticipating premiums: | | |
| Company I | $20.76 | $32.32 |
| Company II | 21.25 | 32.18 |
| Company III | 20.22 | 31.93 |
| Company IV | 21.08 | 32.80 |
| Company V | 21.27 | 31.65 |
| Average | 20.90 | 32.26 |

Senator LONG. Our next witness will be Mr. William B. Elson, Jr., Swift & Co. Employees Benefit Association.

Mr. Elson, if you are prepared, we will proceed.

Mr. ELSON. Yes, sir.

Senator LONG. Will you proceed, Mr. Elson?

## STATEMENT OF WILLIAM B. ELSON, JR., COUNSEL, SWIFT & CO. EMPLOYEES BENEFIT ASSOCIATION; ACCOMPANIED BY C. H. LANG, MANAGER; MICHAEL VERDEROSA, MEMBER, ADVISORY COMMITTEE; JOSEPH ARAMOWICZ, MEMBER ADVISORY COMMITTEE; AND JOSEPH B. MEEGAN, SECRETARY, THE BACK OF THE YARDS SOCIAL ACTION CLUB OF CHICAGO

Mr. ELSON. My name is William B. Elson. As an employee of Swift & Co., I am a member of and legal counsel for Swift & Co. Employees Benefit Association. With me today are Mr. C. H. Lang, manager of the association; Mr. Michael Verderosa, a member of the advisory committee from South St. Paul, Minn.; and Mr. Joseph Aramowicz, a member of the advisory committee from Evansville, Ind., whom we hope will join us momentarily.

The advisory committee, consisting entirely of employees, is the governing body of the Association.

We are also very proud to have with us Mr. Joseph B. Meegan, secretary of the Back of the Yards Social Action Club of Chicago.

This is Mr. Meegan in whose area are located the homes of a substantial number of our members.

Swift & Co. Employees Benefit Association was organized by a group of employees as a common law trust in 1907. The association provides death benefit coverage for 57,000 employees (including former employees), with maximum coverage of $4,000 and average coverage of less than $2,000. It provides accident and sickness benefits for a maximum of 2 years to approximately 50,000 employees. In 1958, approximately 700 death claims were paid, and sickness and accident benefits averaging about $200 were paid to almost 8,000 members. For about 80 percent of both office and plant employees located in every State of the United States, their total life insurance protection is provided by membership in the association and group insurance under the company plan. The benefits provided by the association have been supplemented by employer-financed hospitalization and medical care insurance and by group life insurance, the cost of which is shared by employer and employee.

A person becomes eligible for membership in the association upon becoming an employee of Swift & Co. The cost of noncancellable term life protection, which is fully paid on retirement after 25 years' membership, was fixed in 1907 at $13 per thousand for one who becomes a member before age 45, and has never been increased. Such coverage is not generally available with commercial life insurance companies at any price. Many of the plant workers engage in hazardous employment, for which an occupational rating is imposed by commercial companies. Payment of contributions is waived for a maximum of 2 years for a member absent from work because of sickness or accident. For modest cost, employees may elect, also, sickness and accident benefits which provide a weekly benefit up to a maximum of 2 years.

Since 1921 the association has been taxed as a life insurance company. The association had been in existence for more than 20 years at the time of enactment in 1928 of the exemption for employee benefit associations providing for the payment of life, sickness, accident, or other benefits to the members of such associations, or their dependents, as is now embodied in section 501(c)(9) of the 1954 code. As originally enacted, and amended in 1942 retroactively to 1928, the exemption was limited to organizations receiving less than 15 percent of income from sources other than contributions of employer and employees.

As a result, however, of sound management, and the youthful average age of its early membership, the association accumulated an excess of membership dues over benefits paid. The investment income from this fund was taken into account in fixing the amount of the death benefit contribution which is a matter of contract and cannot be increased. Nevertheless, the amount of our investment income has not been less than 15 percent of our annual income. Thus, although similar associations of employees of private employers have been exempt from tax, our association has never qualified for the tax exemption, and has been taxable as a life insurance company.

During the last 15 years our tax liability as a life insurance company has ranged from 0 to $26,000, and this burden was considered not to be so onerous as to warrant petition to the Congress for relief. Under H.R. 4245, however, our tax liability for 1958 is estimated to be at least $478,000. The impact of such a burden would make it impossible for the association to meet the $105 million in death benefits for which it is presently obligated, and to continue to pay current accident and sickness benefits. Termination of the association is as certain as night follows the day, if the provisions of H.R. 4245 are not amended.

Except for the impending passage of H.R. 4245, the association is in sound financial condition. The reserves of the association have been established upon independent actuarial analysis, and the manager, Mr. Lang, is responsible for the administration and overall sufficiency of the program.

The justification for tax exemption of employees benefit associations like ours is readily apparent, since such employees' beneficiary associations provide a minimum of life insurance for employees at a cost below that at which comparable coverage could be obtained commercially, and sickness and accident protection on a nonprofit basis. In our case, the coverage, with its paid-up protection and premium waiver features, which I previously mentioned, simply is not available with any domestic commercial insurance company.

Over the years, such associations have been of special value among employees of relatively slight skill, large families and lower educational attainment, who were not generally serviced by the commercial insurance companies. The formation of this association by a group of employees in 1907 was their practical solution to "passing the hat" when a fellow employee died or was seriously ill or injured.

Under existing law, and indeed from the date of the original exemption in 1928, a voluntary employees' beneficiary association fails for exemption if more than 15 percent of its income is derived from investments or from any other sources, except contributions of employer and employee. It is not apparent why the limitation upon income from investments should be a disqualifying factor, since the ability of an organization to carry out its obligations to its members—especially for the payment of death benefits—is vitally affected by the amount of income it receives in addition to current contributions.

This was apparently recognized by Congress in 1939, when exemption was extended to voluntary employees' beneficiary associations composed of individuals who are officers and employees of the U.S. Government, without limitation as to source of income.

Our membership is limited to employees of Swift & Co. (and about 75 percent of all employees are presently covered). It is not possible under our deed of trust to expand the scope of activities into a commercial insurance company by soliciting the general public. Nor is it possible, because the death benefit coverage is noncancellable, either to increase the contributions or to reduce the benefits.

Amendment of the proposed changes in subchapter L of chapter 1 of the 1954 Code, to deal specifically with this problem, would be neither practicable nor desirable. We are patently a nonprofit association, operated solely for the benefit of the employees without other than incidental, intangible benefit to the employer. The policies, rules and regulations of the association are established by an advisory committee of 50 members.

Mr. Verderosa and Mr. Aramowicz are committee members, duly elected by the association members at their plants in South St. Paul, and Evansville, respectively.

All property of the association is held in trust under the laws of the State of Illinois and is managed by uncompensated trustees for the exclusive benefit of members. The association clearly falls within the general category of organizations exempt under section 501(c) of the 1954 Code. Consequently, it is urged that the same act which now threatens the existence of the association be the medium for granting the complete exemption which its organization and operation over the years and its prospect of continued service to 57,000 employees in the future surely merit.

There has been referred to the committee an amendment to H.R. 4245 intended to be proposed by Senator Carlson—for himself and Senator Hartke—which would provide the necessary exemption, but would insure taxability of profits of any trade or business activity unrelated to the exempt purposes in the same manner that unrelated trade or business income of other exempt organizations is already subject to tax.

The family protection of 57,000 people is jeopardized, if H.R. 4245 should pass in its present form. If our Employe Benefit Association should be terminated, many of its members will be unable to replace, at any cost, the life insurance protection thereby lost. Since H.R. 4245 creates the threat to the existence of the association, we urge the amendment proposed by Senator Carlson and Senator Hartke. This amendment would obviate the havoc which its enactment would otherwise cause for our members and their families.

This simple amendment would give me and my 57,000 fellow members the same protection now accorded to Federal employees under section 501(c)(10), subject however to the limitations with respect to unrelated trade or business.

Senator KERR (presiding). Thank you very much, Mr. Elson.

Are there questions?

Senator CARLSON. Mr. Chairman, I have a question.

Mr. Elson, you and the other members, employees of the Swift & Co., appear here today greatly concerned about the future welfare—as a matter of fact, I notice you used the word "termination" of this voluntary insurance program should H.R. 4245 be enacted; is that right?

Mr. ELSON. That is correct, sir.

Senator CARLSON. What part of a member's total life insurance protection is represented by the death benefit coverage of your association?

Mr. ELSON. Well, our studies indicate, and we checked, for example, with Messrs. Verderosa and Aramowicz with respect to their membership in local plants, and we have checked with other local plants, and it appears that in about 85 percent of the cases the member's total life insurance consists of membersip in this association, plus such life insurance as he may be participating in under the group life plan.

Senator CARLSON. What is the average age of your employees?

Mr. ELSON. 47.7 is the average age of the members of the association.

Senator CARLSON. Have you given any thought to how the older members would replace their death benefits, the coverage of them, if the association were terminated?

Mr. ELSON. We are particularly concerned about that group which is in the older age bracket, if for no other reason, a very strong likelihood that they would not be in position to pass a medical examination.

Assuming they were able to pass the necessary physical examination, they would be in a position where term insurance available through commercial companies would be for a period extending not beyond age 65, sometimes only age 62 or 60, whereas what he is losing is something that continues for life, and to the extent that it has been in effect for 25 years. When he retires it continues for life without cost.

There is just no basis of comparing what he has and what he can get, assuming he can meet the medical requirements.

Senator CARLSON. Senator Hartke of Indiana was called to the floor a few moments ago, and he asked me to ask you two questions that he wanted to get the answers to in the record.

No. 1: How does the association invest the reserve funds to meet future death benefits? Who makes the decision; in what types of securities do you invest?

Mr. ELSON. The investment of the funds is the responsibility of five uncompensated trustees.

The investments are in Government bonds, industrial corporate bonds, utilities, railroads, and in securities, equity securities.

I do not know that I covered all the parts of that compound question.

Senator CARLSON. I think it is well answered.

The second question is: Has there ever been any dividend or refund to members of your association?

Mr. ELSON. No, sir. There is no provision and, as a matter of fact, it will be contrary to the provisions of the deed of trust to make dividend payments to members.

Senator CARLSON. Senator Curtis of Nebraska had to go to the floor, and he wanted me to express his personal interest in this. It is of concern to all of us who are familiar with the operations of this great company.

Mr. Chairman, I ask unanimous consent, if Mr. Elson did not already do so, that the membership and the States of the Union that are listed as part of his statement be made a part of the record.

Senator KERR. Very well.

(The exhibit referred to is as follows:)

EXHIBIT A

SWIFT & CO. EMPLOYEES BENEFIT ASSOCIATION MEMBERSHIP ACCORDING TO STATES EMPLOYEES

| | | | |
|---|---|---|---|
| Alabama | 270 | New York | 1,002 |
| Arizona | 52 | North Carolina | 847 |
| Arkansas | 72 | North Dakota | 16 |
| California | 1,489 | Ohio | 1,158 |
| Colorado | 702 | Oklahoma | 139 |
| Connecticut | 103 | Oregon | 509 |
| Delaware | 60 | Pennsylvania | 647 |
| District of Columbia | 137 | Rhode Island | 57 |
| Florida | 569 | South Carolina | 205 |
| Georgia | 1,361 | South Dakota | 190 |
| Idaho | 79 | Tennessee | 1,036 |
| Illinois | 7,068 | Texas | 2,823 |
| Indiana | 1,081 | Utah | 367 |
| Iowa | 1,890 | Vermont | 25 |
| Kansas | 1,694 | Virginia | 208 |
| Kentucky | 92 | Washington | 84 |
| Louisiana | 401 | West Virginia | 44 |
| Maine | 80 | Wisconsin | 1,148 |
| Maryland | 506 | Wyoming | 11 |
| Massachusetts | 1,039 | Outside continental United States | 8,097 |
| Michigan | 190 | | |
| Minnesota | 3,708 | Total | 43,411 |
| Mississippi | 259 | Pension and retired employees 7,205 | |
| Missouri | 8,405 | Former employees 5,984 | |
| Montana | 14 | | 13,279 |
| Nebraska | 1,834 | | |
| Nevada | 7 | Total membership | 56,690 |
| New Hampshire | 25 | | |
| New Jersey | 1,333 | | |
| New Mexico | 24 | | |

Senator CARLSON. That is all.

Senator KERR. Senator Anderson?

Senator ANDERSON. Mr. Chairman, I have gone over this a little bit, and I think this is a case we ought to try to do something with. Is there any peculiarity in the deed of trust that will someday terminate this company, or will it go on for a thousand years?

Mr. ELSON. Actually, the specific provision in the deed of trust, in order to comply with the rule against perpetuities in effect in Illinois, was that the trust will expire 21 years after the death of the last of the original organizing group. Although it was organized 52 years ago, we still have living members of that group. So that we are a minimum of 21 years plus away from termination of the trust.

However, you get into some legal ramifications.

The termination of the trust cannot, under the Illinois law, terminate the obligation under the then outstanding noncancellable death benefit certificates.

Senator ANDERSON. To existing members?

Mr. ELSON. That is correct.

Senator ANDERSON. But would it be possible for a stranger to come in now, a wholly new person that becomes an employee, and get the insurance after the termination of the trust?

Mr. ELSON. I do not believe the way the instrument now reads he could.

Looking ahead 20 years, and we have tried to look ahead, we hope our existence is not about to be terminated by virtue of the tax bill; we have done some study, and we have visualized what our position is, having to go to the courts in Illinois and asking them to construe something that will provide for their continued existence, if that is deemed desirable at that time.

Senator ANDERSON. Mr. Chairman, I thought that possibly when we got down to the bill we might write one of those carefully drawn amendments that provides that a trust organized prior to 1910, and expiring 50 years from the present date, might be protected in a certain manner. I merely want to suggest if you have any language that would do that I would think it might be all right.

This is a rather unique organization. I do not think it is a bad organization. I do not think it jeopardizes the institution of life insurance.

However, granting some wide-open exemption might bring on a flood of new programs that would not be as soundly managed as this would be.

It would seem to me if you would suggest some language that might be protective in a way so that we do not open the gates, but we deal specifically with this very special problem, then my conscience would not be hurt by dealing with it specifically.

Mr. ELSON. We'll be very happy to try to submit alternate proposals in the way of an amendment that would offer protection to the revenue and to the insurance industry and to everybody else that properly has it coming to them.

(Mr. Elston subsequently submitted the following for the record:)

HOPKINS, SUTTER, OWEN, MULROY & WENTZ,
*Chicago, Ill., March 12, 1959.*

Re Swift & Company employes benefit association.

The Honorable CLINTON P. ANDERSON,
*Senate Office Building, Washington, D.C.*

MY DEAR SENATOR: When Mr. William B. Elson, Jr., appeared before the Finance Committee on March 5 in support of an amendment to H.R. 4245, intended to be proposed by Senator Carlson, for himself and for Senator Hartke, you asked that consideration be given to further restricting the scope of the amendment so that it would apply only to the specific problem confronting Swift & Co. Employes Benefit Association. You asked that Mr. Elson submit to you any suggestion for so restricting the scope of the proposed amendment.

It is believed that the degree of restriction suggested by you can be met by adding to section 501(c)(9) of the Internal Revenue Code the following:

"provided, however, that subsection (B) hereof shall not be applicable in the case of a voluntary employees beneficiary association providing for the payment of life, sick, or accident benefits to its members or their dependents if such voluntary employees beneficiary association was in existence on March 1, 1913."

Under the language proposed above, the 85 percent limitation contained in section 501(c)(9) would continue to be applicable to voluntary employees beneficiary associations generally. The income restriction would be removed only for an association paying life, sick or accident benefits (note that it could not pay "other benefits") to its members or their dependents but only if the association was in existence on March 1, 1913.

We appreciate your consideration of this matter and will welcome the opportunity to discuss this further with you or with any of the members of your staff.

Very truly yours,

WILLIAM A. CROMARTIE,
*Attorney for Swift & Co., Employes Benefit Association.*

Senator ANDERSON. You know very well sometimes as soon as you get out a new way of shopping for groceries, that the next week there is a whole flood of new ventures that come around and tell you how you can do this and how you can do that.

I am not trying to open the door so that we will build a new institution of insurance.

Mr. ELSON. I realize that, and it is because of our antiquity and the way we have done business for 52 years that we certainly are not proposing anything new in the way of, shall we say, tax avoidance.

Senator ANDERSON. I am not trying to say that the amendment to be offered by Senators Carlson and Hartke is not good, because I have not seen it. All I want to say is that I want to see you get some help, but I would not want to see you destroy life insurance in the United States by an outbreak of a rash of new mutual groups in the industries.

Mr. ELSON. We fully concur in that position.

Senator KERR. Senator Douglas?

Senator DOUGLAS. Mr. Elson, how does your association differ from many ordinary mutual life associations which sell term life insurance?

Mr. ELSON. Well, there are a number of differences.

For example, as I have indicated, there are no dividend payments. We issue only one type of policy. We issue a policy that cannot exceed $4,000. It is available only to the limited specific group, namely, employees of Swift & Co.

The equivalent of the officers and directors of a mutual company are an advisory committee. Our trustees are uncompensated, and, well, maybe that about hits the high points.

That is something that we have done some thinking about, because we thought it was necessary to proceed in a sound manner to be able to differentiate our situation.

I might also point out that we do not have paid solicitors, agents, claim adjusters, or anything of that sort.

We do not engage in any pair advertising, promotional material, and then—this does not maybe go to the organization—but it goes to the difference in the character of the coverage we issue—to the best of our knowledge a mutual, or a stock company for that matter, issuing term life insurance does not have this pair-up feature at age 65. To the extent that they have waiver of premiums, there normally is a waiting period, as, for example, the group policy in which these same people participate has a 9-month waiting period. We have no waiting period in connection with premium waiver. So that there are very material real substantial differences, we believe.

Senator DOUGLAS. How do the gains or losses from an operation of your association differ from the gains and losses from the operations of a commercial life insurance company or a stock company which writes term life insurance?

Mr. ELSON. Well, I would say this: That in constructing the rate originally, it was necessary to take into account the obligation that will ultimately appear in this paid-up feature retirement after 25 years of coverage, and to the extent that there are what might be termed underwriting gains, we are sorely in need of those to keep even with the unusual commitments that are contained in our term coverage.

Senator DOUGLAS. How do your reserves compare with the reserves which are maintained by commercial life insurance companies?

Mr. ELSON. They are established on a comparable basis.

As a matter of fact, probably even more conservatively, we are still using the American experience table at 3 percent which, as you well know, as you commented——

Senator DOUGLAS. Did you say the American experience table? For what year?

Mr. ELSON. The pre-1941.

Senator DOUGLAS. You mean using the experience table of 1867?

Mr. ELSON. 1867 at 3 percent interest, so we think we are protecting our people reasonably well, and the independent actuaries who review us are in agreement.

Senator DOUGLAS. Now, just where does this bill hurt you? Does it hurt you in phase 1, on investment income, or phase 2, gains from operations or underwriting, or where?

Mr. ELSON. Actually, it hurts us in a very real, substantial way under both phases, with a little greater hurt under phase 1. But it hits us terribly hard under both phases.

Senator DOUGLAS. Now, do I understand that gains which you make from underwriting are distributed by you in supplementary benefits?

Mr. ELSON. I would not state that it is done in any direct manner. In substance, looking at the total group, the source of funds from which to pay what you refer to as supplemental benefits, which I interpret to be this paid-up feature at age 65—Am I correct?

Senator DOUGLAS. Yes.

Mr. ELSON. The full accumulation of underwriting gains, to use that phase—any other "surplus" funds that we may have, are needed to take care of our total obligation under these death benefit certificates.

Senator DOUGLAS. So that the gains which you may make from using an 1867 life table do not go to officers or individuals or stockholders, or what-not—but to the policyholders themselves.

Mr. ELSON. Yes, sir.

Senator DOUGLAS. Thank you.

It is interesting to see this old life mortality table hang on. But I am glad it is used for the benefit of the policyholders, and not for the benefit of insiders.

I am very glad to see here Mr. Joseph Meegan, who is the active head of the Back of the Yards Council, and who is one of the finest citizens of Chicago.

Mr. Meegan, can you give any testimony as to the actual beneficial effect of this association on the families that you try to help?

## STATEMENT OF JOSEPH MEEGAN, ON BEHALF OF BACK OF THE YARDS SOCIAL ACTION CLUB

Mr. MEEGAN. Yes, I can, Senator.

First of all, I would like to renew my friendship with the former Secretary of Agriculture, who did so much in sponsoring the school lunch program in the early days, which is now in operation in over 60,000 schools throughout the country.

Senator KERR. Are you referring to the Senator from New Mexico?

Mr. MEEGAN. I certainly am.

Well, since 1939 I have been identified with social work in the community known as Back of the Yards in Chicago. A large number of our wage earners, among the 100,000 residents in the community, have worked in the stockyards. And for nearly 20 years I have seen stockyard workers afflicted by sickness, injury, and even death that resulted in poverty and human misery and suffering in their families, and which eventually, in some cases, led to the breakdown of family life. And this was especially true years ago, when we had problems of tuberculosis and pneumonia in the freezers, in the packinghouses.

I can honestly say that in all the years I have been associated with social work in Back of the Yards—and that is nearly 20 years—that I have never had a family whose father or wage earner was identified with Swift & Co. that ever came to us for financial assistance. This organization took care of their own people. And this is very much in keeping with the philosophy of the Back of the Yards Council and the Back of the Yards Social Action Club which I represent here today—the people themselves will work out their own destiny.

I can say this for the other packinghouse workers—I mean for the packinghouse workers who are associated with other companies—I can tell you that in the early days, when this employees' association was formed, people had to come to the local tavern owners, who were then the social workers in the area. They came to them for assistance. They came to their churches for assistance. They came to the city, to the State, to the Government. They came to their neighbors and fellow employees to pass the hat for needy families of packinghouse workers.

So I am pleased to say I came here today at the expense of the Social Action Club, representing the community, and not this organization at all, to state to you, Senator Douglas, and all of you fine gentlemen, that in my opinion this organization deserves your consideration for the amendment that they are asking.

Senator DOUGLAS. Thank you very much.

Mr. MEEGAN. Thank you.

Senator DOUGLAS. That is all.

Senator KERR. Senator Talmadge.

Senator TALMADGE. No questions.

Senator KERR. Mr. Elson, will you furnish us a financial statement of your company, or of this company, for the last 6 years, including the latest one?

Mr. ELSON. Yes, sir.

Senator KERR. And put them into the record.

(The statement referred to reads as follows:)

SWIFT & CO. EMPLOYEES BENEFIT ASSOCIATION

*Statement of income and expenditures for the year ended June 30, 1958*

| | |
|---|---|
| Income: | |
| Sickness and accident benefit contributions | $1,721,308 |
| Death benefit contributions | 1,400,325 |
| From investments | 1,186,277 |
| Miscellaneous | 5,789 |
| Total income | 4,313,699 |
| Expenditures: | |
| Sickness benefits paid | 1,178,152 |
| Accident benefits paid | 554,834 |
| Total sickness and accident benefits paid | 1,732,986 |
| Death benefits paid | 939,118 |
| Direct operating costs | 124,410 |
| General medical expense | 84,598 |
| Federal income taxes | 28,325 |
| Miscellaneous | 13,561 |
| Total expenditures | 2,922,998 |
| Net applied to reserve for benefits | 1,390,701 |
| Total | 4,313,699 |

RESERVE FOR PAYMENT OF BENEFITS JUNE 30, 1958

| | |
|---|---|
| Reserve, June 30, 1957 | 24,511,189 |
| Added during year, as above | 1,390,701 |
| Reserve, June 30, 1958 | 25,901,890 |
| Total death benefits in force | 106,547,200 |

BALANCE SHEET AT JUNE 30, 1958

| | |
|---|---|
| Assets: | |
| Cash in banks | 262,671 |
| Accounts receivable | 188,443 |
| Bonds, at cost, premiums and discounts amortized: | |
| U.S. Government | 2,239,513 |
| Industrial | 3,895,417 |
| Utilities | 4,683,313 |
| Railroads and equipment trusts | 4,052,594 |
| Foreign | 1,696,865 |
| Miscellaneous | 2,288,902 |
| Total bonds | 18,856,604 |
| Stocks, at cost | 6,676,443 |
| Total assets | 25,984,161 |
| Liabilities and reserves: | |
| Accounts payable | 82,271 |
| Reserve for payment of benefits | 25,901,890 |
| Total liabilities and reserves | 25,984,161 |

STATEMENT OF THE AUDITING COMMITTEE

We have examined the balance sheet of Swift & Co. Employees Benefit Association as of June 30, 1958, and the related statement of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards including a review of the system of internal control, a check of the cash disbursements for the year then ended, and other accounting records checked or tested to the extent we considered necessary.

In our opinion, based upon such examination the statements mentioned above present fairly the financial condition of the association as of June 30, 1958, and the results of its business for the year ended that date.

AUDITING COMMITTEE,
(Signed) J. B. KULCZYK, *Chairman.*

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SWIFT & CO. EMPLOYEES BENEFITS ASSOCIATION

*Statement of income and expenditures for the year ended June 30, 1957*

| | |
|---|---|
| Income: | |
| Sickness and accident benefit contributions | $1, 893, 193 |
| Death benefit contributions | 1, 481, 118 |
| From investments | 1, 269, 674 |
| Miscellaneous | 5, 705 |
| Total income | 4, 649, 690 |
| Expenditures: | |
| Sickness benefits paid | 1, 139, 105 |
| Accident benefits paid | 562, 486 |
| Total sickness and accident benefits paid | 1, 701, 591 |
| Death benefits paid | 865, 805 |
| Direct operating costs | 136, 417 |
| General medical expense | 84, 784 |
| Federal income taxes | 24, 082 |
| Miscellaneous | 6, 503 |
| Total expenditures | 2, 819, 182 |
| Net applied to reserve for benefits | 1, 830, 508 |
| Total | 4, 649, 690 |

RESERVE FOR PAYMENT OF BENEFITS JUNE 30, 1957

| | |
|---|---|
| Reserve, June 30, 1956 | 22, 680, 681 |
| Added during year, as above | 1, 830, 508 |
| Reserve, June 30, 1957 | 24, 511, 189 |
| Total death benefits in force | 112, 805, 800 |

BALANCE SHEET AT JUNE 30, 1957

| | |
|---|---|
| Assets: | |
| Cash in banks | 182, 543 |
| Accounts receivable | 200, 411 |
| Bonds, at cost, premiums and discounts amortized: | |
| U.S. Government | 1, 945, 743 |
| Industrial | 3, 428, 751 |
| Utilities | 4, 694, 674 |
| Railroads and equipment trusts | 4, 380, 799 |
| Foreign | 1, 625, 374 |
| Miscellaneous | 2, 043, 456 |
| Total bonds | 18, 118, 797 |
| Stocks, at cost | 6, 087, 698 |
| Total assets | 24, 589, 449 |
| Liabilities and Reserves: | |
| Accounts payable | 72, 260 |
| Reserve for payment of benefits | 24, 511, 189 |
| Total liabilities and reserves | 24, 589, 449 |

STATEMENT OF THE AUDITING COMMITTEE

We have examined the balance sheet of Swift & Co. Employees Benefit Association as of June 30, 1957, and the related statement of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards including a review of the system of internal control, a check of the cash disbursements for the year then ended, and other accounting records checked or tested to the extent we considered necessary.

In our opinion, based upon such examination, the statements mentioned above present fairly the financial condition of the association as of June 30, 1957, and the results of its business for the year ended that date.

AUDITING COMMITTEE,
(Signed) R. B. STROHM, *Chairman.*

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SWIFT & CO. EMPLOYEES BENEFIT ASSOCIATION

*Statement of income and expenditures, for the year ended June 30, 1956*

| | |
|---|---|
| Income: | |
| Sickness and accident benefit contributions | $1,725,217 |
| Death benefit contributions | 1,286,612 |
| From investments | 898,552 |
| Miscellaneous | 6,992 |
| Total income | 3,911,373 |
| Expenditures: | |
| Sickness benefits paid | 1,057,872 |
| Accident benefits paid | 522,116 |
| Total sickness and accident benefits paid | 1,579,988 |
| Death benefits paid | 895,023 |
| Direct operating costs | 135,478 |
| General medical expense | 83,957 |
| Federal income taxes | 21,704 |
| Miscellaneous | 6,058 |
| Total expenditures | 2,722,208 |
| Net applied to reserve for benefits (see below) | 1,189,165 |
| | 3,911,373 |

RESERVE FOR PAYMENT OF BENEFITS, JUNE 30, 1956

| | |
|---|---|
| Reserve June 30, 1955 | 21,491,516 |
| Added during year, as above | 1,189,165 |
| Reserve June 30, 1956 | 22,680,681 |
| Total death benefits in force | 116,372,600 |

BALANCE SHEET AT JUNE 30, 1956

| | |
|---|---|
| Assets: | |
| Cash in banks | $133, 013 |
| Accounts receivable | 196, 159 |
| Bonds, at cost, premiums and discounts amortized: | |
| U.S. Government | 3, 147, 401 |
| Industrial | 3, 437, 117 |
| Utilities | 4, 467, 940 |
| Railroads and equipment trusts | 3, 708, 715 |
| Dominion of Canada (issued or guaranteed by) | 942, 873 |
| Miscellaneous | 1, 494, 796 |
| Total bonds | 17, 198, 842 |
| Stocks, at cost | 5, 238, 664 |
| Total assets | 22, 766, 678 |
| Liabilities and reserves: | |
| Accounts payable | 85, 997 |
| Reserve for payment of benefits | 22, 680, 681 |
| Total liabilities and reserves | 22, 766, 678 |

STATEMENT OF THE AUDITING COMMITTEE

We have examined the balance sheet of Swift & Co. Employees Benefit Association as of June 30, 1956, and the related statement of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards, including a review of the system of internal control, a check of the cash disbursements for the year then ended, and other accounting records checked or tested to the extent we considered necessary.

In our opinion, based upon such examination, the statements mentioned above present fairly the financial condition of the association as of June 30, 1956, and the results of its business for the year ended that date.

AUDITING COMMITTEE,
(Signed) C. O. SULLIVAN, *Chairman.*

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SWIFT & CO. EMPLOYEES BENEFIT ASSOCIATION

*Statement of income and expenditures for the year ended June 30, 1955*

| | |
|---|---|
| Income: | |
| Sickness and accident benefit contributions | $1, 523, 539 |
| Death benefit contributions | 1, 125, 158 |
| From investments | 855, 216 |
| Miscellaneous | 3, 247 |
| Total income | 3, 507, 160 |
| Expenditures: | |
| Sickness benefits paid | 957, 928 |
| Accident benefits paid | 427, 748 |
| Total sickness and accident benefits paid | 1, 385, 676 |
| Death benefits paid | 733, 289 |
| Direct operating costs | 124, 016 |
| General medical expense | 104, 622 |
| Federal income taxes | 10, 752 |
| Miscellaneous | 5, 618 |
| Total expenditures | 2, 363, 973 |
| Net applied to reserve for benefits | 1, 143, 187 |
| Total | 3, 507, 160 |

RESERVE FOR PAYMENT OF BENEFITS, JUNE 30, 1955

| | |
|---|---|
| Reserve June 30, 1954 | $20, 348, 329 |
| Added during year, as above | 1, 143, 187 |
| Reserve June 30, 1955 | 21, 491, 516 |
| Total death benefits in force | 93, 539, 000 |

BALANCE SHEET OF JUNE 30, 1955

| | |
|---|---|
| Assets: | |
| Cash in banks | 125, 946 |
| Accounts receivable | 216, 217 |
| Bonds, at cost, premiums and discounts amortized: | |
| U.S. Government | 2, 785, 942 |
| Industrial | 3, 799, 625 |
| Utilities | 4, 093, 625 |
| Railroads and equipment trusts | 3, 402, 432 |
| Dominion of Canada (issued or guaranteed by) | 729, 944 |
| Miscellaneous | 1, 170, 090 |
| Total bonds | 15, 981, 658 |
| Stocks, at cost | 5, 235, 509 |
| Total assets | 21, 559, 330 |
| Liabilities and reserves: | |
| Accounts payable | 67, 814 |
| Reserve for payment of benefits | 21, 491, 516 |
| Total liabilities and reserves | 21, 559, 330 |

STATEMENT OF THE AUDITING COMMITTEE

We have examined the balance sheet of Swift & Co. Employes Benefit Association as of June 30, 1955, and the related statement of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards including a review of the system of internal control, a check of the cash disbursements for the year then ended, and other accounting records checked or tested to the extent we considered necessary.

In our opinion, based upon such examination, the statements mentioned above present fairly the financial condition of the association as of June 30, 1955, and the results of its business for the year ended that date.

AUDITING COMMITTEE,
(Signed) F. T. CARTER, *Chairman*.

## Swift & Co. Employees Benefit Association

*Statement of income and expenditures for the year ended June 30, 1954*

| | |
|---|---|
| **Income:** | |
| Sickness and accident benefit contributions | $1,432,107 |
| Death benefit contributions | 1,063,427 |
| From investments | 689,666 |
| Miscellaneous | 5,090 |
| Total income | 3,190,290 |
| **Expenditures:** | |
| Sickness benefits paid | 909,462 |
| Accident benefits paid | 383,393 |
| Total sickness and accident benefits paid | 1,292,855 |
| Death benefits paid | 760,540 |
| Direct operating costs | 121,107 |
| General medical expense | 113,341 |
| Federal income taxes | 9,249 |
| Miscellaneous | 5,216 |
| Total expenditures | 2,302,308 |
| Net applied to reserve for benefits (see below) | 887,982 |
| Total | 3,190,290 |

### RESERVE FOR PAYMENT OF BENEFITS, JUNE 30, 1954

| | |
|---|---|
| Reserve June 30, 1953 | 19,460,347 |
| Added during year, as above | 887,982 |
| Reserve June 30, 1954 | 20,348,829 |
| Total death benefits in force | 87,594,600 |

### BALANCE SHEET AT JUNE 30, 1954

| | |
|---|---|
| **Assets:** | |
| Cash in banks | 218,349 |
| Accounts receivable | 211,946 |
| Bonds, at cost, premiums and discounts amortized: | |
| U.S. Government | 1,996,965 |
| Industrial | 3,430,067 |
| Utilities | 3,944,251 |
| Railroad and equipment trusts | 3,265,121 |
| Dominion of Canada (issued or guaranteed by) | 892,603 |
| Miscellaneous | 1,463,809 |
| Total bonds | 14,922,816 |
| Stocks, at cost | 4,992,404 |
| Total assets | 20,415,515 |
| **Liabilities and reserves:** | |
| Accounts payable | 67,186 |
| Reserve for payment of benefits | 20,348,329 |
| Total liabilities and reserves | 20,415,515 |

STATEMENT OF THE AUDITING COMMITTEE

We have examined the balance sheet of Swift & Co. Employes Benefit Association as of June 30, 1954, and the related statement of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards including a review of the system of internal control, a check of the cash disbursements for the year then ended, and other accounting records checked or tested to the extent we considered necessary.

In our opinion, based upon such examination, the statements mentioned above present fairly the financial conditions of the association as at June 30, 1954, and the results of its business for the year ended that date.

AUDITING COMMITTEE,
(Signed) J. B. GILMOUR, *Chairman.*

SWIFT & CO. EMPLOYES BENEFIT ASSOCIATION

*Statement of income and expenditures for the year ended June 30, 1953*

| | |
|---|---|
| Income: | |
| Sickness and accident benefit contributions | $1,226,414.99 |
| Death benefit contributions | 1,028,947.79 |
| From investments | 690,441.20 |
| Miscellaneous | 13,004.68 |
| Total income | 2,958,808.66 |
| Expenditures: | |
| Sickness benefits paid | 950,763.79 |
| Accident benefits paid | 389,309.60 |
| Total sickness and accident benefits paid | 1,340,073.39 |
| Death benefits paid | 746,891.08 |
| Direct operating costs | 116,270.76 |
| General medical expense | 108,272.93 |
| Federal income taxes | 10,865.06 |
| Miscellaneous | 5,252.23 |
| Total expenditures | 2,327,625.45 |
| Net applied to reserve for benefits (see below) | 631,193.21 |
| Total | 2,958,808.66 |

RESERVE FOR PAYMENT OF BENEFITS, JUNE 30, 1953

| | |
|---|---|
| Reserve, June 30, 1952 | 18,829,163.77 |
| Added during year, as above | 631,183.21 |
| Reserve, June 30, 1953 | 19,460,346.98 |
| Total death benefits in force | 82,719,400.00 |

BALANCE SHEET AT JUNE 30, 1953

| | |
|---|---|
| Assets: | |
| Cash on hand and in banks | $130, 766.03 |
| Accounts receivable | 185, 172.99 |
| Bonds, at cost, premiums and discounts amortized: | |
| U.S. Government | 2, 661, 851.90 |
| Industrial | 3, 832, 848.52 |
| Utilities | 3, 676, 065.76 |
| Railroad and equipment trusts | 2, 821, 009.94 |
| Dominion of Canada (issued or guaranteed by) | 840, 712.67 |
| Miscellaneous | 1, 233, 241.58 |
| Total bonds | 14, 565, 230.37 |
| Stocks, at cost | 4, 644, 856.65 |
| Total assets | 19, 526, 026.04 |
| Liabilities and reserves: | |
| Accounts payable | 65, 679.06 |
| Reserve for payment of benefits | 19, 460, 346.98 |
| Total liabilities and reserves | 19, 526, 026.04 |

STATEMENT OF THE AUDITING COMMITTEE

We have examined the balance sheet of Swift & Co. Employees Benefit Association as of June 30, 1953, and the related statement of income for the year then ended. Our examination was made in accordance with generally accepted auditing standards, including a review of the system of internal control, a check of the cash disbursements for the year then ended, and other accounting records checked or tested to the extent we considered necessary.

In our opinion, based upon such examination, the statements mentioned above present fairly the financial condition of the association as at June 30, 1953, and the results of its business for the year ended that date.

AUDITING COMMITTEE,
(Signed) H.C. PIRCH, *Chairman.*

Senator KERR. I have but one remark to make.

You state, "We are patently a nonprofit association." I take it that you are as such by choice.

Mr. ELSON. That was the choice of the original members.

Senator KERR. And of the present management?

Mr. ELSON. Yes.

Senator KERR. There is one difference between this organization and 2 or 3 that I am associated with—they are also nonprofit organizations, but not by choice.

Thank you very much, Mr. Elson.

Mr. ELSON. Thank you.

Senator KERR. Mr. Bruce Batho.

Senator TALMADGE. Mr. Chairman, this next witness comes from Atlanta, Ga. He is vice president and on the board of directors of Life of Georgia, one of our most outstanding and progressive insurance companies.

Senator KERR. Thank you, Senator Talmadge.

Before you start, Mr. Batho, I want to express appreciation to all the witnesses that are here for your patience and forebearance. I do this for myself and for the committee. And I say that for ourselves—we regret the degree to which these hearings have extended themselves. We regret it nearly as much for ourselves as we do for you, but especially for you. We appreciate your patience. It is our purpose to hear the other witnesses who are scheduled for today before we adjourn.

All right, Mr. Batho.

## STATEMENT OF BRUCE BATHO, VICE PRESIDENT AND COMPTROLLER, LIFE INSURANCE CO. OF GEORGIA, ATLANTA, GA.

Mr. Batho. I wish to thank Senator Talmadge for his introduction.

I am Bruce Batho, vice president and comptroller and also a director of the Life Insurance Co. of Georgia, Atlanta, Ga. My company is a stock life insurance company issuing nonparticipating policies. I am an actuary and am a member of the Society of Actuaries. I am speaking on behalf of my company, but the views which I will present are concurred in by many.

H.R. 4245 proposes a completely new basis for taxation of the income of life insurance companies. In its three phases it will tax the total earnings of stock life insurance companies.

The Treasury estimates that the tax which it will produce on 1958 income is $540 million to $560 million, and industry figures indicate $558 million. This is an immediate tax increase of 75 percent (retroactive to last year) over the amount which would have resulted from the tax base last used.

We do not know of any instance in which the taxes of a tremendous industry such as ours have been increased to this degree at any one time. To make such an increase effective at this time, when tax deductions are being thought of as desirable and appropriate seems to us to be unconscionable.

The States, to whom Congress has left the supervision of life insurance, impose premium taxes totaling approximately $300 million. And as a result, life insurance savings are already more heavily taxed than any other form of thrift.

We feel that we are somewhat unfairly in the position of having to choose between H.R. 4245 with the tremendously increased tax burden which it will produce for many companies, and the obsolete 1942 tax formula which everyone, including the Treasury, concedes to be undesirable.

H.R. 4245 does, however, correct many flaws in the previous tax laws applying to our industry. We support the general framework of the bill and its taxation of all of the income of a stock company.

The following provisions which it now contains in phase 2 are absolutely essential to the maintenance of a proper competitive relationship between the stock and the mutual companies:

(1) A deduction of at least 10 percent of the increase in reserves for nonparticipating policies;

(2) A deduction of 2 percent of premiums for group insurance;

(3) Deferment of tax on a portion of operating gains necessary for the protection of policyholders; and

(4) A minimum tax base for mutual companies which cannot be controlled by dividends to policyholders.

We wish to recommend and request amendment of the bill in two specific areas. These relate to—

(1) The basis for the "policy and other contract liability deduction" found in section 805; and

(2) The treatment of tax-exempt interest and dividends received.

The first point on which I wish to comment, namely, the policy interest deduction in section 805, relates only to phase 1. At this point it is provided that investment income which is applicable to policy reserves shall not be taxed but shall be deducted from the company's net investment income. To determine the amount of this deduction, the amount of such reserves is multiplied by an interest rate known as the deduction rate.

The fact is that, in computing premium rates, life insurance companies anticipate that they will earn, and accordingly use, an interest rate higher than the reserve rate stated in the policy. The interest rate for which they allow credit in the determination of premiums is based upon their actual interest earning experience.

We believe that the policy reserve deduction should be based upon the actual rate of interest earned by an individual company, on either an annual or a 5-year average basis, and strongly urge that the bill be amended accordingly.

The second item about which I would like to comment is the treatment of tax-exempt interest and dividends received.

In the discussion of H.R. 4245 in the House, Mr. Mills was asked whether interest from municipal bonds was free from tax under this bill and he indicated that he thought that it was.

Actually part of a company's interest income is deductible under the bill solely because it is interest income on policy reserves which is necessary to mature such policies. This deduction is available whether the interest comes from tax-exempt bonds or from other sources. The bill provides in effect in section 809(f) that while tax-exempt interest is deductible, the other deductions will be reduced proportionately by reason of the receipt of such tax-exempt interest. And as a result, most of the tax advantage of investing in tax-exempt bonds is lost to a life insurance company.

The best test of this is first to compute a company's tax assuming it has no tax-exempt interest, and then to recompute it assuming that some specific amount of its income is from tax-exempt bonds. The difference will not be 52 percent of such tax-exempt interest. In our case it is only about 10 percent. The average for all companies is probably about 15 percent.

Life of Georgia has bought many municipal bonds. They were bought in a direct effort to help finance installations such as water and sewer systems. These are usually financed by municipal obligations, and with our rapidly increasing population the need for them is unusually great. If the life insurance industry does not have the full benefit of tax-free municipal bonds, it will probably reduce or eliminate such purchases. The interest rate offered by most municipal bonds is too low to make them attractive investments, unless they receive effective tax exemption.

As H.R. 4245 now stands, it is not possible for a life insurance company to invest either its capital or surplus funds in municipal bonds and receive the interest on them free from tax; at least, not unless it first invests all of its policyholders' reserve funds in municipal bonds. And this would be absurd.

Both individuals and other corporations are granted such a tax right. We should be accorded a similar treatment.

The difficulty arises because of the effective presumption in the bill that any investment by a life insurance company in either tax-exempt bonds or in stocks of other corporations must be divided proportionately or prorated, for tax purposes, between policyholder reserve funds and other company funds. We know of no logical basis for such a requirement. We should have the privilege of investing capital and surplus funds in any legal manner and should receive the same tax treatment on the income from such investments as others receive. In other words, we should be able, for tax purposes, to allocate municipal bond and corporate stock investments to funds other than policy reserves up to the amount of such funds.

The bill now provides in phase 3 for full deduction of tax-exempt interest and for the usual deduction for dividends received. This phase relates to the taxation of the underwriting and general earnings of a stock company which were not previously taxed in phase 2 at the time they first appeared. It is only reasonable and proper that the same treatment be applied in phase 2 to the taxation of the same general earnings which are taxed in it.

We strongly urge, therefore, that H.R. 4245 be amended to provide in phase 2 a deduction for interest on tax-exempt bonds and for dividends from stocks to the extent that such investments do not exceed the company's funds which are other than policy reserves. We believe you will agree that the limitation just started will prevent any "double deduction."

You may be wondering why I recommend that a change to allow full deduction of tax-exempt interest and dividends received be made in phase 2 but not in phase 1. Phase 1 does not purport to be a tax on total income. It is more similar in its nature to the 1942 formula and to the subsequent stopgap laws. Phases 2 and 3, however, are based upon total income. They include underwriting gains as well as investment income. They include deductions for policy claims and general operating expenses as well as the increase in policy reserves. They "put the bite on" stock companies making substantial profits. They are like the income tax law applying to other classes of corporations. They are more like the 1913–21 tax on life insurance companies. Tax-exempt interest and dividends received should be effectively deductible in them without reduction in other deductions so long as the investments producing such income do not exceed the amount of funds which are other than policy reserves.

Again, let me say that under H.R. 4245 the tax advantage of municipal bonds to us is about 10 percent of their interest whereas to a regular corporate holder it remains 52 percent. Under this bill the overall taxes are in many instances doubled or tripled, and the case for full tax-free status of municipal bonds when held by a life insurance company becomes much more important than previously. The stakes are simply greater. If we do not own these bonds, someone else will, and they will receive the full tax exemption.

While I have said much less about the deduction for dividends received than for tax-exempt interest, they have been treated similarly in the bill and the arguments for corrective amendment are also similar.

Not being a lawyer, I would not claim to speak with any authority on the very serious question of whether the present treatment of taxation of interest on State or municipal bonds in H.R. 4245 is constitutional or not. I would like, however, to append to this testimony a memorandum on this subject prepared by legal counsel. I trust that you will give it your attention.

Senator KERR. It may be received and made a part of the record.

(The memorandum referred to is as follows:)

MEMORANDUM IN RE CONSTITUTIONALITY OF INCOME TAX ON INCOME DERIVED FROM TAX-EXEMPT SECURITIES

The Federal Government has no power to tax the obligations or interest therefrom of a State or political subdivision. This limitation is not based upon any express prohibition in the Constitution, but is implied from the independence of the National and State Governments within their respective spheres and from the provisions of the Constitution looking toward the maintenance of our dual system of government. It first developed from the doctrine announced by the Supreme Court in *McCulloch* v. *Maryland* (4 Wheat. 316), decided in 1819. In that case, Chief Justice Marshall, who rendered the opinion, held that a State could not constitutionally impose a tax upon notes issued by the Bank of the United States. In 1870 the Supreme Court, in an opinion rendered by Mr. Justice Nelson in *Collector* v. *Day* (11 Wall. 113), relying upon its decision in *McCulloch* v. *Maryland*, made it clear that this prohibition was reciprocal in character and, therefore, Congress has no power under the Constitution to tax State officers or employees. However, it was not until the *Pollock* case (157 U.S. 429), that the Supreme Court specifically held that the Federal Government could not tax income from securities issued by States or political subdivisions thereof. Chief Justice Fuller who delivered the opinion of the Court made the following statement as to this point:

"It is contended that, although the property or revenues of the States or their instrumentalities cannot be taxed, nevertheless the income derived from State, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason; * * *. It is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution."

The Pollock case held the 1894 Income Tax Act unconstitutional, not only on the ground that it taxed income from State securities but also on the ground that a tax on the income from property was a direct tax and, therefore, invalid because not apportioned according to population. This last ground was the primary cause of the amendment to the Constitution which provides that "the Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States and without regard to any census or enumeration." For some time thereafter, it was contended that the clause in the 16th amendment, "from whatever source derived" permitted the taxation of the income from State bonds by the Federal Government. However, in 1920 the Supreme Court in *Evans* v. *Gore* (253 U.S. 245), held that the 16th amendment conferred no new power on Congress to tax as income something that Congress could not tax prior to adoption of the 16th amendment. In this connection, Justice Van Devanter said:

"Thus the genesis and words of the amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another."

The fact that the Federal Government has no power to tax income of State securities, notwithstanding the provisions of the 16th amendment, was definitely established in the *National Life Insurance Company* v. *United States* (277 U.S. 508). In that case an act of Congress taxing income of insurance companies granted a deduction for income tax purposes equal to 4 percent of their reserve. Under the terms of the statute, this deduction was considerably restricted as the taxpayer received income from tax-exempt securities. The Supreme Court held that such a method of taxation constituted a discrimination against the holders of tax-exempt securities and was, therefore, invalid under the Constitution.

In a similar case involving the State taxation of Federal securities held by life insurance companies, the Supreme Court has held that a State may not subject a taxpayer to a great tax burden upon his taxable property because it owns U.S. securities. In this case, *Missouri ex rel. Missouri Insurance Co.* v. *Gehner* (281 U.S. 313), an Ohio statute levied a tax on the net value of the assets of insurance companies in excess of the legally required reserve necessary to reinsure its outstanding risks and of any unpaid policy claims. The insurance company made a return pursuant to this act. The total value of its personal property was approximately $448,000, including $94,000 in U.S. bonds. The legal reserve and unpaid claims amounted to about $334,000. It deducted such bonds, reserve, and claims, leaving about $20,000 to be taxed. The State board of equalization and the State courts refused to accept this computation, claiming that the company's liabilities were chargeable against all its assets, taxable and nontaxable alike, and should be apportioned accordingly. In accordance with this conclusion, the State court arrived at a taxable net value by the following method:

"It divided the total taxable assets, $496,265.33 ($349,000, municipal and mortgage bonds; $5,265.33, cash; and $142,000, real estate), by the total assets, $590,265.33 ($349,000, municipal and mortgage bonds; $5,265.33 cash; $94,000, U.S. bonds; and $142,000, real estate). The result was $0.84. The total liabilities, $333,486.69, were then multiplied by $0.84. The result was $280,128.81. This was subtracted from $354,265.33, the total taxable personal assets, leaving $74,136.52 as the taxable net value."

In other words, the State court held that the law required the reserve and unpaid claims to be reduced by the proportion that the value of the U.S. bonds bore to the total assets, and by this method used the value of the U.S. bonds to increase the taxable amount. The Supreme Court held the statute as so construed invalid, stating that "because the ownership of U.S. bonds is made the basis of denying the full exemtpion which is accorded to those who own no such bonds, this amounts to an infringement of the guaranteed freedom from taxation."

It is to be observed that the pro rata disallowance rule under the Ohio statute which was held unconstitutional in the *Missouri* v. *Gehner* case is very similar to the pro rata rule contained in section 809(d) of the present bill.

Senator KERR. Senator Long.

Senator LONG. I would just like to get your judgment as to the attractiveness of U.S. Government bonds for insurance companies in this bill.

If I understand this bill, now, and if we adopt the amendment being recommended here, not only would you not pay any tax on the income from municipal bonds and from State bonds, and other tax-exempt bonds but you would be able to deduct expenses incurred in purchasing those bonds.

You would pay the tax on Government bonds, if I understand you correctly. That is, you would pay the tax on 24½ percent of the income that you received on U.S. Government bonds.

Would that be correct?

Mr. BATHO. I think generally that would be correct, Senator; yes.

Senator LONG. But, on the other hand, with regard to dividends from stock companies, it is proposed in this bill that there would be this 85 percent dividend credit, if I understand the bill. So you would only pay on 24½ percent of 15 percent. Is that correct, as you understand this bill?

Mr. BATHO. I wish you would restate that, Senator. I did not get that premise.

Senator LONG. It is my understanding on the dividend for corporate stock that is held by the insurance company, you would first get the dividend credit of 85 percent. That would leave just 15 percent of that income subject to tax. And then, if I understand correctly, you would only pay 24½ percent of that 15 percent. Is that correct—or is that different from your understanding of this bill?

Mr. BATHO. As I understand the bill, as it is now written, while the dividend received deduction is provided for, other deductions under the bill are reduced on the theory that to fail to do so would provide a double deduction.

Now, I do not believe that it is necessary to reduce the other deductions to prevent a double deduction, but that is what the bill now provides.

Senator LONG. Well, now, is this your understanding with regard to the taxation of dividends which insurance companies receive on corporate stock in other corporations—that they would first get the 85 percent dividend credit, leaving 15 percent subject to tax, and that they would then pay taxes on 24½ percent of that 15 percent at the rate of 52 percent?

Mr. BATO. No, sir, that is not my understanding—because of this adjustment of other deductions. I do not think that the two items can be divorced. If you say "We give it to you" on the one hand, but in another section of the bill you say "We take it away from you," I do not believe that you can look at one without looking at the other.

Senator LONG. Just how does that other section work that takes it away from you? How in effect does it take it away from you?

Mr. BATHO. There are sections, one in phase 1 and one in phase 2, which say that to the extent that this deduction is allowed the other deductions for interest on policy reserves and for phase 2 for other things will be reduced proportionately.

Senator LONG. So in phase 2, then, you feel that you do not get the benefit of the 85 percent dividend credit.

Mr. BATHO. We certainly do not, sir.

Senator LONG. And you pay on that in phase 2.

Mr. BATHO. We pay on that in both phases. It is done in both phases, the same thing.

Senator LONG. I was under the impression that you got the full benefit, 85 percent dividend credit. Now, perhaps that is one misleading impression I had.

Mr. BATHO. I think it is a misleading impression which many have, because it is written that way in the bill in one place, but then it is taken away in another place, up to a proportionate part, depending upon the ratio of reserves to total assets.

Senator LONG. Well, with regard to taxation in phase 1, it is your understanding that you would get the full benefit or less than the full benefit of the 85 percent dividend credit.

Mr. BATHO. Very much less.

Senator LONG. Now, even in phase 1 you do not get the full benefit of it.

Mr. BATHO. That is correct.

Senator LONG. It is your understanding that you do not get the benefit of it in phase 2 as well.

Mr. BATHO. That is correct.

Senator LONG. Thank you very much.

Senator KERR. Senator Carlson.

Senator CARLSON. If I understand you correctly, Mr. Batho, you support the use of a 5-year average earned rate of interest in phase 1.

Mr. BATHO. That is correct, Senator.

Senator CARLSON. Well, now, how much would such a change reduce the tax revenue, in your opinion?

Mr. BATHO. Well, the industry estimates which I have seen indicate that the total tax revenue would be reduced from approximately $558 million to approximately $514 million, or a reduction of about 8 percent.

Senator CARLSON. You do not mean by that that each company would get an 8 percent reduction, do you?

Mr. BATHO. No; it would not work that way, Senator. Actually, there would be a very, very few companies whose tax would be increased by this amendment. The treatment would be different for different individual companies.

Generally speaking, the companies with conservative valuation interest rates would receive a larger reduction, while those companies with less conservative interest valuation rates would receive not quite so much benefit.

Beyond that, companies which pay tax under phase 1, but not under phase 2, would receive the full benefit of the reduction, whereas companies which pay taxes under phase 1 and under phase 2, while they would receive the benefit under phase 1 would have half of it added back again under phase 2, and they would not receive the entire benefit.

Senator CARLSON. Well, I am not sure that I completely followed you. Do you have any idea of an example?

Mr. BATHO. Yes. If we take two companies, company A and company B, and we assume that company A pays no tax under phase 2—a reduction of $10,000 in phase 1 taxes will decrease its total taxes by $10,000. But, on the other hand, a company, company B, which pays taxes, under both phases 1 and 2, while it would receive a tax reduction of $10,000 under phase 1, it would have added under phase 2 a half of that amount, or $5,000, so that it would receive only a net reduction of $5,000.

Senator CARLSON. Now, in which category does your company fall?

Mr. BATHO. My company, Senator, pays tax under both phases, and therefore we would be like company 2—we would receive approximately half of the full credit.

Senator CARLSON. Well, then, it occurs to me it would not make much difference whether we had the proposed bill or the 5-year average, as far as you are concerned.

Mr. BATHO. Well, we would not gain as much by it as some companies would, Senator. But I believe that is sound in principle. I think that it should be adopted. And because of the fact that some companies would gain more under it than others, I think there is an additional justification for allowing this credit in phase 2 for tax-exempt interest, which would be of benefit to companies like ourselves.

Senator CARLSON. Thank you very much, Mr. Chairman.

Senator KERR. Senator Anderson.

Senator ANDERSON. As you started out, I thought I was going to have a good many questions to ask you, because of the reference to retroactivity of the bill and so forth. But I took a good look at the history of the company, and I see it was started with only $26,000 of paid-in capital, and by stock dividends it has raised that up to $7 million. Somebody must be doing a good job of management for a long time.

Mr. BATHO. Thank you, Senator.

Senator ANDERSON. I find myself pretty well satisfied with the statement you have made. I do not completely agree with it, but I think it is a good statement. And I certainly think it is a fine company, from the results of it.

Mr. BATHO. Thank you, sir.

Senator KERR. Senator Curtis.

Senator CURTIS. I have no questions.

Senator KERR. Senator Talmadge.

Senator TALMADGE. I want to compliment you on your lucid statement. It was excellently presented. I could not agree with you more on the proposition of tax-exempt bonds. If they are exempt for one taxpayer, they ought to be exempt for all.

Senator KERR. Thank you very much, Mr. Batho.

Our next witness is Mr. Guy H. Amerman.

## STATEMENT OF GUY H. AMERMAN, VICE PRESIDENT AND ACTUARY OF CONTINENTAL AMERICAN LIFE INSURANCE CO., WILMINGTON, DEL.

Mr. AMERMAN. My name is Guy H. Amerman. I am vice president and actuary of the Continental American Life Insurance Co. in Wilmington, Del.

I am appearing as an officer of my company, as a citizen and a policyholder.

To save a little time, I will attempt to glide quickly over part of my remarks here.

As a citizen, I recognize the need for increased revenue. As a policyholder, I want it to be based on a sound law that will not hurt the insurance companies.

My company is a stock company but writes only participating insurance. As a result, we partake to a considerable degree of the characterization of both stock and mutual companies, and we think that our figures, though small, being measured in hundreds of thousands, rather than hundreds of millions that you have been hearing about, are typical of the industry.

Like many of the witnesses who have appeared, we think the general framework of H.R. 4245 is sound. If the Congress has decided, as I am informed it has decided, that the total net income rather than only the investment income of life insurance companies must be taxed, then this bill and basic principle is probably as satisfactory a means as can be devised.

Certain details, we believe, are unsound and I will discuss correction of them later.

I want to clear up one that appears to be a misconception that has appeared several times in the course of these hearings.

This bill will tax all the net income of stock companies. It has been stated—I am departing here a little from what I have written—more than once that only about 13 percent of investment income is being taxed; that roughly 75 percent of the income is exempt; and then you apply 52 percent to the balance, so only 13 percent gets taxed.

The thing that has been overlooked whenever that statement has been made is that the more you reduce the taxable investment income, the greater you make the taxable income in phases 2 and 3, because all of the excess of the true net corporate income over the taxable investment income goes into phases 2 and 3.

I will give you some figures from my own company which will make that very clear in a few minutes.

The phase 1 net income is related to the old net investment income concept and is taxed at 52 percent immediately. The phase 2 net income is 50 percent of the balance of the net income and is taxed at 52 percent. Phase 3 net income is the entire balance of net income and is temporarily added to policyholders' surplus, defined in the law, but if ever found not to be needed for the safety of the policyholders is taxed at 52 percent when distributed to stockholders.

As I understand it, the initial tax under phase 1 was divided to put a floor under the taxable income of mutual companies and to put a ceiling on the amount of net income to be taxed under phases 2 and 3. The allocation of half of the balance of net income to phase 3 is in recognition of the fact that the true net income of a life insurance company cannot be determined on a year-to-year basis and that consequently accumulation of reasonable surplus for the protection of the policyholders is a necessity.

Based on our own company net income for 1958, the figures being in thousands, we see that our total net income—and this is on a basis comparable to what any corporation would be taxed on, not a life insurance corporation—is $987,000, of which $802,000 is taxed fully in phase 1, $93,000 more taxed fully in phase 2, and $92,000 not taxed currently but deferred by being put temporarily in the policyholders' surplus fund as defined.

The total tax on our income amounts to $460,000, which is 46.6 percent of our total net income.

Now, when someone says, as some did today, that the investment income is only taxed at the rate of 14 percent, here we see that in the case of an actual company—and these are not unusual figures—I think they are fairly down the middle as a company average—we are currently taxed at about 47 percent by the Federal Government. We are also taxed by the States.

Senator KERR. You mean under the bill.

Mr. AMERMAN. Under the bill, yes.

Senator KERR. All right.

Mr. AMERMAN. The comparison is that against the $460,000 that would be produced by H.R. 4245, just as it is, without amendment, we would have had to pay $446,000 if the 1942 basis had been allowed to remain in force. We would have been taxed $258,000 had the 1957

Mills stopgap law been extended another year. And our tax on the 1957 Mills stopgap law on 1957 income was $235,000.

I have already mentioned that 91 percent of our total net income is taxed immediately, 81 percent in phase 1 and 10 percent in phase 2.

If you take into account the State premium taxes, which sound small, being only 2 percent roughly of gross premium income, but actually over 15 percent of net income, it is plain that Continental American, as well as life insurance companies generally, is taxed immediately more heavily than corporations in general, and ultimately when phase 3 becomes operative much more heavily.

Senator KERR. Phase 3.

Mr. AMERMAN. Phase 3, yes. Even allowing for the 52 percent Federal rates, so that the 15 percent of net income in the form of State premium taxes really only costs us, say, 7 percent, the 7 percent plus the 47 percent Federal tax, immediate Federal tax I have already indicated comes to 54 percent, which you see is more than corporations generally are paying.

Now, other speakers have already pointed out that the tax is too great under this bill as first drawn, that the aggregate tax, that is, goes beyond the goal which was set, of around $500 million. And note that the $500 million is itself a 71-percent increase in tax over the $293 million in 1957. I think this excessive yield can be adjusted by correcting two features of the bill which are arbitrary and illogical.

Now, both have been covered by other speakers and I am not going to go into them.

Senator KERR. I would be glad if you would go right ahead. There is no use speeding up. You are next to the last witness.

Mr. AMERMAN. All right. I will cover them, then.

I think it not on the basis of sound principle but solely as a rule of thumb to push the total tax revenue to or above that magic $500 million goal, that the deduction rate in section 805 (b) (2) was based in part on the interest rate required to maintain reserves, either the particular company rate or the average rate for the industry, if higher. Neither rate is proper for this purpose, since both rates are arbitrarily determined by management decisions. In any event, no company's tax should any longer be based on the average of other company results. This is the global feature on the basis of which we have been criticizing every bill since 1940. This feature of the bill should be stricken out.

The industry had proposed, instead, using each year the actual net earned interest rate of each company. This is sound, but was rejected as producing insufficient revenue.

Now it is being proposed to use the 5-year average net earned rate for each company. My own opinion is that the single-year rate of each company is proper and sound, but I cannot state that the 5-year average rate is unsound. And so, if the powers that be want to use the 5-year average rate, we will not object—even if we had the power.

Senator KERR. I do not like to interrupt you, but you have told us that if H.R. 4245 goes into effect as written, it would cost your company 54 percent, including your State taxes.

Mr. AMERMAN. I said it would cost us 47 percent paid to the Federal Government. And I see now I said that incorrectly. It is more than that, because the 47 percent is after allowing for the deduction on account of the State taxes. The State taxes are 15 percent of net income, roughly, added to the 47 makes 62. I was wrong when I said I should only count half of the State premium taxes.

Senator KERR. I thought that.

Mr. AMERMAN. I was wrong—because that half has already been allowed for.

Senator KERR. So the actual statement would be 62 percent.

Mr. AMERMAN. Yes, sir.

Senator KERR. Now, then, tell me what effect the amendment you now urge here of the 5-year average rate—what effect would that have?

Mr. AMERMAN. In our case, substitution of the 5-year average rate would cut off $31,000 of tax, which is just about 3 percent of our corporate and net income. In other words, it would reduce the 62 percent to 59 percent.

Senator KERR. All right.

Mr. AMERMAN. That comes a little later.

Now I have made a point with respect to tax-exempt interest in phases 2 and 3 and the dividend received deduction.

The bill limits allowances to life companies for tax-exempt interest and dividends received to about 30 percent of the allowances for corporations generally. Now, that 30 percent is an average. It would be up a little for some and down a little for others. But it is pretty close to 30 percent.

I give a little example here—other examples have been given. There are some very fine ones in Mr. Cummings' testimony, from Minnesota Mutual, in that book he gave you.

Senator KERR. I was not here when he gave it, but I read it very carefully.

Mr. AMERMAN. These examples here are simple, which is a virtue, and I think approaches it from a little different viewpoint.

Suppose we taken an ordinary corporation which has a couple of millions of spare cash not needed for inventory or what not at the moment, so they invest it in tax-exempt bonds and stocks—a million each—producing $70,000 of gross income, $30,000 from tax-exempt interest and $40,000 from stock dividends.

Its net taxable income—understanding that the gross income has increased $70,000—is increased only $6,000, made up of zero on account of the tax-exempt interest and $6,000 on account of the $40,000 of dividends after taking the 85 percent dividends received deduction.

Now, if a life insurance company, under H.R. 4245, made exactly the same investment, it would have its net taxable income increased, not by $6,000 but by $51,000, because section 809(f) would effectively take away—the provision of section 815(b)(2) notwithstanding—approximately 70 percent of the benefit of tax-exempt interest and the dividends received deduction.

This limitation in the case of life insurance companies—I have stuck my neck out here by stating that it is based on a mistaken conception. It may be based on some other reasoning than what I have given here, but this is the way I see it—the mistaken conception that the bill taxes life insurance companies on only a part of their investment income, and that investment deductions should be correspondingly scaled down. I have already testified that this bill does not tax life insurance companies on only a part of their net investment income, but it taxes life insurance companies on total income. And since that is true, we think we should have the same deductions for tax-exempt interest and dividends received as other corporations have—**not more, but just the same.**

Now, that correction, if made, for the tax-exempt interest and the dividends-received deduction, would cut another $13,000 off our tax, which, with the $31,000 I mentioned a moment ago, on account of using the 5-year average, would give a total reduction of $44,000; would reduce our tax from $460,000, under the bill as written, to $416,000 under the proposed adjustments.

Senator KERR. Now, what would that leave your tax percentagewise as to your net as you estimate it?

Mr. AMERMAN. Well, $44,000 is 4.5 percent of $987,000, if I figure correctly and quickly in my head.

So we started with 46.6 under the bill as it was, plus 15 percent in State income taxes—that was 61.6. Take off 4.5 and you have got 57 percent, give or take a tenth of 1 percent.

Senator KERR. Is it your recommendation that we leave this bill so as to tax you 57 percent?

Mr. AMERMAN. I don't think we have much choice. You need a lot of revenue. We are not the largest company by any means; in fact, we are one of the small ones. You have to get money from the industry. We feel that this is perhaps the best we can get, and so we have quit struggling. That is about the size of it. But we would like to see you go as far as this. I think you have found a considerable unanimity on both of these things I have suggested—the 5-year average and the tax-exempt interest and dividends-received deductions.

We would love it if you would cut our tax still more, but we do not expect you will

Senator KERR. Well, now, what would these two amendments cost in revenue—and your estimate is H.R. 4245 would produce $558 million?

Mr. AMERMAN. $558 million is the figure that has been given me by some of our associations that are in a position to aggregate the figures and the estimates of the companies. I believe that the first correction, using the 5-year average rate, would cut that from $558 million down to $514 million. This is, I believe, the best figure the fellows who are doing the estimating now have.

The other one—I do not know that as precisely as I do the first one—but I think it would cut it to just under $500 million—maybe $490 million or $495 million.

Senator KERR. Now, that is for the 1958 tax.

Mr. AMERMAN. Yes, sir.

Senator KERR. What is your estimate if the bill were passed as written but with just these two amendments? Would it produce increasing revenue in your judgment, year after year, or otherwise?

Mr. AMERMAN. I believe that it would. The growth of the industry has been such that I believe you would get, even with these two amendments, well over $500 million on 1959 income.

Senator KERR. All right, sir; you may proceed.

Mr. AMERMAN. Regarding features important to retain—I am stating my opinion, which agrees with that of several others who have testified here, that there are three features of this bill that are important to retain.

If you are going to try to tax the total net income of life companies, then there should be retained this provision to tax under phase 3—not now, but only at the time of distribution—any amounts added to the policyholders surplus account as defined in the bill.

We are a stock company, as I testified, writing only participating insurance. We have still a little nonparticipating insurance in force. We cannot say that we will never start again to issue nonparticipating insurance. So we are interested in that item of allowance of 10 percent of the increase in reserves on nonparticipating insurance. It means little to us now, but we think it is a sound provision—and looking at it from the point of view of the whole industry, it should be retained.

The allowance of 2 percent of group insurance premiums I think is rather obvious. One State requires you to set aside 2 percent of group premiums in a contingency reserve that is just like a liability. It is just like money spent for the time being. The company should be given that allowance, whether stock or mutual.

The bill contains proper limitation to see that that fund so set aside does not become too large. I think that is relatively noncontroversial, but I thought I would mention it.

That is my statement.

Senator KERR. Thank you very much.

Senator LONG. I have no questions.

Senator KERR. Senator Curtis.

Senator CURTIS. I have one question. Is your company taxed higher than the average for the industry under this proposed law as written?

Mr. AMERMAN. I do not know. Well, I have this $558 million figure for the industry, and the $460,000 figure for our company. I do not have the corresponding taxable income, so that I could see how it would work out.

Senator CURTIS. I was referring to your 47 percent.

Mr. AMERMAN. Well, I think it would be general for insurance companies to be taxed by this bill, together with—no—you mentioned 47. That is just this bill. I think it would be general for the companies to be taxed pretty well up toward 45, 46, even up in some cases maybe 57 percent of their total investment income. Mr. Slater, of the John Hancock, testified a few moments ago that the mutual companies would actually be taxed $50 million more than—his group of mutual companies I think it was—$50 million more than the total of their net corporate income, I mean, more than 52 percent of the total of their net corporate income would be. I think that there is going to be very little income, considering the aggregate, that will escape immediate tax in phase 2 under this bill.

In our case, as I have testified, it is only 9 percent, and that is much more than made up by the premium tax levy for which the States are already nicking us.

Senator CURTIS. That is all, Mr. Chairman.

Senator KERR. Thank you very much.

Our next witness is Mr. Matthias.

## STATEMENT OF RUSSELL H. MATTHIAS, GENERAL COUNSEL, STATE FARM LIFE INSURANCE CO. OF BLOOMINGTON, ILL., ACCOMPANIED BY ROBERT C. PERRY, FIRST VICE PRESIDENT

Mr. MATTHIAS. My name is Russell H. Matthias. I am general counsel of the State Farm Life Insurance Co. of Bloomington, Ill., which is a stock company, organized in 1929, with over 427,000 policyholders and with slightly over $1,382 million of insurance in force. Our company does not write accident and health or industrial insurance and only a limited amount of group.

Senator KERR. Do you write credit insurance?

Mr. MATTHIAS. We write a limited amount of credit insurance on our automobile finance premiums; yes, sir.

We are what is usually known as an ordinary company writing individual policies on individual lives. All of our business is participating, even though we are a stock company.

Associated with me is Robert C. Perry, first vice president, who will assist on any actuarial questions.

My discussion is limited solely to H.R. 4245 and its effect on our company and those similarly situated, regardless of the amendments heretofore presented by representatives of mutual and stock companies during these hearings.

In the case of State Farm Life Insurance Co., the Federal income tax for 1957 was $333,000.

If the same stopgap formula applied to 1958, the tax would have been $401,000, an increase of 20 percent in itself.

However, under H.R. 4245 the 1958 tax for State Farm Life would be $1,419,000 broken down by phases 1 and 2 as follows: $869,000, phase 1, and $550,000, phase 2, with an additional liability for tax on accrued but previously untaxed income at the end of 1957 of just under $80,000 more. That is the carryback.

Thus, H.R. 4245 creates tax liabilities of $1,499,000 with respect to income accrued prior to 1959. This is 4½ times the tax for 1957 and over 3½ times the 1958 tax on the stopgap formula. It is well over twice the tax payable under the so-called 1942 law now in effect—$697,000.

It has been said frequently during the development of H.R. 4245 that one purpose of the law is to tax specialty companies not previously subject to much tax. State Farm is a stock company, but it is not a specialty company in any sense. It was incorporated 30 years ago as the second step in the plan of the State Farm Companies to support one agent in providing personal insurance service to his clients, which essentially is coverage for the private passenger car, the residence and its contents, and the family financial security program through ordinary life insurance.

Our institution is a pioneer in this method of serving clients through one agent for both selling and servicing, backed by nearby regional offices for the administrative work.

While 1929 was probably the worst possible year to begin a life insurance operation, we have managed to pay dividends to policyholders each year beginning with the first. It has taken great care and long-range planning to gradually increase interest yields over a long period until the net before Federal income taxes in 1958 was 3.88 percent, which, of course, is not spectacular.

Through conservative policy or management of the mortality strain and expenses our life company has always operated within its premium income, its capital and surplus to protect policyholders now standing at $20 million against $164 million of assets.

As an integral part of the charting of our future security each year, we have considered it desirable to hold more than the usual margins of safety in the surplus position on the basis that our death, maturity, and surrender dividends would eventually distribute accumulated surplus equitably among persisting policyholders. Now we are being penalized for having accumulated safety margins on a conservative basis in the interest of our policyholders.

In addition to this method of distributing surplus to those policyholders who step out of our mortality pool at older ages, annual policyholder dividends are paid, being computed under the asset share mehod of surplus distribution, projected 20 or more years into the future.

To make any change in either or both of these methods of distribution of surplus is a very complex operation. It is necessary to classify each policy as to kind, year of issue, and age at entry, and then project the formula each year for 20 years, and in most instances even farther, to terminal ages of 55, 60, and 65.

There is no way of knowing prior to 1958 what the proposed Federal income tax legislation would develop and without something specific no plan could be made for changes in the formula of distributing policyholder dividends.

In view of previous statements made by the taxing authorities, now in 1959 we were surprised to learn that the final form of H.R. 4245 resulted in a fourfold increase in 1958 taxes over the formula in effect in 1957.

We shall have to make some very important readjustments in our financial planning which, in the life insurance business, requires projections far into the future. These changes cannot be made to take effect immediately. Naturally, we must produce a formula that will pay whatever tax Congress sees fit to apply, but we should not have to do it suddenly, even retroactively, through application to the operations closed for 1958. We should be given time for study and the development of a program which will properly reflect any new level of taxes to which our business is subject.

Such substantial increases in Federal income taxes as have been indicated so obviously affect the ability of the company to accumulate adequate surplus to protect policyholders, and to pay dividends to policyholders and stockholders, that there is no need to belabor the point. Such abrupt tax increases on a retroactive basis do not seem to be reasonable and equitable. We therefore urge that consideration be given to providing for a transitional period of not less than 5 years during which taxes according to the stopgap law in effect for 1957 would gradually grade into those required under H.R. 4245.

I notice in the hearings, Senators, that there has been this projection made—that is, they have talked about transitional periods, but nobody has offered a formula.

We propose for consideration a formula which limits the combined tax from phases 1 and 2 only of H.R. 4245 to a maximum of either (1) a percentage of the tax under the stopgap formula in effect prior to 1958, or (2) a percentage of the tax under H.R. 4245, whichever is the larger. The maximums we suggest as appropriate are:

For 1958, 175 percent of stopgap or 50 percent of H.R. 4245, whichever is larger;

For 1959, 200 percent of stopgap or 60 percent of H.R. 4245, whichever is larger;

For 1960, 225 percent of stopgap or 70 percent of H.R. 4245, whichever is larger;

For 1961, 250 percent of stopgap or 80 percent of H.R. 4245, whichever is larger;

For 1962, 275 percent of stopgap or 90 percent of H.R. 4245, whichever is larger.

As previously mentioned, this maximum would relate only to phases 1 and 2. Phase 3 would not be affected.

A transitional formula such as that suggested would seem to be suitable in the light of a statement made by Mr. Robert B. Anderson, Secretary of the Treasury, in a letter to Chairman Mills, of the House Ways and Means Committee, dated April 10, 1958, relating to a new method of taxing life insurance companies.

We quote:

Provision should be made for a gradual transition to the new method over a 3- to 5-year period. During this transition, the tax would be computed as a weighted average of the tax under the new method and the tax under the present stopgap method, with gradually increasing weight to the new method.

The proposed transitional plan provides for a substantial immediate increase in taxes, ranging upward from 175 percent of those payable under the stopgap formula. At the same time, such a transitional plan would give companies such as ours an opportunity to make adjustments in our plan of operating so as to make appropriate financial provision for the new level of taxes to be applicable to the life insurance business and its policyholders.

I might say, as an additional statement, that we use the 175 percent basis because the Treasury is seeking an additional 70 percent over the stopgap formula, and this goes as high as 75 percent.

Senator KERR. Have you estimated the cost of the amendment you have suggested in the fiscal years designated as being those that would be included in the transition period?

Mr. MATTHIAS. No, sir, Senator. That is a pretty hard estimate. We do not have the figures. So we could not estimate it.

Senator KERR. Any questions?

Senator CARLSON. Mr. Chairman, those of us out in the great agricultural Midwest have followed with great interest the growth and development of the State Farm Life Insurance Co. of Bloomington.

I wanted to ask you this question. Is your company really a parent company in a way of life insurance companies such as have been organized by the Kansas State Farm Bureau?

Mr. MATTHIAS. Senator, we started the original company, State Farm at Bloomington, and we had associated with us all the farm bureaus, including those of your State, Kansas, and those of the Senator from Nebraska. And then, as we grew, and as the farm bureaus became more profitable, they broke off and organized their own automobile companies, their own fire companies, and their own life companies. And we assisted in that preparation. And we are happy to see them do it.

Senator CARLSON. I have a wire from the president of the Kansas Farm Life Insurance Co. of the Kansas Farm Bureau, and I would like to ask that it be made a part of the record. He expresses himself pretty much as Mr. Matthias has in regard to this bill.

Senator KERR. The telegram will be made a part of the record at this point.

(The telegram reads as follows:)

Senator FRANK CARLSON,
*U.S. Senate Office Building,*
*Washington, D.C.:*

Kansas Farm Life greatly concerned taxation of life insurance companies. We feel new legislation will result in higher costs of insurance to policyholders and that insufficient consideration has been given to the economic impact of such. We are not opposed to a reasonable increase in Federal tax but feel that the method of predetermining the amount of tax desired from the industry is unfair and discriminating legislation. Full allowance should be given to exempt interest on municipal securities. Present bill does not permit such since tax is imposed on exempt interest income in phase No. 2 when gain from operations is considered. Our portfolio contains 27 of such securities and loss of even a part of exempt status would make such issues less desirable for investment. Other investors are not so penalized. A large part of our holdings are Kansas municipal issues. Small companies must not be placed in jeopardy by excessive tax burden. The proposed legislation would at least double our present total tax and as such might well result in injury to the policyholders we serve.

W. J. BOONE,
*President, Kansas Farm Life, Kansas Farm Bureau.*

Senator KERR. Senator Curtis.

Senator CURTIS. What State Farm companies are associated together, using the same agents?

Mr. MATTHIAS. State Farm Mutual Automobile Insurance Co., State Farm Fire & Casualty Co., State Farm Life Insurance Co., Senator. Incidentally, we have a branch of our office in your State, sir.

Senator CURTIS. Two of them are stock, or just one?

Mr. MATTHIAS. Two of them are stock—the fire company and the life company.

Senator CURTIS. Mr. Chairman, the hour is late. I have no further questions.

Senator KERR. Gentlemen, I think you are one of the most wonderful groups of witnesses I have ever seen. I appreciate your patience and indulgence.

We will now recess until the 17th.

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

LIFE INSURANCE ASSOCIATION OF AMERICA,
*New York, N.Y., March 15, 1959.*

Hon. HARRY FLOOD BYRD,
*Chairman, Senate Finance Committee,*
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: Several witnesses appearing before the Senate Finance Committee during the recent hearings on the taxation of life insurance companies contended that H.R. 4245 indirectly disallows a complete deduction for interest on tax-free bonds. It was estimated that the granting of a full deduction for interest on such bonds, without reduction of the reserve interest deduction, would result in a revenue loss for tax year 1958 of approximately $35 million. This estimate assumes that the bill would be amended in both phase 1 and phase 2.

The Life Insurance Association of America has not taken a position with respect to this issue. In our study of the matter, however, we have come to the conclusion that the question raised with respect to H.R. 4245 could also be raised with respect to the 1942 act. While the 1942 act and the pending bill deal with the subject of tax-free interest somewhat differently, the end result in both cases is to exclude tax-free interest in one part of the computation of taxable income, but to deny a deduction for such tax-free interest insofar as it constitutes a part of the reserve interest requirement. Approximately the same treatment—and therefore the same constitutional question—prevailed under the Mills-Curtis stopgap law applicable to tax years 1955 through 1957.

The purpose of this letter is to suggest that, in your further consideration of the question of interest on tax-free bonds, recognition should be given to the fact that the revenue for tax year 1958, under the 1942 law, would be reduced to below $470 million if the change in treatment of such interest as recommended in connection with H.R. 4245 were also applied to the 1942 law. In this connection witnesses before your committee have urged that sound tax principles rather than precise revenue goals should govern the ultimate terms of H.R. 4245, and we were gratified to note that several members of the Senate Finance Committee expressed concurrence on this viewpoint. In that event, of course, the revenue that would be produced under the 1942 act would be irrelevant.

We recognize, however, that the existence of the 1942 law creates an unusual legislative situation which might exert some influence on the final decisions Congress reaches with respect to this legislation. Consequently should your committee decide to amend H.R. 4245 to grant a full deduction for reserve-interest requirements as well as a full deduction for tax-free interest, then it would seem only fair that in your considerations the revenue estimate under the 1942 law should be reduced to the range of $460 to $470 million.

In other words, if in considering H.R. 4245 the constitutional question is decided in favor of the taxpayer, it should be decided the same way in connection with the 1942 law, with a corresponding reduction in the estimates under the law. If such a course is not followed, the life insurance business might be placed in a position where insistence upon the $500 million estimate under the 1942 law as a revenue target might preclude the consideration by the Senate Finance Committee of other changes in the bill which are both meritorious and sound in principle.

Sincerely yours,

EUGENE M. THORÉ,
*Vice President and General Counsel.*

(See also p. 124.)

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STATEMENT SUBMITTED BY FRANK P. SAMFORD, PRESIDENT, LIBERTY NATIONAL LIFE INSURANCE CO., BIRMINGHAM, ALA., ON H.R. 4245, LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959

My name is Frank P. Samford. I am president of Liberty National Life Insurance Co. of Birmingham, Ala., and I am speaking for that company. Liberty National is a comparatively small company with total assets of $262 million. It is a stock life insurance company, and all of its business is nonparticipating.

I have read most of the testimony given before your committee on March 10, 11, and 12, and I would like to address my entire statement to the importance of leaving in H.R. 4245 the special deductions permitted stock life insurance companies.

I have always opposed the so-called corporate approach for the taxation of life insurance companies for two reasons. First, I feared that such an approach would result in superimposing a measure of Federal supervision on top of State supervision since it would require the Internal Revenue Department to check the operations of life insurance companies, including their reserve calculations. Second, I feared that the corporate approach would make it impossible for stock life insurance companies to build sufficient safeguards into their financial structures. My experience as a director of other corporations has taught me that every plan is considered on the basis of tax consequences. I felt that if this were injected into the operations of life insurance companies so that tax considerations might be considered before safety of policyholders, the result might be to undermine the safety of stock life insurance companies.

For these reasons I was very hopeful that the House Ways and Means Committee with the assistance of the Treasury Department would find a proper method for taxing stock life insurance companies without resorting to the total income or corporate approach. I would like to say in the beginning that I believe a fair and equitable tax law should provide the same safety and security for policyholders of a stock company as is provided for policyholders of a mutual company and at the same time should place the stockholders of a stock life insurance company in exactly the same position as the stockholders of any other corporation. The stockholders of life insurance companies are entitled to no more favorable treatment than the stockholders of any other corporation.

The House Ways and Means Committee in H.R. 4245 recognized these problems, but apparently was not able to devise a plan that would properly tax stock companies without resorting in part to the so-called total income or corporate approach. Honorable Wilbur D. Mills, chairman of the House Ways and Means Committee, in presenting this resolution to the House made this statement according to the Congressional Record:

"Our willingness to tax the companies on total operations does not in itself eliminate the serious problems that we faced in this industry, and it was necessary to design a total income tax that would take into account the difficulty in measuring profit on longrun business and the difficulty created by the predominant position of the large mutual companies."

I believe that H.R. 4245 has to a large degree met these difficulties. However, it any of the allowances granted stock companies should be removed or disallowed, in my judgment, the competitive position of the two types of companies would be destroyed. In that event the stock companies would not only be unable to compete with the large mutual companies, but would have difficulty in maintaining sufficient margins of safety to protect their existing policyholders.

To meet the difficulties outlined by Mr. Mills, H.R. 4245 provides a special deduction of 10 percent of the increase in reserves on nonparticipating insurance contracts in computing underwriting income. I am convinced that this provision is absolutely essential if companies such as ours are to remain sound and justify the continued confidence of our policyholders and of the insuring public. As has been previously pointed out to this committee the higher premiums charged on participating life insurance are a very effective safety margin. Because of these higher premiums mutual companies do not need as great a surplus or contingency reserve as do stock companies. In the event of adverse experience, policy dividends can be reduced by mutual companies. This expedient is not available to stock companies which must rely entirely on their surplus and contingency reserves.

If an income tax at the corporate rate were levied on all funds that might be added to the surplus and contingency reserve of a stock company, I believe it would be impossible for such a company to maintain adequate safety margins. Such a law would make it necessary for nonparticipating premium rates to be increased on business issued in the future. Since this would have the effect of putting stock companies out of competition with mutual companies, it would greatly reduce the volume of business which they could hope to acquire. Even more serious than this, however, would be the effect upon existing policyholders. Sound management dictates, and has always dictated when there was no tax consideration, that each year as reserves increase, surplus should be increased. The necessity for surplus was clearly brought out by Mr. Menry F. Rood, senior vice president of the Lincoln National Life Insurance Co., in his testimony before this committee. Each year as reserves increase on policies issued many years ago, it is necessary for the company in some way not only to establish the reserve but to also establish as a safety margin a percentage of this reserve increase. In the case of nonparticipating policies a larger percentage is received than in the case of participating policies.

The value of a dollar today is very much less than it was when many of the policies that are presently in force were issued. It is true that the payment the company is called upon to make is in these same devalued dollars, but all of the expense incident to handling the business must be paid in depreciated dollars, or to put it another way, at inflated prices. Fortunately for the life insurance companies and their policyholders, mortality has improved. This has made it possible for the companies to meet operating expenses and maintain satisfactory surpluses as well as to pay dividends to stockholders.

There is an important additional reason for the special 10-percent deduction that should not be overlooked. It is a recognized fact that reserves maintained by stock companies are on the average lower than reserves maintained by mutual companies on comparable policies. Which type of company is maintaining the proper reserve? Only the future will tell. Both types of companies assume the same ultimate obligation; in the process one company undertakes to earn 3 percent or 3½ percent on the policy reserves while another company obligates itself to earn only 2 or 2½ percent. The company assuming the higher interest rate puts up a smaller reserve. This means that under similar conditions its apparent net gain from operations is greater than that of the company putting up the larger reserve. If the full net gain from operations is taxed, then it is clear that the company putting up the smaller reserve will pay more taxes and will consequently have less funds remaining to guarantee its policy obligations than the company which puts up the larger reserve. Traditionally the stock companies have assumed the higher interest rate which means that they have put up the smaller reserves. These reserves may or may not be adequate. If the mutual companies are right, then the reserves of stock companies will prove to be inadequate, and if extra funds are not available to the stock companies from surplus or contingency reserves, these companies will be in trouble.

In our company the effect of this higher interest assumption is vividly illustrated by the following facts: Our average interest requirement on all reserves is approximately 3.2 percent which is substantially above the industry average. If we were to recalculate our reserves on the basis of 2½ percent, our total capital, surplus, and contingency reserve would be reduced by more than one-half. Furthermore, if all of our reserves had been on this basis for the year 1958, our apparent net gain from operations for the year would have been reduced by approximately one-third. In fact, the reduction would have been slightly greater than the 10 percent special deduction permitted us by H.R. 4245. In other words, this 10 percent deduction would only serve to place us in a comparable position taxwise with a company assuming a 2½-percent interest return. In our case, therefore, this 10-percent deduction is not really available to provide contingency margins comparable to those provided by the higher premiums charged by mutual companies since it is all needed to adjust for the lower reserves which result from our higher interest assumption.

Historically, stock companies when first organized usually established the minimum reserves permitted by the statutes of the States in which they operate. As they have grown and as funds have been available they have strengthened reserves. In our case a large volume of business was issued with an interest assumption of 4 percent. Over the years we have added to these reserves, but at the present time, as I have said, our average interest requirement on all reserves is still approximately 3.2 percent. We had hoped to continue to strengthen these reserves but probably will not be able to do so if H.R. 4245 is enacted. This would make it imperative that we have safety margins over and above our reserves if we are to be sure that all contract obligations can be met.

The other provision contained in H.R. 4245, which I think is essential, is the deferment of one-half of the tax on underwriting income until such time as it has been clearly established that the profit to be taxed was in fact profit and not simply a bookkeeping entry.

Everyone recognizes the long-term nature of the business. A contract is not completed until the policy has terminated. Policies in force upon which premiums are being paid can really be considered as "work in process." A contractor constructing a building cannot determine with certainty when the building is half completed just what his profit or loss has been up to that point. Only when the building is finally completed and accepted by the owners and all bills have been paid by the contractor does he know with certainty the amount of profit, if any, which he has made on his contract. The same is true with a life insurance policy except that instead of terminating in 1, 2, or 3 years, it extends over a much longer period. The cases are alike, however, in that a life insurance company cannot definitely determine its profits as long as the contract is still in force and has not been completed.

Mr. Mills in explaining this provision to the House of Representatives made the following statement:

"This provision basically reflects uncertainty as to whether or not the other 50 percent is, in fact, income until the longrun contingencies have been eliminated. When the company, however, by its own action indicates that the policyholder surplus is not needed in the business and distributes it to stockholders in any manner whatever, then the money comes back into the tax base.

"In dealing with the underwriting income, therefore, it is provided that no funds will be paid to shareholders before they have paid the full corporate rate, just as is the case with respect to the tax on dividends of any other corporation. In view of the difficulty of me assuring this income on an annual basis, however, we provide that the company can postpone tax on part of this income as long as it is held as a surplus earmarked for the policyholders and not for the stockholders."

To my mind this is an eminently sound provision, and I would emphasize that the deferment of this tax is not for the benefit of stockholders but to protect the millions of policyholders who hold nonparticipating or guaranteed cost life insurance policies.

Some of the questions directed by members of your committee to witnesses have indicated a feeling that the 10-percent special deduction and the underwriting gains on which taxes are deferred would be available to companies for the purpose of expansion. It is inconceivable to me that these funds would be so used. While not required by State law and not assigned to individual policy contracts, these funds are nevertheless in the nature of reserves and would be invested for the protection of policyholders in the same manner that policy reserves are invested. The necessity of maintaining an adequate surplus for the protection of policyholders has always been recognized by the companies. So long as these funds are retained as surplus they are not available to finance the expansion of a company.

I am sure you will agree that the institution of life insurance has an enviable record for safety and soundness. The public generally accepts the fact that the companies are sound and that they are and will continue to be in a position to pay claims under policies as they arise. I am convinced that no member of this committee wishes to impose a tax upon stock companies which would have the effect of jeopardizing the ability of the companies to pay claims as they mature. The House Ways and Means Committee felt that the special deduction of 10 percent and the deferment of one-half of the tax on underwriting income were necessary to avoid this danger. I would urge this committee to allow these provisions to remain unchanged.

Before I close, I would like to tell you the effect of H.R. 4245 on our company. Under the 1955-57 law (the Mills-Curtis Act), our tax on 1958 business would have been about $735,000. Under the 1942 law our tax would be about $1,250,000. Under H.R. 4245, as well as we can calculate it, our tax would be about $2 million. It is clear from these figures that even with the allowances provided for stock companies writing nonparticipating business our tax would still be materially increased.

I appreciate your courtesy in allotting time to me, but since there have been so many witnesses I am filing this statement instead of taking the time of the committee to present it personally.

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THE MUTUAL LIFE INSURANCE CO. OF NEW YORK,
*Pueblo, Colo., March 11, 1959.*

Hon. GORDON ALLOTT,
*Senate Office Building, Washington, D.C.*

DEAR GORDON: Thanks for your prompt answer to my telegram. I am very happy to relay any thoughts I might have in regard to this pending legislation.

There are some 120 million life insurance policyholders in America, and the cash values of their policies represent the one largest savings element in the country. To discourage this ambition to be self-reliant and independent is not, in my opinion, healthy for our national economy. The more people who can become financially independent, the fewer people charity or government will have to support in times of adversity. This bill will increase the cost of their thrift and the vital protection which goes with it. Why penalize the life insurance industry, which is the only institution that guarantees family security from the first day a contract is signed. If widows and orphans had to survive on their other forms of savings to supplement social security, they would be in a bad way.

In a mutual life insurance company there are no "profits." Any "profits" are returned to the policyholder as a refund. Of course, this is not true in a nonmutual or stock company. A share of the profits go to the stockholders, who are entitled to a return on their investment. But they are not necessarily policyholders. The sole aim of a mutual company is to provide insurance at the lowest possible cost.

In virtually all cases, H.R. 4245 would impose an unfair penalty on mutual policyowners by failing to grant mutuals a tax deduction when their operating gains are less than their investment income. Such a deduction is provided for the stock company.

This bill gives an advantage to the life insurance companies which use higher interest assumptions on policy reserves. But higher interest assumptions produce reserves on policy obligations, and are therefore less conservative. The bill could be amended so as to use a 5-year individual company average for computing the reserve interest deduction, so as to treat each company individually and avoid basing the tax on an industrywide average, which would favor some companies and penalize others. I believe the provisions in regard to qualified pension plans should be revised so that they would receive the same tax treatment as trusteed plans.

The provision providing for taxing investment income from annuities is unfair. It is just another form of double taxation.

There are many more inequities in the bill, but these are the most glaring. The life insurance industry expects to pay their fair share of the taxload, but I believe this does not fit that description.

I appreciate hearing from you and I hope you will be able to help us get this bill amended.

Kindest personal regards.

Most sincerely,

GUY L. EVANS,
*Field Underwriter.*

P.S.—Give my regards to Warren Elliott.

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NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
*New York, N.Y., March 16, 1959.*

Hon. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building, Washington, D.C.*

MY DEAR SENATOR BYRD: We refer to H.R. 4245, the proposed "Life Insurance Company Income Tax Act of 1955." As you know, in the States of New York, Massachusetts, and Connecticut, mutual savings banks are authorized to engage in the life insurance business. Section 594 of the Internal Revenue Code provides in effect that such banks are to be taxed like ordinary corporations on that part of their income not allocable to the business of the life insurance department, and on the income of the life insurance department "at the rates of and in the manner provided in subchapter L (sec. 801 and following) with respect to life insurance companies."

We express no opinion in this letter on the substantive merits or demerits of the bill. We have, however, reviewed it in an effort to determine whether there is anything in it inconsistent with the general scheme of section 594. So far as we can determine, there is no such inconsistency, but we should appreciate it if your committee could in its report confirm our interpretation, for instance, by stating that nothing in the bill is intended to change the practice of treating life insurance departments of mutual savings banks as life insurance companies for the purpose of computing the partial tax on the income of such life insurance departments described in section 594 of the Code. We have particularly noted the provision of section 817(b) of the bill whereby certain gain is required to be determined by reference to the fair market value of property on December 31, 1958, if on that date the fair market value exceeds the adjusted basis, and the taxpayer has been a life insurance company at all times on and after that date. We assume that this provision, or any similar provision, would apply in computing the tax of a savings bank life insurance department even though in a technical sense, the department is not a life insurance company.

Another provision which has given some concern to us is that of the last sentence of section 811(b)(1), which states that in computing the deduction for dividends to policyholders, there shall be included as amounts held (as reserves for dividends to policyholders) at the end of any taxable year "amounts set aside, before the 16th day of the third month of the year following such taxable year, for payment during the year following such taxable year." In

New York, the actuary of the savings banks life insurance fund is required to analyze and prepare figures for the annual report of 48 issuing banks and to make dividend recommendations to those banks. It is physically impossible to complete this work for all these banks before the last week of February. As a part of this study, the amounts of dividends to be set aside for the following year are determined. These figures are then placed in the annual reports to the superintendent of banks, which are due on March 1. It may not be possible in all cases to complete formal action for setting aside reserves for dividends by the 15th of March. A similar situation prevails in Massachusetts where the State actuary is required by law to make corresponding determinations for each of the issuing banks in that State. Accordingly, we should appreciate your committee's giving consideration to changing the last sentence of section 811(b)(1) to read as follows:

"For purposes of subparagraphs (A) and (B), there shall be included as amounts held at the end of any taxable year amounts set aside before the time prescribed by law for filing the return for such taxable year (including extensions thereof), for payment during the year following such taxable year."

This would correspond, for instance, to the somewhat similar treatment provided for accrual basis taxpayers with respect to contributions to pension trusts in section 404(a)(6).

Very truly yours,

WILLIAM A. LYON, *President.*

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STATEMENT OF C. H. POINDEXTER, PRESIDENT, COASTAL STATES LIFE INSURANCE CO., RE: H.R. 4245

Coastal States Life Insurance Co. is a small company, with just over $200 million insurance in force and assets approximating $24 million; it is also a young company, converted in 1947 to a stock company from a fraternal. It is engaged in the ordinary, industrial, and group life insurance fields, and also writes individual and group accident and health contracts.

After a careful examination of H.R. 4245, we believe that its passage would be disastrous to the competitive position of our small company and all other small or young companies in the Nation engaged in a similar business. The tax burden would be less serious than the competitive disaster from the special tax deductions proposed for those large mutual companies that now dominate certain fields. Its immediate impact would be the complete destruction of our carefully developed group and group accident and health operations, because we would be unable to compete with those companies able to write tax-exempt pension plans in combination with other group, using pension windfalls for dividends on group and group accident and health.

In general, we do not feel that a tax measure, beginning with 1959, reduces the taxes imposed upon a handful of companies, while most life insurance companies must pay 70 percent or more increases, is other than unjust, inequitable, unfair, capricious, and dangerous to the economy, to which the rapidly growing smaller companies are vital, especially in the Southeast, Southwest, Mountain States, and Midwest.

The measure, as sent to the Senate, provides certain "alleviating sections" for small stock companies, including a special treatment of preliminary term methods of reserving. However, many small companies would find it very difficult to avail themselves of these deductions, since they would require three different sets of books, three versions of accounting, and very sharply increased home office expense.

We are convinced, especially in view of the testimony before the Senate Finance Committee by representatives of every segment of the life insurance industry, that the investment income approach is the only method by which Congress can develop a tax bill that would be both productive to the Treasury and fair to everyone in the industry. The so-called Mills-Curtis stopgap, with a readjusted deduction rate to provide a greater tax yield, is such an approach.

To the small life insurance company, three things are most important in a Federal income tax bill: (1) its competitive effect, in which H.R. 4245 appears to be the worst ever proposed; (2) its stability and long range effect, both of which are lacking in H.R. 4245; (3) simplicity. Of these three, for many of us, the third is almost the most important, and H.R. 4245 is the most complex labyrinth of words, mysterious mathematical calculations, combinations of unrelated average results, and violations of accepted accounting practices that can be imagined.

The Treasury, in 1958, sought the tried-and-rejected total income approach, because it yielded more money; this year they abandoned it, because gains from operations had sharply declined and the prospective yield of their pet bill would be about $100 million less than the sum they had hoped for. H.R. 4245 represents nothing more than the piling of unrelated figures arbitrarily together to obtain a result approximating the yield of the 1942 act, which the Treasury agrees is unjust and unreasonable.

Small insurance companies, with an experience such as ours at Coastal States Life, hope that from these hearings will develop a measure that will produce adequate revenue, that will not require too frequent revision, and that will not destroy them competitively by special tax allowances to their larger rivals.

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STATEMENT OF STERLING HOLLOWAY, CHAIRMAN OF THE BOARD OF CONTINENTAL LIFE INSURANCE CO.

My name is Sterling Holloway. I am chairman of the board of Continental Life Insurance Co. of Fort Worth, Tex., a stock company organized February 18, 1948.

Continental Life Insurance Co. issues nonparticipating and participating ordinary life business.

Our company had operating losses in the years 1955, 1956, and 1957, but we made a small profit in 1958. Our company is a member of the Texas Life Convention and our position concerning H.R. 4245 is generally in agreement with that of the Texas Life Convention, being different only in emphasis. Our views can be summarized as follows:

We believe that on sound tax principles and to avoid discrimination between classes of companies, the ideal solution would be a Federal income tax law imposing a tax on net investment income, defined substantially as in phase 1 of H.R. 4245, with an additional provision that any funds over and above amounts transferred to shareholders' surplus account which are distributed to stockholders in the form of cash dividends would be subject to tax at the time of distribution.

However, we feel that the degree of discrimination presently contained in H.R. 4245 is not unbearable and that it could be somewhat mitigated by the following amendments, which we urge be given consideration by the committee:

1. An amendment to section 805 to provide for the use of each individual company's 5-year average net interest earned rate, in lieu of the average now provided in computation of the deduction rate.

2. An amendment of section 809(d)(6) to provide an increase from 10 percent to 12 percent in the deduction for increases in nonparticipating reserves. This increase was urged before both the Treasury staff and the House Ways and Means Committee and can be fully justified and supported by statistical studies.

3. An amendment to provide that tax-exempt interest would in fact be fully tax exempt in all phases of H.R. 4245.

4. An amendment to the provision for a shareholders' surplus fund to provide that any surplus contributed by shareholders in the future will be immediately credited to such fund.

5. An amendment to create what might be called an "accumulated surplus account," equal to the amount of the accumulated earned surplus of each company on December 31, 1958, and from which 2 percent per annum would be transferred to the shareholders' surplus fund until such accumulated surplus account is exhausted.

6. An amendment to provide that losses from operations of the years 1955, 1956, and 1957 be allowed as a loss carryover deduction.

I urge the committee to consider favorably the foregoing amendments which will minimize the obviously discriminatory effect of the bill as now drawn and I thank the committee for the privilege of being allowed to submit my views for consideration.

CHICAGO, ILL., *March 16, 1959.*

Re Life Insurance Company Income Tax Act of 1959, H.R. 4245

Hon. HARRY F. BYRD,
*U.S. Senate, Washington, D.C.:*

The Benefit Association of Railway Employees is a small mutual life insurance company founded in 1913 in Chicago, Ill. For the year 1957 we incurred an operating loss of $60,481.59 before Federal income tax due to adverse claim experience. Under the Mills law (1955–57) that supposedly gives insurance companies a tax advantage our company paid a Federal income tax of $228,-963.47 for 1957 on the $60,481.59 loss incurred as our company has suffered under the inequities of past life insurance tax laws. We would appreciate your consideration of the following changes in proposed tax law H.R. 4245:

(1) Removal of the discrimination in the accumulation of surplus for small insurance companies. The small company requires a larger surplus in proportion to its size as its claim experience tends to fluctuate to a greater extent than does that of a large company.

This greater accumulation of surplus could be provided for by (*a*) altering section 809(g) to provide that the limitations mentioned do not apply to small insurance companies, and by (*b*) altering section 809(d)(7) to include individual accident and health insurance.

(2) Removal of the discrimination under the Mills law (1955–57) whereby some small insurance companies were required to pay a Federal income tax while sustaining losses from operations. These inequities could be corrected by altering section 812(b)(1)(B) to allow loss carrybacks to taxable years prior to January 1, 1958. This change would help many small companies and cost the Treasury a negligible amount.

PAUL E. KELLER,
*President, Benefit Association of Railway Employees.*

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THE MUTUAL LIFE INSURANCE CO. OF NEW YORK,
*Boise, Idaho, March 12, 1959.*

Re H.R. 4255

Hon. FRANK CHURCH,
*U.S. Senator, Senate Office Building, Washington, D.C.*

DEAR FRANK: It was surely good to talk with you on the phone yesterday. I am certainly proud of the fine reputation you are building nationally. You are doing a wonderful selling job for the State of Idaho.

Frank, relative to H.R. 4255, we are concerned basically about two things: One, that mutual legal reserve life insurance companies are not discriminated against where problems pertaining to the industry as a whole are concerned, and, two, that dividends as a return of premium are not jeopardized due to unreasonable taxation.

Here are some ideas that might be considered in clarifying these points:

Of the $775,739,552 of insurance in force by the 20 top companies in the State of Idaho in 1957, $368,943,147 of this was produced by mutual life insurance companies. (The 1957 statistics were used because the 1958 figures have not been published yet.) So, any taxation involving these mutual companies would materially affect a considerable amount of money and many thousands of Idaho policyholders.

At the present time, life insurance taxes are three times greater than average taxes on other forms of thrift.

State premium taxes and Federal income tax, if expressed as a percentage of premiums, have risen by 99 percent since 1945. In the same period, the volume of Federal income taxes paid by life insurance companies has climbed 1,000 percent, or five times as fast as the industry has grown.

Mutual companies have only 63 percent of the total life insurance in force, and only 58 percent of the gain from operations. But under the new bill they would pay 72 percent of the Federal taxes that will be levied on the life insurance business.

Under the proposed legislation, H.R. 4245, life insurance companies would pay nearly $545 million in Federal income taxes alone on 1958 revenue. This would represent a tax boost of more than 70 percent in a single year.

State taxes on life insurance premiums for 1958 will exceed $300 million. This, when added to Federal income taxes of $545 million, means a total of $845 million, more than twice the burden of such taxes 5 years ago. And this takes no account of some $150 million of social security, real estate, and miscellaneous taxes which bring the total tax burden to about nearly $1 billion.

H.R. 4245 overlooks the first objective of mutual insurance companies.

The sole aim of mutual companies is to provide insurance at the lowest possible cost. When a mutual company ends up the year with more money than it needs to meet its obligations, it returns the surplus in the form of premium refunds.

H.R. 4245 gives an advantage to the life insurance companies which use higher interest assumptions on policy reserves. But higher interest assumptions produce lower reserves on policy obligations, and are therefore less conservative.

In virtually all cases, H.R. 4245 would impose an unfair penalty on mutual policyholders by failing to grant mutuals a tax deduction when their operating gains are less than their investment income. Such a deduction is provided for nonmutuals.

H.R. 4245 should be amended to remove discriminatory provisions. This could be accomplished by:

Using a 5-year individual company average for computing the reserve interest deduction so as to treat each company individually and avoid basing the tax on industrywide averages which favor some companies and penalize others.

Allowing mutual companies proper deductions of any deficit that may arise if operating gains fall short of investment income.

Revising the provisions on qualified pension plans so that they receive the same tax treatment as trusteed plans do.

Permitting a deduction for investment income from annuities so as to avoid unfair double taxation.

These proposed amendments would improve H.R. 4245 because:

The tax on policyholder savings would be more equitable.

There would be no tax incentive to weaken policy reserves.

Mutual companies with low operating gains would not be penalized by excessive tax on their investment income. This is essential to the growth and competitive position of small mutual companies.

Conservatively managed companies would not be penalized by a higher rate of tax.

Life insurance companies expect to pay their fair share of Federal taxes. They ask only that the taxation law be nondiscriminatory.

It is highly probable that no other major industry in the history of the United States has ever faced the serious threat of a 70 percent tax boost in 1 year.

Frank, I think our position is fairly clear. We are not trying to avoid payment of increased taxes, but merely to modify the bill so that policyholders' dividends are not going to suffer beyond reason.

Thank you very much for your kind consideration, and my very best wishes to you for your continued success.

Sincerely,

J. RICHARD CLARKE, *Manager.*

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FARMERS & TRADERS LIFE INSURANCE CO.,
*Syracuse, N.Y., March 16, 1959.*

Re Proposed amendment to H.R. 4245

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

DEAR SENATOR BYRD, AND OTHER MEMBERS OF THE FINANCE COMMITTEE: We would like to call your attention to the fact that our company is in the process of mutualization in accordance with the enclosed mutualization plan which was approved by the superintendent of insurance on November 15, 1954.

We are required under this plan to make payments out of earnings and for that reason, we are in the same situation as the Ohio National Life Insurance Co., and we feel the same way as they do about the necessity for relief under H.R. 4245. Accordingly, we favor the proposed amendment submitted by the Ohio National Life Insurance Co. to your committee which is in the form attached to this letter.

Very truly yours,

EDWIN W. HENNE, *President.*

PROPOSED AMENDMENT TO H.R. 4245, TO CORRECT THE RETROACTIVE ASPECT OF THE BILL AS IT AFFECTS A LIFE INSURANCE COMPANY IN PROCESS OF MUTUALIZATION UNDER A MUTUALIZATION PLAN COMMITTED FOR PRIOR TO THE PROPOSED EFFECTIVE DATE OF THE BILL.

In subpart C—Gain and loss from operations—section 809(d), an additional deduction should be inserted immediately following paragraph (8) at the bottom of page 24 of the February 9, 1959, print, as follows:

"(9) Any distribution during the taxable year to shareholders in acquisition of stock pursuant to a plan of mutualization agreed upon prior to January 1, 1958, under the mutualization laws of the taxpayer's State of domicile."

The above addition would require the following changes on page 25 of the February 9, 1959, print of the bill:

Paragraph (9) of section 809(d) would be renumbered as paragraph "(10)".

The reference in the first sentence of section 809(e), to subsection (d) (9), would be changed to refer to subsection "(d) (10)".

PLAN FOR MUTUALIZATION OF FARMERS AND TRADERS LIFE INSURANCE CO., OF SYRACUSE, N.Y.

PLAN

For the conversion of the Farmers and Traders Life Insurance Co., of Syracuse, N.Y., hereinafter referred to as the company, into a mutual life insurance corporation and for the acquisition of shares of its capital stock to that end, pursuant to section 199 of the insurance law of the State of New York.

I

The company hereby determines to become a mutual life insurance corporation.

II

The company is to pay the sum of $1,000, hereinafter referred to as the mutualization price, for each share of the outstanding 3,000 shares of its capital stock of the par value of $100 acquired pursuant to this plan, provided that the plan shall be approved and subject to the performance of the conditions therein provided:

(*a*) by a vote of the stockholders representing a majority of the capital stock at a meeting of the stockholders to be called for the purpose;

(*b*) by a majority vote of all policyholders each insured in an amount at least equal to $1,000 and whose insurance shall have been in force for at least 1 year prior to aforesaid stockholders meeting and who shall vote at the meeting to be called for the purpose and in the manner hereinafter provided;

(*c*) by the superintendent of insurance of the State of New York in writing.

Upon the approval of the plan as above set forth the company shall make payments for the acquisition of the stock in the following manner but subject to the stipulations herein enumerated;

(*d*) An initial principal payment of $200 per share shall be made on the mutualization price in 1954 at the time of acquisition of stock acquired on or prior to December 31, 1954; on January 1, 1955, an additional principal payment not exceeding $100 per share shall be made on the purchase price of such stock; and upon the acquisition of stock subsequent to December 31, 1954, the principal payment to be made per share shall be equal to the principal sum per share previously paid on account of the mutualization price per share for stock acquired prior thereto.

(*e*) Subsequent annual principal payments on the mutualization price shall be made on January 2, 1956, and yearly thereafter until the aggregate principal payments provided in paragraphs (*d*) and (*e*) shall equal the mutualization price.

(*f*) Interest on the balance of the mutualization price remaining unpaid from time to time, computed from the date of acquisition of the stock at the rate of 3 percent per annum, shall be paid on the first days of each January, April, July and October next ensuing until the entire mutualization price shall have been paid.

(*g*) Until January 1, 1955, the company shall continue to write nonparticipating policies and contracts and beginning January 1, 1955, the company shall issue participating life insurance policies and deferred annuity and pure endowment contracts. Effective as of said date there shall be a separation in the accounts of the company as between all policies and contracts written prior to January 1, 1955, which shall be known as the nonparticipating business, and all policies and contracts written thereafter, which shall be known as the participating business.

(*h*) All principal payments on the mutualization price shall be made from the accumulated net earnings of the nonparticipating business only. All interest payments on the unpaid balances of the mutualization price shall be paid from the accumulated net earnings of the nonparticipating business only. Provided, however, that such principal and interest payments shall not reduce the surplus to policyholders (both nonparticipating and participating) below 5 percent of the policy reserves and policy liabilities (both nonparticipating and participating) of the company.

All payments above referred to shall require the prior approval of the board of directors of the company and the superintendent of insurance of the State of New York.

DEFINITIONS

"Surplus to policyholders" shall have the meaning given to that term in section 4 of the insurance law of the State of New York, except there shall be deducted therefrom the special surplus fund as provided in article III.

"Policy reserves and policy liabilities" shall consist of the sum of the items enumerated and defined as such in subsection 1 of section 207 of the insurance law of the State of New York and comparable items for accident and health insurance policies.

"Accumulated net earnings" shall be the "surplus to policyholders" of $2,019,121.80 as reported in the company's annual statement as at December 31, 1953, plus the net earnings on the nonparticipating business thereafter and less any principal distributions made pursuant to paragraphs (*d*) and (*e*) of article II, interest payments made pursuant to paragraph (*f*) of article II and amounts set aside as a special surplus fund pursuant to article III of this plan.

"Net earnings" on nonparticipating business shall be determined annually in the following manner from the following items allocable to the nonparticipating business, which items shall correspond to the items in the 1953 annual statement of the company as filed with the superintendent of insurance of the State of New York: The excess of the sum of "Special surplus funds December 31, current year," item 49, "Unassigned surplus, December 31, current year, "item 50, and principal distributions and interest payments made to mutualization certificate holders in the current calendar year, over the sum of "Special surplus funds December 31, previous year," item 34 and "Unassigned surplus December 31, previous year," item 35, in the surplus account on page 4.

III

At the time of making each principal payment an equal amount per share shall be set aside for each share of stock which has not been acquired pursuant to the plan, as a special surplus fund for the purpose of making payment to stockholders who subsequently may transfer their stock in accordance with paragraph V. Such amount shall not be a liability of the company until such stock is so transferred.

IV

EXPECTED PERIOD OF DEFERRED PAYMENTS

It can be expected with normal earnings that a period of about 10 years from January 3, 1955, may be required to complete the payments of the mutualization price with 3 percent interest on the remaining unpaid balances.

V

Upon the approval of the plan as above set forth and the delivery by a stockholder or by the voting trustees in his behalf, as the case may be, of his stock certificate or certificates, properly endorsed for transfer, and the surrender of the voting trust certificates, if any, properly endorsed for transfer, such stockholder, or his successor in interest shall receive from the company upon delivery of the certificate or certificates to the mutualization trustees, cash per share in an amount determined as above stated and a mutualization certificate evidencing his rights under this plan to the deferred balance of the purchase price. The certificate shall be in a form approved by the company and the superintendent of insurance of the State of New York. Such certificate shall be transferable by assignment thereof. Upon such transfer of a stockholder's certificate or certificates of stock to the mutualization trustees he shall thereupon cease to be a stockholder in the company.

VI

The plan is to be submitted to the stockholders of the company at a special meeting of stockholders called for that purpose as provided by law, to be held at such time or times as shall be determined by the board of directors of the company upon due notice at 418 State Tower Building, Syracuse, N.Y. Ten days' notice in writing of the time, place, and purpose of such meeting is to be given by serving each stockholder personally or by mailing a copy of such notice to each stockholder of record entitled to vote at such meeting, at his address as the same appears on the books of the company at the date of the mailing of such notice and the notice is to be accompanied by a copy of this plan. Each stockholder will be entitled to one vote for each share of stock appearing by the books of the company to be owned by him and may vote in person or by proxy. The result of the vote cast at such meeting shall be certified by the secretary of the company to the superintendent of insurance.

VII

The trustees, herein called "Mutualization trustees," to whom stock purchased or acquired under this plan shall be assigned or transferred, pursuant to the insurance law of the State of New York, shall be the following named: Edwin W. Henne, Herschel D. Newsom, and Louis J. Taber, who shall hold the stock so acquired in trust for all of the policyholders of the company in accordance with section 199 of the insurance law of the State of New York. Vacancies in their number, occuring by resignation, disability, or death, shall be filled by the board of directors of this company with the approval of the superintendent of insurance of the State of New York.

VIII

A meeting of policyholders each insured for at least $1,000 and whose insurance shall have been in force for at least 1 years prior to the stockholders meeting shall be held at the office of the company at such time or times as shall be determined by the board of directors of the company and upon giving 30 days prior notice thereof for the purpose of voting for or against this plan. The superintendent of insurance of the State of New York shall conduct, supervise, and direct the method of procedure of said meeting as provided by law.

A notice in writing shall be given of the policyholders meeting to each of such policyholders, by mailing a notice of the time, place, and purpose of the meeting to each of such policyholders at his latest address, as shown by the company's books, at least 30 days before the date of the meeting. There shall be enclosed in a sealed envelope containing the notice, a copy of the plan of mutualization, an official ballot in a form approved by the superintendent of insurance and a suitable return gummed envelope, postage prepaid, having inscribed thereon the name and address of the home office of the company. There shall also be enclosed in such sealed envelope, a suitable blank proxy and the statement of the right of the policyholder to vote either in person, by mail, or by proxy. Each of such policyholders, whether insured under one or more policies, shall have but one vote, and may vote in person, by proxy, or by mail. The vote cast at the meeting shall be canvassed by three inspectors to be appointed by the superintendent of insurance, who shall certify the result to the company and to the superintendent of insurance.

IX

Upon the final consummation of the plan, the company is to become a mutual life insurance corporation without capital stock pursuant to the provisions of the Insurance law of the State of New York.

Dated at Syracuse, N.Y., May 15, 1954.

LOUIS J. TABER,
*President, Farmers and Traders Life Insurance Co.*

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SUPPLEMENT TO STATEMENT OF JARVIS FARLEY

(Statement filed March 5, 1959)

H.R. 4245 has been developed under such pressure of time, without full opportunity for study and testing, that new and unexpected aspects keep coming to light. This supplementary statement describes what we trust is an unintended penalty affecting very few companies at most and possibly only one. A simple amendment is suggested which we believe would apply only to those few companies, possibly only one company, and would avoid serious injustice to that company.

Section 818(e) of H.R. 4245 is designed to tax accruals as of December 31, 1957, which otherwise would go untaxed because of the change from cash basis to accrual basis. The subject is discussed at page 18 and page 43 of House Report No. 34 accompanying H.R. 4245. The principle is to apply the Mills stopgap tax to those accruals, so that the tax adjustment would equal the difference between the tax actually paid on the cash basis over past years and the tax which would have been paid if the company had filed its returns on the accrual basis over past years. For most companies the provision works out that way. A company which does not encounter the two times limit on the reserve interest deduction would have a tax adjustment equal to 7.8 percent of the net 1957 accruals, and a company whose reserve deduction has been consistently greater than the two times limit would have a tax adjustment equal to 52 percent of the 1957 net accruals.

A problem arises for a company for which the reserve deduction was consistently below the two times limit until 1957, in which year the deduction equalled the limit for the first time. For such a company the tax adjustment required by section 818(e) would be 52 percent of the 1957 accruals even though the additional amount of tax through the years on the accrual basis would have been a small fraction of that amount. Specifically, consider a life insurance company which writes a type of insurance which is characterized by an unusually high degree of long-term risk, and which, therefore, has followed conservative policies in reserve valuation and in dividends to stockholders. As a result of such conservatism the company's ratio of surplus to assets is above average and its net investment income is considerably higher than the interest required to maintain reserves. In 1957, for the first time, the reserve and other policy liability deduction encountered the limit at twice the amount of interest required to maintain reserves.

At the end of 1957 accrued interest was about $200,000. If the adjustment required by section 818(e) were made without regard to the top limit on the reserve and other policy liability deduction, the additional tax (to be spread over 10 years) would have totaled about $15,000. As a result of having encountered the two times limit in 1957, however, the additional tax required by section 818(e) would be over $100,000. If the company had reported income in 1957 and prior years on an accrual basis, its aggregate taxes over such prior years would have been higher by about $22,000, so that about 80 percent of that $100,000 additional tax would represent a windfall to the Treasury, accruing solely because the transition came at the end of the only year when the company encountered the two times limit on its reserve and other policy liability deduction.

It might be noted in passing that the "bunching" problem is even more complicated for a company which had been taxed under section 204 IRC prior to 1942. In that case the amount of interest accrued at the end of 1941 was taken into the computation of the tax under section 204 for 1941, and the same amount would have been included in income received in 1942. To the extent of the amount of interest of accrued at the end of 1941, therefore, the tax under section 818(e) would represent triple taxation.

The problem may be unique to this company. Certainly there can be very few companies in a position such that the tax adjustment imposed by section 818(e) is several times as great as the amount of extra tax that would have been paid if tax returns had been on an accrual basis throughout. The unique situation of this company is highlighted by the fact that in 1958 the two times limit on the reserve interest deduction exceeded the deduction itself by more than $22,000; and therein lies a solution to the problem. The adjustment method used in section 818(e), based on this principle of section 481 IRC, is to find one tenth of the net adjustment for 1957 accruals, add said one tenth to the 1957 income, recompute the 1957 tax on the basis of that amount, and find the amount by which the resulting tax exceeds the actual 1957 tax. The total adjustment is equal to 10 times that difference.

This company's net accruals at the end of 1957 were just under $200,000. One tenth of the net accruals would be just under $20,000. Recall that in its 1958 return the limit exceeded the reserve interest deduction by slightly over $22,000. If the company were to base the recomputation on its 1958 return, using one-tenth of the net accrual at the end of 1957, the result would be to produce a tax adjustment which would be roughly equal to what the additional tax would have been if the company had filed on an accrual basis in all previous years from 1942 on.

H.R. 4245 could be made to authorize that result simply by inserting after "The amount of the taxpayer's tax for 1957" in the second sentence of section 818(e)(1) (that is, at the end of line 21 of page 19, as printed on February 9, 1959) the following: "(or, at the option of the taxpayer, 1958)". The effect of that insertion would be that the actual 1957 accruals could be used in a recomputation of either the 1957 or the 1958 tax in determining the net increase (or decrease). It would make no difference to most companies which year was used. The rest of section 818(e) is such that we believe that no other change would be necessary to accomplish that result.

Such a change is desirable for the following reasons:

1. It corrects what otherwise would be the serious injustice of requiring payment of an adjusted tax several times larger than would have actually been collected if the company had always filed on the accrual basis.

2. That result is brought about by an amendment which is very easy to make.

3. The amendment would in no way reduce the tax of any company for which the reserve interest deduction had consistently been limited by the two times rule, nor would it affect any taxpayer which did not encounter the unusual and possibly unique problem of this company.

4. The reduction in tax would be insignificant from the Treasury's viewpoint. In the case of this company the total adjustment would be about $85,000 lower, and it might be that no other company would be affected.

5. By correcting an injustice which would lie heavily upon this company it reaches more nearly the purpose of the adjustment, based upon the treatment provided by section 481 for other taxpayers where pre-1954 adjustments were involved.

(See also p. 129.)

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CENTURY LIFE INSURANCE CO.,
*Fort Worth, Tex., March 16, 1959.*

Re Suggested amendment of H.R. 4245 to protect solvency of small life insurance companies.

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

DEAR SENATOR BYRD: Enclosed is a suggested amendment of H.R. 4245, the purpose of which is to exempt small stock life insurance companies from the tax on gain from operations until they can build up their capital and surplus not to exceed $5 million.

Some of the reasons in support of the suggested amendment are set forth in the enclosed statement containing the amendment. We think this amendment is vital to the survival of many of the small life insurance companies in the United States.

We sincerely trust you and the other members of the Senate Finance Committee will give the amendment favorable consideration.

Very truly yours,

CENTURY LIFE INSURANCE CO.,
By FRANK H. RAWLINGS,
*Vice-President-General Counsel.*

SUGGESTED AMENDMENT OF H.R. 4245 TO PERMIT SMALL LIFE INSURANCE COMPANIES TO BUILD UP THEIR SURPLUS AND CAPITAL FOR THE PROTECTION OF THEIR POLICYHOLDERS AND EXPLANATORY STATEMENT SUBMITTED BY CENTURY LIFE INSURANCE CO., FORT WORTH, TEX.

The Century Life Insurance Co., a small stock life insurance company of Fort Worth, Tex., submits the suggested amendment to H.R. 4245 set out below:

Amend section 802 of H.R. 4245 by adding at the end of the section a new subsection to be identified as subsection (e) to read as follows:

"(e) Exception: No tax is imposed on the gain from operations in excess of the taxable investment income of any life insurance company unless the capital and surplus funds of such company exceeds the greater of

"(a) 25 percent of the life insurance reserves or

"(b) 60 percent of the sum of the net premiums for such taxable year as determined under section 809(e)(1).

"This exception shall not be applicable to any company the capital and surplus of which is in excess of $5 million."

If this amendment is adopted, it will be necessary also to amend paragraph 2 of subsection (c) of section 815 to conform by adding thereto the following:

"(2) Additions to account. If the gain from operations for any taxable year beginning after December 31, 1958, exceeds the taxable investment income, there shall be added to the policyholders surplus account an amount equal to 50 percent of such excess; provided, however, if a company is exempt from taxation on the gain from operations in excess of its taxable net investment income as provided in section 802(e), then and in that event 100 percent of such excess shall be added to the policyholders surplus account."

The effect of this suggested amendment is to exempt these small companies from the payment of the tax imposed on the gain from operations unless the capital and surplus of the company exceeds 25 percent of its life insurance reserves, or 60 percent of the sum of its net premiums, whichever is the greater. But in no event would this exemption apply if the capital and surplus were in excess of $5 million. Neither would it apply if such earnings are paid out in cash dividends to stockholders because such distribution will still be taxable under section 815 of the bill. Neither will this amendment serve to exempt from taxation the so-called specialty companies because in most instances the capital and surplus of such companies will exceed 25 percent of their insurance reserves or 60 percent of their premiums for such taxable year and, therefore, the proposed suggested amendment would not be applicable to them.

It has been the history of most orthodox life insurance companies that during their initial years of growth the ratio of their capital and surplus to policyholder liabilities has steadily decreased to where after this initial growth period it is a matter of sound company practice to increase this ratio as rapidly as possible. Sufficient capital and surplus funds are in the best interests of policyholders, the industry, and the general public.

During a period of depression it is a historic fact that assets of a life insurance company decrease in value and there should be sufficient surplus funds to protect the policyholders against such shrinkage; in recent years the need of such surplus has been even more accentuated with the advent of possible atomic warfare and the resulting excessive mortality. It is, therefore, not only fitting but in the public interest that small companies be permitted to defer a tax on any operating gains to assist them in creating this surplus protection to policyholders. It is felt that the proposed amendment accomplishes this objective.

There are a larger number of small companies in the country that need the protection of this amendment. These companies, though large in number, represent only a small portion of the business and assets of the industry as a whole. The adoption of this amendment, therefore, would not materially reduce the amount of revenue to be derived from the bill if enacted.

CENTURY LIFE INSURANCE CO.,
*Fort Worth, Tex., March 16, 1959.*

Re suggested amendment of H.R. 4245 modifying the term "distribution" to exclude funds used in redemption of callable preferred stock outstanding as of January 1, 1959

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

DEAR SENATOR BYRD: Enclosed is a suggested amendment of H.R. 4245 to modify the definition of "distribution" contained in subsection (a)(3) of section 815 to provide that funds expended in the redemption of callable preferred stock outstanding as of January 1, 1959, shall not come within the meaning of "distribution."

The effect and reasons for this amendment are set forth in the enclosed explanatory statement containing the amendment.

We trust that the committee will give favorable consideration to this amendment.

Very truly yours,

CENTURY LIFE INSURANCE CO.,
By FRANK H. RAWLINGS,
*Vice President-General Manager.*

SUGGESTED AMENDMENT OF H.R. 4245 TO MODIFY THE TERM "DISTRIBUTION" SO AS TO EXCLUDE FUNDS EXPENDED FOR THE REDEMPTION OF CALLABLE PREFERRED STOCK OUTSTANDING ON JANUARY 1, 1959, AND EXPLANATORY STATEMENT SUBMITTED BY CENTURY LIFE INSURANCE CO., FORT WORTH, TEX.

The following suggested amendment to H.R. 4245 to modify the definition of "distribution" so as to exclude funds expended in the redemption of callable preferred stock outstanding on January 1, 1959, is submitted by Century Life Insurance Co., of Fort Worth, Tex.:

Amend section 815 of H.R. 4245 by rewriting the unnumbered paragraph immediately following subsection (a)(3) to read as follows:

"For purposes of this subsection, the term 'distribution' includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include any distribution made by the corporation in its stock or in rights to acquire its stock; nor shall the term 'distribution' include any funds expended in the complete redemption of callable preferred stock which was outstanding on January 1, 1959."

Under the above referred to unnumbered paragraph immediately following subsecton (a)(3) of section 815 as it is now written, the term "distribution" includes any distribution of funds made in the redemption of stock which is broad enough to include both common stock and preferred stock. The effect of the submitted amendment is to modify the term "distribution" so that funds expended in the redemption of callable preferred stock outstanding on January 1, 1959, will not be included in such term.

It is inherent in the life insurance business that a company must operate at a loss during its early years. Most companies in these early years arrive at a point where it becomes necessary to supplement the surplus originally contributed by its common stockholders.

This, in the past, has generally been accomplished by one of two methods:

1. An issue of callable preferred stock to be retired out of future surplus earnings, or

2. An issue of interest bearing surplus debenture bonds retirable in the same manner.

The retirement of surplus debenture bonds would not (and should not) under the bill as now written be considered as a distribution. It would be inequitable, therefore, to treat the redemption of callable preferred stock, heretofore issued, in any different manner. Both are in effect merely the return of borrowed money.

We do not feel it was the intention of the drafters of H.R. 4245 to make any such discrimination.

STATEMENT OF RICHARD M. SELLERS, EXECUTIVE VICE PRESIDENT, COMMONWEALTH LIFE INSURANCE CO., LOUISVILLE, KY., PREPARED FOR THE COMMITTEE ON FINANCE, U.S. SENATE CONCERNING H.R. 4245

I am Richard M. Sellers, executive vice president of Commonwealth Life Insurance Co. of Louisville, Ky. My company is a stock company of medium size currently issuing only nonparticipating insurance.

If the insurance industry and its policyholders are required to pay a Federal income tax of the magnitude under consideration, we favor the enactment of H.R. 4245 as written. The substitution of the 5-year average earned rate for each individual company has been recommended by almost every industry representative who has appeared before this committee. The use of the 5-year average earned rate will reduce revenue by approximately 8 percent for the industry as a whole but it will increase my own company's tax. We believe that there is merit in the use of the mean of the actual and assumed rate for the current year as provided in H.R. 4245 and that this technique which has been so carefully considered by the House of Representatives and by the Treasury should not be abandoned completely.

Should the Senate Finance Committee adopt the use of the 5-year average earned rate in phase 1 we urge that there be incorporated in the new definition of the deduction rate language similar to the following:

"* * * but in no case during the first 4 years in which this revenue act is in effect shall the deduction rate be less than the amount ascertained by dividing by two the sum of—

"(A) the average rate of interest assumed by the taxpayer in calculating life insurance reserves (other than pension plan reserves), plus

"(B) the percentage obtained by dividing—

"(i) the taxpayer's investment yield for such year by

"(ii) the mean of the taxpayer's assets at the beginning and end of the taxable year.

"If the percentage determined under subparagraph (A) exceeds the percentage determined under subparagraph (B), the deduction rate for the taxable year is the percentage determined under subparagraph (B)."

Adoption of this recommendation would have the effect of providing a transition period during which the reserve interest deduction provided in H.R. 4245 could be used.

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PROVIDENT MUTUAL LIFE INSURANCE CO. OF PHILADELPHIA,
*Denver, Colo., March 14, 1959.*

Re H.R. 4245.

Senator GORDON ALLOTT,
*Senate Office Building,*
*Washington, D.C.*

DEAR SENATOR ALLOTT: Thank you for your prompt reply to my wire of March 2 regarding the proposal for Federal income taxation of life insurance companies. I have deliberately delayed answering your letter because I wanted to study provisions of the bill which you so kindly sent me. I must confess that I am not a tax authority nor a statistician and that, nessesarily you and your colleagues should hear representatives of our industry who are professionally equipped to advise on apparent discrepancies of the bill. It appears that there are some broad effects this bill would have and it is on these following points that I will comment.

1. Economic effects.
2. Relation to other forms of thrift.
3. The changing content of the life insurance program.
4. Social security and other demands on Government.

The other night I was visiting a friend and mentioned the contents of this bill. His first remark was: "I bought life insurance on a permanent basis because it offered me a guarantee with a reasonable potential yield for future years. It looks to me like I may have to go to other forms of saving and forget life insurance." What my friend told me would be repeated millions and millions of times if every policyholder of permanent life insurance knew the contents and far-reaching effects of this bill.

Permanent life insurance affords individuals a basis for building reserves that are guaranteed for future use. In this respect our citizens need not look to government (Federal, State, and city) for relief or welfare benefits. When I first entered the life insurance business in 1951 I took a dim view toward companies like the Metropolitan and the Prudential that sold industrial insurance. I felt that the $250, $500, and $750 insurance policies sold on a weekly payment basis were a poor way of doing business. When we consider, however, the number of families on this basis that would not own life insurance any other way it gives us reason to think. Yes, if these millions of policyholders did not own life insurance, who then would pay for their deaths, disabilities, and old age needs? The taxpayers, of course. In this area of policyholder, every dollar paid by insurance companies is just that much less that taxpayers will be spared. Under H.R. 4245 it appears that we are going to unduly and unfairly tax the very institution that affords us the best tax relief we can get—the individuals who want to be self-supporting will now have to pay a premium for wanting financial security.

The long range effect of this proposed legislation means that very likely the premium income will become depressed. What then? Insurance companies must cut down on financing home building and industrial enterprise. The dollars of the insurance industry hit Main Street in many ways. They have done this for years and years and have, I believe, contributed greatly to the present economic standard of living we enjoy.

In regards to other forms of thrift, I think it is fair to say that the life insurance industry is taxed in a manner that no other thrift institution is taxed. I have reference to the McCarran Act where Congress gave each State the right to tax the life insurance company doing business in that State. When we consider the aggregate of $300 million that will be assessed or has been assessed during 1958 by individual States, this becomes of major significance when the taxation is considered by Congress. Actually, if it were not for the McCarran Act, Congress could be using the $300 million taken by States.

Prospects for life insurance will continue to buy permanent life insurance so long as there is a reasonable profit that can be anticipated. I have seen a change of thinking regarding the type of policy and it seems to be getting too far to term insurance. It is agreed that term insurance (no savings content) has its place, however, with even less profit anticipated, and even higher rate of term will be purchased.

One good aspect of permanent life insurance is that it gives the policyholder a semicompulsory systematic method of savings. Often times clients will tell us they are going to buy term insurance and invest the difference. This is a lark. I have made it a point to check up on some of these clients and find that they have done nothing toward investing the difference. This means that these clients will not have the necessary dollars when opportunity, emergency, and old age arrive. In the short time that I have been in the life insurance business I have seen the wonderful good that cash dollars have done for clients in this regard. Unfair and punitive taxation will give our future prospects even more reason to look in other areas for putting their savings dollars. Probably most unfortunate is that they may not put them anywhere.

The final point I wish to discuss is the Welfare State. Yes, every time there is an election we hear all the promises of giving more and more in Federal benefits. The Democrats started this theme just after the last depression and have succeeded in selling a welfare program to our people. In the last 7 years social security benefits have skyrocketed—and so have the taxes. Any number of times I have had a daddy say, "social security will take care of my family and me when I am old." You know, I am sure, that social security was never intended to do the whole job of financial security. The net effect of unfairly increasing taxes to be paid by life insurance companies and policyholders will create even greater demands for Government to do the job. Our country was founded on the principle of enterprise—let's keep it that way.

H.R. 4245 should be carefully reviewed in light of the serious questions and implications that it can have on our national economy. It should be further reviewed to be sure that mutual and nonpar companies are still competitively on the same basis. In light of the McCarran Act the aggregate tax imposed on life insurance companies should be considered.

I hope that you will overlook typographical errors but I felt that my thoughts should be expressed even though a secretary is not in the office on Saturday.

Thank you for your interest in my views and I trust that a prudent decision will result when the bill is submitted to you for consideration.

Very truly yours,

GEORGE BRUGGER,
*Special Representative, Member of Board of Directors of Denver Association of Life Underwriters.*

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STATEMENT OF RAYMOND H. BELKNAP, PRESIDENT, THE UNITED STATES LIFE INSURANCE CO. IN THE CITY OF NEW YORK

I desire to submit this statement to the Senate Finance Committee in connection with that committee's hearings on H.R. 4245 relating to the taxation of life insurance companies. The reason is that in developing this bill it is my belief that insufficient consideration has been given to the problems which will be created for the United States Life Insurance Co. in the city of New York and a few other concerns similarly situated with respect to their foreign operations.

The United States Life Insurance Co. in the city of New York is a publicly owned stock life insurance company. It operates domestically in 30 States and is one of the few American life insurance companies with extensive interests in 16 of the foreign countries where the United States is actively encouraging economic growth and development. It is actively soliciting new business in Cuba, Panama, Colombia, Venezuela, and Puerto Rico and has sizable amounts of existing business in the Philippines and Guatemala.

Ten percent of its total ordinary life insurance in force covers lives of residents of the 16 foreign countries in which it does business. As of December 31, 1958, it had foreign investments of $13,600,000 representing 12.94 percent of its total admitted assets. In other words, the United States Life Insurance Co. in the city of New York, while not a giant force in the foreign economic operations of the United States, is nonetheless a leader in a field of private economic activity which might well be encouraged by the U.S. Government.

In recent years, our company has been placed at an increasing disadvantage with respect to its ability to compete with foreign-domiciled insurance companies. The reasons for this will be set forth in brief.

Most countries of the world regard the savings aspect of life insurance as a matter coequal in importance to the family protection factor. As a result, life insurance companies have been traditionally treated taxwise in such a way as to insure that they would remain a repository of savings and so as to allow them to charge reasonable premium rates. A typical example is Canada, which is the home base of numerous life insurance companies with which our company is in active competition in Central and South America as well as in the Caribbean area. Under Canadian law the income of a life insurance company is not taxed except for amounts set aside for dividends to shareholders. The result is, of course, that a mutual life insurance company is not taxed on income at all and even a stock life insurance company is taxed only to the extent that amounts are set aside for dividends to shareholders.

A domestic tax on the income derived from foreign sales of life insurance creates a competitive disadvantage in that a foreign company not so taxed can offer a lower net premium cost than can an American life insurance company.

Even without the tax rise contemplated under H.R. 4245 the United States Life Insurance Co. in the city of New York currently operates at some competitive disadvantage in foreign countries. The domesic tax effect of H.R. 4245 could well be such that our company and others similarly situated might be priced out of the world insurance market.

A great amount of attention has been devoted in the postwar period to means by which private American investment abroad may be expanded. The expansion of business in foreign countries by American life insurance companies is one of the means by which this might be done. The imposition of the taxes contemplated under H.R. 4245, however, may in fact be a powerful deterrent.

Our company believes that it should attain competitive conditions equal to those under which insurance companies of other countries operate abroad. It believes that an amendment to H.R. 4245 would remove some of the gross inequities which exist under the present law and which would exist in even more startling form under H.R. 4245. This amendment would have as its purpose the exclusion from the concept of "life insurance company taxable income" under section 802 of H.R. 4245 that net income derived from sources without the

United States and Canada. The purpose of this amendment would be, then, to free from domestic taxation amounts earned by life insurance companies as a result of their foreign sales operations.

The actual effect of this amendment on U.S. tax collections would be small. It is estimated that with respect to 1958 taxes of the United States Life Insurance Co. in the city of New York, the saving would be about $50,000 For the entire industry it is our estimate that the loss of revenue would be only about $500,000. At the same time, for these few companies passage of this amendment would remove a serious competitive barrier and might encourage other domestic life insurance companies to expand abroad.

Passage of this amendment would have another significant effect for life insurance companies operating abroad. In many cases profits from foreign operations have been illusory. Exchange restrictions have limited the ability of all U.S. companies to repatriate their income on a current basis and, when repatriation has been allowed, it has often been with currency which is heavily devalued. At the same time, such profits must be accounted for on a current basis with respect to U.S. tax law. The effect which H.R. 4245 would have had upon the United States Life Insurance Co. in the city of New York profits in Colombia during 1953, 1954, and 1955 is shown below:

| Profits 1953-55 | Exchange rate conversion | Taxable profits | U.S. tax paid |
|---|---|---|---|
| A. Col$702,830.96 | 40 cents (official rate) | $281,135.84 | $146,190.64 |
| B. Col$702,830.96 | 21.48 cents (actual upon repatriation) | 150,939.14 | 78,488.35 |
| Overtaxation | | | 67,702.29 |

Line A represents the actual U.S. taxes that would have been payable on Colombian income in the years 1953, 1954, and 1955. Yet line B shows that the profits actually realized were almost 50 percent lower than those on which taxes were paid.

While this is a problem generally faced by all U.S. companies engaged in foreign operations, it is particularly severe for life insurance companies. The reason is that such companies are required to retain a portion of their reserves in certain countries and must maintain certain fixed amounts of capital and surplus as a condition of doing business therein. As a result, they cannot adjust their foreign income with the freedom of industrial and commercial concerns which do not bear such restrictions. Exclusion of such income would provide a solution to this problem and would provide an additional inducement for domestic life insurance companies to engage in foreign operations. Yet is would entail no great loss in tax receipts.

In conclusion, I hope that in considering revision of H.R. 4245, thought will be given to the means which I have suggested of reducing the competitive disadvantages under which the U.S. Life Insurance Co. in the city of New York and a few other similar concerns currently operate. The first benefits of such relief might be reasonably expected to flow to those companies already selling life insurance in foreign countries. Of greater significance, however, is the probability that such relief would encourage other life insurance companies to engage in foreign operations. Together wih the expectable expansion of business by those already selling abroad, this total increase in business would undoubtedly lead to the investment of life isurance reserves by these private concerns in the foreign countries where life insurance was sold. Here lies, potentially, a tremendous opportunity to encourage the investment of private American capital abroad which would cost a relatively insignificant amount in current domestic tax receipts. Such an opportunity is deserving of careful consideration. There is submitted herewith an amendment to H.R. 4245 which would achieve this desirable result.

H.R. 4245

Amendments intended to be proposed to Mr. ——— to the bill H.R. 4245 relating to the taxation of the income of life insurance companies:

viz: On page 55, line 7, strike out the closing quotation marks, and after line 7, insert the following:

"SEC. 820. DOMESTIC LIFE INSURANCE COMPANIES OPERATING IN FOREIGN COUNTRIES.

"(a) GENERAL RULE.—The life insurance taxable income of a domestic life insurance company which during the taxable year carries on a life insurance business within any foreign country (other than Canada) shall be computed in accordance with the provisions of this seciton with respect to such business.

"(b) EXCLUSION OF FOREIGN INVESTMENT INCOME.—In the case of a domestic life insurance company to which subsection (a) applies for the taxable year, the company's taxable investment income shall be reduced by an amount which bears the same ratio to the company's taxable investment income (determined without regard to this section) as—

"(1) the sum of the company's total insurance liabilities on business outside the United States and Canada, bears to

"(2) the company's total insurance liabilities.

For purposes of this paragraph, the term "total insurance liabilities" has the meaning assigned to it by section 819(b)(2).

"(c) EXCLUSION OF GAIN OR LOSS FROM FOREIGN OPERATIONS.—In the case of a domestic life insurance company to which subsection (a) applies for the taxable year—

"(1) ITEMS OF INCOME.—For purposes of section 809(c), income from sources outside the United States and Canada shall not be taken into account. The preceding sentence shall not apply to items taken into account under paragraph (4) of section 809(c) which are derived from sources outside the United States and Canada to the extent that the amount of such items exceeds an amount which bears the same ratio to the gross amount of the items taken into account under such paragraph (determined without regard to this section) as—

"(A) the sum determined under subsection (b)(1), bears to

"(B) the sum determined under subsection (b)(2).

"(2) DEDUCTIONS.—For purposes of section 809(d), no deduction shall be allowed to the extent attributable to income which is excluded under paragraph (1).

"(3) RULES FOR CERTAIN RESERVES.—For purposes of sections 809(c)(2) and 809(d)(2), the items enumerated in section 810(c) shall be computed by excluding amounts attributable to business outside the United States and Canada.

"(4) DIVIDENDS TO POLICYHOLDERS.—For purposes of section 811, dividends and similar distributions on business outside the United States and Canada shall not be taken into account.

"(d) FOREIGN TAX CREDIT INAPPLICABLE.—Subpart A of part III of subchapter N (relating to foreign tax credit) shall not apply to a domestic life insurance company for any taxable year for which subsection (a) applies to such company to the extent that income of such company is excluded under this section."

On page 43, at the end of the matter following line 23, insert the following:

"SEC. 820. Domestic life insurance companies operating in foreign countries."

On page 56, strike out lines 1, 2, and 3, and insert the following:

"such Code is amended—

"(1) by striking out 'The' in the first sentence and inserting in lieu thereof 'Except as provided in section 820(d), the';

"(2) by striking out '811', in the first sentence; and

"(3) by striking out paragraph (1) and inserting in lieu thereof the following:"

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STATEMENT OF JOSEPH M. BRYAN, SENIOR VICE PRESIDENT, JEFFERSON STANDARD LIFE INSURANCE CO.

This memorandum is limited to those aspects of the proposed Life Insurance Company Income Tax Act of 1959 (hereinafter sometimes referred to as "H.R. 4245" and also as "the bill") which pertain to the subject of intercorporate dividend deductions, and is not to be regarded as expressing approval or disapproval of any other portions of H.R. 4245.

THE NATURE AND PURPOSE OF H.R. 4245

It is, we believe, universally conceded that H.R. 4245 is intended to embody a permanent method, applicable to 1958 and subsequent years, for the Federal income taxation of life insurance companies, with the purpose of imposing a type of tax which, after making allowances for the special nature of the life insurance business, will apply the same tax principles and theories which are applicable to the Federal income taxation of other business corporations. In this connection, attention is called to the following statement made by Congressman Mills at the time the bill was considered on the House floor:

"We finally have reached what we think are satisfactory bases for establishing an overall approach to taxation of overall income. We think we are getting at the true income of life insurance companies for the first time since 1921." (Congressional Record, p. 2337, Feb. 18, 1959.)

It would seem to follow from the foregoing that any disparity in treatment of intercorporate dividends received by a life insurance company and those received by another type of business corporation would be not only inequitable but also wholly inconsistent with the avowed objective of the bill itself.

INTERCORPORATE DIVIDENDS RECEIVED DEDUCTIONS ALLOWED UNDER H.R. 4245 ARE NOT EQUIVALENT TO THOSE ALLOWED OTHER BUSINESS CORPORATIONS

In both subpart B (the "Investment Income" phase) and in subpart C (the "Gains and Loss from Operations" phase) a deduction, up to the usual 85 percent, is allowed (secs. 804(c)(7) and 809(d)(9)) for intercorporate dividends received. However, the bill contains other provisions (secs. 805(e), 809(f), and 818(f)) which reduce or purport to reduce these deductions to the point where they become only a minor fraction of the 85 percent which is allowed to other business corporations.

Presumably these provisions which would quite materially limit the amount of the intercorporate dividends received deduction are based upon the premise that the provisions are necessary to prevent double deductions. The headings of the subsections would so indicate. It is seriously debatable that double deductions would be involved, but in any case the life insurance companies would not be accorded the same privileges as other business corporations, and thus one of the avowed purposes of the bill would not be accomplished

In the case of a life insurance company, the cash dividends which it receives from another corporation (subject to income taxes on its own earnings) are, as in the case of any other corporation receiving such dividends, placed among its general cash assets, and are not segregated, earmarked or used specifically for policy reserve and contract liability requirements any more than such dividends received by a business corporation are specifically applied to wages, raw material costs, debt service or other proper business purposes.

Business corporations other than life insurance companies which pay interest on corporate indebtedness in the same year in which these same corporations receive cash dividends from other corporations do not have their interest deductions disallowed or reduced by reason of the intercorporate dividends received deduction which they are allowed, nor are the intercorporate dividends received deductions reduced because of the interest payments. This raises the question: Why should a life insurance company's deduction for policy reserves and other contract liability (whether such deduction occurs under subpart B or subpart C) be reduced because the company has received the same 85-percent intercorporate dividend deduction allowed to other corporations? The inequity of the situation seems obvious, especially when H.R. 4245 recognizes that the life insurance reserve deduction is as proper and necessary a deduction as is a deduction for interest on debt.

For the foregoing reasons, we believe the Senate Finance Committee should approve and sponsor such changes in H.R. 4245 as may be appropriate to allow life insurance companies the same deduction (85 percent) for intercorporate dividends received as is allowed other business corporations.

STATEMENT OF JACK C. VAUGHN, PRESIDENT, SPARTAN NATIONAL LIFE INSURANCE CO., DALLAS, TEX.

The Spartan National Life Insurance Co. is a stock company which operates only within the State of Texas. By comparison with the giants in the insurance industry, several of which have billions of dollars of insurance in force, Spartan is an extremely small company, having only approximately $6 million of life insurance in force at the present time. It is also a young company, having been in existence only since 1954, and like many other small companies, is constantly faced with an uphill struggle for survival competing with the "Goliaths" of the industry.

To begin with I submit that the taxing formula as proposed under H.R. 4245 would not reach a truly equitable tax result for all life insurance companies, particularly small companies. This is so since the total income approach would in part tax premiums paid by policyholders, which are in reality payments to the insurance company primarily to develop the reserves necessary to pay the policies on maturity and to provide for contingencies.

Of utmost importance, however, is the need for special consideration and special treatment for small life insurance companies. In this connection it is important to remember that all life insurance policies, although written by various companies, are basically the same. Therefore, probably the principal way life insurance companies compete and try to attract more business and therefore grow is by reducing premiums. Unfortunately, most smaller companies cannot meet rate reduction competition from the larger companies because of the squeeze they find themselves in from low revenues, the requirement for higher reserves on their old business and the need to provide for the special risks to which small companies are peculiarly susceptible.

Considering further the problems of low revenues and high reserve requirements, it should be noted that among all U.S. life insurance companies the average ratio of assets owned by companies to the insurance in force is approximately 22 percent. In other words, the life insurance companies have only $22 worth of assets at the moment for every $100 worth of life insurance they will ultimately have to pay out in proceeds. Also, according to the figures from the Spectator Year Book and the Institute of Life Insurance, only 3 percent of life insurance company assets are invested in common stock, whereas 35 percent is invested in mortgages, 7 percent in U.S. Government securities and the balance in other conservative investments. As a result, life insurance companies generally obtain a very low rate of return from their investment portfolios.

Small companies particularly are squeezed between slow growth and the need for reserves to provide for possible death claim experience which deviates from the mortality tables. A small young life insurance company in particular is in an adverse position because, unless it is extremely successful, it will almost always sustain a loss for its first 10 years as a result of the high first year cost of writing insurance. Coupled with this is the added problem that during periods of inflation, such as we are presently experiencing, the overhead expenses increase much faster than investment gains so that the companies are in a further squeeze since almost all premiums are fixed amounts continuing throughout the life of the policy. In order to cope with these increased costs, the small company will have to raise premiums on new policies, thus losing ground to the larger companies.

Because of these factors and especially because of the possibility, in the case of the smaller companies, that the reserves established pursuant to the present Commissioners Standard Ordinary Table of Mortality could prove to be considerably lower than the actual losses sustained, a special and substantial annual deduction should be allowed to permit small and young life insurance companies to provide for such a contingency. Such a deduction would help the smaller companies to save the amount of money necessary to protect themselves against the special risks to which they are subjected.

Since life insurance is basically the sharing of losses by a large number of insureds, one of the basic principles of life insurance is that a large number of people be insured so as to make minimal the speculative aspect of deviating from the mortality tables. It is well recognized that the new and small life insurance companies are all confronted with the very serious problem of writing life insurance policies on a sufficiently large number of persons to protect against this speculative aspect of the mortality tables. Since the new and small companies often cannot obtain a sufficiently large number of separate risks to be certain that the law of averages under the mortality tables will work properly insofar as these companies are concerned, and since the companies, because of competitive reasons, cannot raise their premiums, they must look to sources other than premiums for income not only to operate profitably but more important to secure the future necessary death payments.

This is accomplished by their investment portfolios which, if profitable, will increase the policyholders' protection by increasing the surplus or special contingencies funds over and above what is required by the mortality tables reserve. If the small life insurance companies must pay a high tax on this investment income, which is usually higher than premium income in newer and smaller companies, the resulting net increase in surplus is relatively low and, as a result, the funds for payment of policyholders' claims may not be adequate. The small life insurance companies deserve and must have special tax consideration covering their investment income. The 5 percent exclusion as presently incorporated in H.R. 4245 is grossly inadequate, since the special consideration given to the excess of premium income over net investment income will benefit the "Goliaths" of the industry, but will be to the prejudice of the small and new companies if they are not given an offsetting benefit for their investment incomes.

In conclusion, it should always be remembered that life insurance companies are completely different from conventional corporations, both in their operations and in their service to the public. Therefore, the philosophy and consideration behind the taxation of conventional corporations should not apply to life insurance companies. Furthermore, life insurance companies are already overburdened by taxes imposed by the various States within which they operate. I commend these facts to your consideration in working out a more equitable formula for taxing life insurance companies.

(Whereupon, at 7:10 p.m., the committee was recessed until Tuesday, March 17, 1959, at an hour to be set by the chairman.)

# TAX FORMULA FOR LIFE INSURANCE COMPANIES

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**TUESDAY, MARCH 17, 1959**

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

The committee met, pursuant to recess, at 10:25 a.m., in room 2221 New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Frear, Anderson, Gore, Talmadge, Hartke, Williams, Carlson, Bennett, Butler, and Cotton.

Also present: Elizabeth B. Springer, chief clerk.

L. N. Woodworth, economist, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is the Honorable Scott W. Lucas, representing the Western National Life Insurance Co. of Texas.

Senator Lucas.

## STATEMENT OF SCOTT W. LUCAS, WESTERN NATIONAL LIFE INSURANCE CO. OF TEXAS

Mr. LUCAS. Mr. Chairman, and members of the committee, as the chairman said, I represent the Western National Life Insurance Co. of Texas, whose principal place of business is Amarillo, Tex. The president of that company is one Earl O'Keefe.

Senator KERR. What is the name?

Mr. LUCAS. Earl O'Keefe, who is supposed to be here today to answer any and all questions with respect to the operations of his company. Unfortunately, he is detained as a result of illness and cannot be here. He has collaborated with me in the manuscript that I am about to file.

I want to make just one brief statement with respect to the organization of this company back in 1944, as the Credit Life Insurance Co. at that time.

From that point the company started writing a full line of insurance. Today they write ordinary life, endowments, annuities, group insurance, accident and health, and credit life insurance.

With that brief statement, Mr. Chairman, I should like to ask leave to file the manuscript that I have prepared and have it incorporated into the record at this point.

The CHAIRMAN. Without objection, the insertion will be made in the record.

(The document referred to is as follows:)

STATEMENT OF SCOTT W. LUCAS ON BEHALF OF WESTERN NATIONAL LIFE INSURANCE CO. OF TEXAS, ON H.R. 4245

My name is Scott W. Lucas, an attorney at law in Washington, D.C., with offices at 1025 Connecticut Avenue, N.W. This statement is being submitted on behalf of Western National Life Insurance Co. of Texas, Amarillo, Tex. The company is a stock life insurance company which, in the absence of any new legislation, would be taxed under section 811 of the Internal Revenue Code of 1954.

This company writes a full line of insurance—ordinary life, endowments, annuities, group insurance, accident and health, and credit life insurance. It is advisable to state that this company was organized in 1944 and wrote at that time only credit life insurance, and since that time has branched out into writing substantial amounts of other insurance, as described above.

We believe that if the bill before us had been the law in force in 1944 the tax under this bill involving credit life insurance companies would have prohibited this company from ever engaging successfully in ordinary life and other types of insurance. We believe that it is a matter of common knowledge to this committee that many an ordinary life company today operating successfully started in the beginning as a specialty company, writing accident and health, hospitalization, and other specialty types of insurance.

A brief history of this measure is set forth. The bill before the committee was passed by the House of Representatives on February 10, 1959, sent to the Senate, and appropriately referred to this committee for consideration. It is understood that while the Committee on Ways and Means was considering this bill in executive session, a motion was made to strike out step 3 of the bill, the motion being defeated.

In the supplemental views on this bill, found on page 87 of the report on this bill by the Committee on Ways and Means, we find, among other things, the following language:

"We are concerned that insufficient consideration has been given to the economic impact of the revenue implications of the bill H.R. 4245. We do not make the point that too little, just enough, or too much revenue is extracted from the insurance industry and its policyholders; we do make the point that the economic aspects of this issue must be further studied and evaluated before the Congress can have confidence that the tax burden imposed under your committee's bill is appropriate in magnitude and equitable in distribution."

This supplemental report was signed by ten members of said committee.

One of the members of the Ways and Means Committee moved to recommit the bill, and that move was defeated.

My purpose before your committee today is to demonstrate conclusively that H.R. 4245 discriminates against certain life insurance companies writing term insurance. Because the company I represent writes a substantial amount of credit life insurance, we are affected by the discriminatory features aimed at the specialty companies.

CREDIT LIFE INSURANCE COMPANIES ARE LIFE INSURANCE COMPANIES

The bill does not require close scrutiny for one to see that it discriminates against certain life insurance companies. I respectfully urge you to observe that it is not the credit life insurance business which is being discriminated against, but rather certain companies who are particularly engaged in this endeavor. Any gain that may accrue from the underwriting of credit life insurance may be taxed at one rate in a mutual company, possibly at a higher rate in certain stock companies, and at still higher rates in a so-called specialty company. Indeed, in some cases, such gains bear no tax at all in the hands of the first two classes of companies. In practice, however, such gains will always be taxed in a company which, in its infancy, writes predominantly but one type of life insurance—credit life insurance.

Having explored the facts which lead to this discrimination, I shall with your permission, offer certain suggestions which could eliminate the discriminatory features of the bill. If in the opinion of this committee it is deemed necessary to permit such discrimination, I would take this opportunity to offer further suggestions which would tend to ameliorate the discrimination.

H.R. 4245 IS DISCRIMINATORY AGAINST CREDIT LIFE INSURANCE COMPANIES

*A. Overall discrimination*

At the outset I stated that my principal purpose in making this presentation to your committee was to demonstrate in an unequivocal and irrefutable manner that the bill discriminates, not against the credit life insurance business in the United States, but rather against certain life insurance companies who are engaged in this business. A simple illustration will prove the existence of this discrimination in an overall sense.

Assume that company A is a mutual life insurance company; company B a multiple-line stock life insurance company; and company C a so-called specialty company. Assume further that all three companies realize a $1 million net operating gain attributable to underwriting credit life insurance written at the same premium rate. I am certain that every man on this committee will agree that the tax impact on this $1 million gain should be identical in all three companies. This is not so. It is true that phases 1 and 2 of this bill are legally applicable to company A, the mutual company, and also applicable to company B, the multiple-line stock company. That being the case, one would logically conclude that as between these two companies the tax impact would be identical. In practice we find that by reason of the mutual company's deduction for its dividends to policyholders permitted by section 809(d)(3) under the bill, the result may be that its taxable investment income will exceed its gain from operations. Under the bill its tax base then will be its taxable investment income. Thus, a mutual company has escaped the tax imposed by phase 2.

The multiple-line stock company, writing predominantly nonparticipating contracts is not in a position to remove itself from phase 2. Thus, we see that a multiple-line stock company cannot enjoy the degree of maneuverability available to a mutual company. Let us not, however, assume that a multiple-line stock company will always be taxed under phase 2. The investment of the large reserves required by this type of company might well produce taxable investment income which exceeds the gains from operation. This result would depend upon the individual experience of each such company. We can say that were this $1 million gain realized by a multiple-line company, it may or may not be taxed under phase 2. In instances where the gain is taxed under phase 2, it is submitted that the tax constitutes discrimination between stock companies as a group and mutual companies as a group.

Let us examine the tax impact to a so-called specialty company realizing this same $1 million gain. Most of these companies are of rather recent vintage and at this period in their history find themselves with a preponderance of credit life business. It should be stated for the record, however, that many of such companies, similar to the one I represent, are also writing ordinary life business. We have seen that credit life insurance companies do have reserves but such reserves decrease over the term of the policy, while reserves from ordinary life business are constantly ascending. Therefore, while on the surface it would appear that a so-called specialty company would be in the same position as a multiple line stock company, in that its investment income would exceed its operating gains, as a practical matter the reverse is true. In most cases, operating gains will exceed investment income. This means that specialty companies will always incur a tax under phase 2.

Let us pause here to review the inequities revealed thus far. With a $1 million gain from credit life insurance business, the following tax results under phase 2 would obtain under the bill:

(*a*) The mutual company, in practice, will incur no tax.
(*b*) The multiple-line stock company may or may not incur a tax.
(*c*) The specialty company, in practice, will incur a tax.

Many companies, which today are known as specialty companies, desire to remain in the insurance business and to expand into multiple-line companies. As I stated above, many of the multiple-line companies of today started as specialty companies. The thrust of this bill would probably forever prevent the realization of this goal.

*B. Phase 3 discrimination.*

The foregoing discrimination is but one part of the overall discrimination. Phase 3 dashes all hopes that a relatively new company writing credit life insurance may even survive.

If a company does manage to arrive at that state where it has operating gains in excess of taxable investment income, under phase 2, 50 percent of that excess is taxed at ordinary rates. The balance of this excess (the other 50 percent) is placed in a newly created account known as policyholders surplus. On its surface, the limitations on this account cause the imposition of an automatic tax. Once again, however, in practice, this aspect of phase 3 would cause additional tax only to so-called specialty companies. By operation of section 815(d)(4) under H.R. 4245, after the expiration of a relatively short period of time, these specialty companies will always be taxed on the other 50 percent of underwriting gains.

We immediately learn that phase 3 in its entirety has no application to a mutual life insurance company. Thus, the mutual company is never required to pay additional taxes on income from sources identical to that accruing to stock companies. It is evident that at this point formal discrimination exists between stock companies and mutual companies as a class. The proposed section 815(c) would apply to all stock life insurance companies. Again, as a practical matter, it will have no effect upon a multiple line stock company. After a period of time, however, this section, by reason of the cap imposed, will always affect a specialty company.

PHASE 3 IS NOT A NEEDED REVENUE PRODUCER AND SHOULD BE ELIMINATED

Let us explore the practical effect of section 815(d)(4) upon stock companies. This section provides for an automatic tax if certain conditions are met. Simply stated, when amounts in the newly created policyholders surplus account exceed the greater of—

(*a*) 25 percent of the life insurance reserves; or

(*b*) 60 percent of the sum of the net premiums for such taxable year;

such excess is subject to tax at 52 percent. For the reasons indicated above, most new credit life insurance companies will have operating gains exceeding their taxable investment income, and consequently will incur a tax under phase 2. The remainder of the phase 2 tax base must be transferred to policyholders surplus. A specialty company will, in a short time, meet the limitations of this cap provision and consequently incur the automatic phase 3 tax referred to above. Thus, on any net gains from underwriting credit life insurance, the specialty company is taxed in toto at 52 percent of its gain. If multipleline stock companies were similarly affected, it is recognized that between specialty companies and multiple-line companies there is no discrimination. However, such is not the case.

Expert witnesses have testified before your committee that their own companies' reserves are such that the 25 percent of reserves would not have application to their company. Indeed, David A. Lindsay, assistant to the Secretary of the Treasury, testifying before this committee a couple of weeks ago, conceded that the 25 percent test is no ceiling at all. In other words, while multiple-line stock companies come within the purview of section 815(d)(4), in practice this section will result in no additional tax to them.

It is equally apparent that due to the magnitude of total premiums in a multiple-line stock company, the 60-percent-of-premiums test would also be inapplicable to them. Thus we find that, through the operation of a revenue law, a credit life insurance company is placed at a serious competitive disadvantage. It is obvious that no company faced with this competitive disadvantage can long endure. Of necessity, such company must either merge with or sell to another life insurance company of a type which enjoys preferential treatment under the bill or cede its credit life business to that same type of tax-favored company. The Treasury Department cannot hope to obtain revenue by the operation of the "cap" provision, as the affected companies cannot remain in business. I, therefore, respectfully urge this committee carefully to review section 815(d)(4) with a view to its elimination. It serves to harm not the credit life insurance business in the United States, but rather a few companies whose only sin has been to engage largely in this legitimate business.

POSSIBLE MODIFICATION OF CAP PROVISION

It is submitted that equity can be achieved only by completely removing section 815(d)(4). However, if your committee feels constrained to adopt the fiscal philosophy inherent in said section, may I suggest that it be redrafted along realistic lines.

I would like to discuss the 60-percent-of-premiums test. The difficulty with this test is that it has no relationship to reality. Actually, one is comparing elements as unlike as apples and automobiles. A simple illustration will prove this point. Let us assume a company experiences operating gains in excess of taxable investment income for 4 years. Its policyholders' surplus account has reached 60 percent of current premiums. In the fifth year, its net premiums decline; 60 percent of the fifth year's premiums would be less than the balance in the policyholders surplus account, with a resultant tax on the excess of 52 percent.

One need not be an expert in the insurance industry to realize that the 4 years prior accumulation in the surplus account could not possibly arise from the fifth year's premiums. In spite of this lack of relationship, the bill's test would have one compare the fifth year's net premiums with the prior 4 years' profits. This meaningless relationship thus triggers the automatic 52-percent tax.

Indeed, it is submitted that the protection which the policyholders surplus account is designed to give existing policyholders can be better assured if the ceiling of the account is based upon a measure other than either the reserves or one taxable year's premiums provided by the law. The size of the reserves is a function of the age of life insurance business. Under the level premium plan of doing life insurance business, the reserves of ordinary policies increase every year. Measuring the policyholders surplus for the protection of policyholders on the basis of reserves is not realistic because in the event of a catastrophe which would increase mortality in a short period of time the company would be in a better condition with a surplus based upon the face amount of insurance in force than upon the reserves it holds supporting its policies. In the event of a catastrophe, the company must pay the face amount of insurance, not just the reserves.

Enough has been said to show the capriciousness of this 60-percent-of-premiums test. Happily, it is remarkably easy to adopt a more realistic test, if indeed the "cap" is needed at all. For example, a ceiling based on a percentage (say 5 percent) of the company's insurance in force would at least relate the "cap" to a realistic basis.

OTHER DEFECTS

There are at least three other defects in the bill, unintentional technical imperfections which are inevitable in a measure of such length and complexity.

I respectfully direct your attention to section 815(d)(2) of the bill, which provides as follows:

"(2) Termination as life insurance company.—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), *if for any taxable year the taxpayer is not a life insurance company*, then the amount taken into account under section 802(b)(3) for the preceding taxable year shall be increased by the *amount remaining in its policyholders surplus account* at the close of such preceding taxable year."

Emphasis has been added to the above to show that the caption speaks of the termination of a life insurance company while the text of the section does not.

It is submitted that if a corporation fails to qualify as a life insurance company under the definition of section 801(a) of the bill, no part of the bill should apply to it. This would leave it taxable as any other corporation.

Since a life insurance company could fail to have life reserves in excess of other reserves in one particular year only, it is too great a penalty to tax the entire policyholders surplus account. It would be enough to have the earnings taxable for that year under the general corporate tax. This was the penalty under the prior law taxing life insurance companies.

Under the definition of section 801(a) a company doing life insurance business can fail to qualify as a "life insurance company" whenever its other reserves exceed its life insurance reserves. This can come about even unintentionally through the cancellation of a large group life insurance contract on the one hand, or substantial sudden increases in accident and health insurance reserves on the other.

The effect of this section as now written is to make the entire amount in the policyholders surplus account suddenly taxable.

It seems that this consequence should result only upon a complete cessation of business. Indeed, this was the very word used by Mr. Mills when he described this provision to the House (105 Congressional Record, p. 2337, Feb. 18, 1959).

It is recommended that section 815(d)(2) be amended to show clearly that it relates only to a complete termination of business as a life insurance company.

The exact terms upon which this drastic tax should fall might be subject to debate, but in order to make a concrete proposal the following language is submitted:

Amend section 815(d)(2) to read as follows:

"(2) Termination as life insurance company.—Except as provided in section 381(d)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, *then it is not taxable under this part. If such company should cease doing new business as a life insurance company or fail to qualify as a life insurance company for 3 successive years,* then the amount taken into account under section 802(b)(3) for the preceding taxable year shall be increased by the amount remaining in the policyholders surplus account at the close of such preceding taxable year."

The second defect relates to pre-1959 surplus. Under the bill, distribution is made first out of the shareholders surplus account, then out of policyholders surplus account, and then out of other accounts. A surplus accumulated prior to January 1, 1959, was intended to be tax-free when and if distributed, but since such a surplus under the bill could not be distributed until distribution has been made from the two newly created accounts, the effect of the wording of the bill is to prevent the tax-free distribution of pre-1959 earnings until there has been a tax paid on distributions from the two accounts built up by earnings in 1959 and later.

The third defect relates to the establishment of bad debt reserves. Section 809(e)(2) specifically precludes a life insurance company from establishing a reserve for bad debt losses on mortgage loans. Most life insurance companies have substantial investments in mortgage loans on which there is a normal loss experience. As a matter of fact, there have been periods in the past when losses on mortgage loans have been catastrophic. There seems to be no valid reason to discriminate against life insurance companies in the establishment of a reasonable reserve for losses on mortgage loans.

The effective date of phase 2 should be postponed for 1 year, because it effects a substantial change in the method of taxing life insurance companies long after their operations for the year to which the bill applied, namely 1958, have been concluded and after the filing of annual statements by the companies with various State insurance departments. The enactment of the bill may require a variety of revisions in figures already reported in these annual statements.

The bill further compounds the unfairness by making applicable to 1958 a tax formula not dreamed of or considered before the latter part of 1958 and for which no accurate provision could have been made by any of the companies affected, as is required by prudent business management.

CONCLUSION

The credit life companies are perfectly willing to pay their fair share of taxes. These companies concede that they have accumulated substantial gains tax-free, as indeed other insurance companies have, due to the fact that the tax base of life insurance companies has been for many years investment income. I wish to make the point, however, that such tax-free accumulation of gains has not been the result of trickery, evasion, or subterfuge. Rather this state of affairs resulted solely through the operation of the tax laws.

The CHAIRMAN. Have you anything further to say, Senator?

Mr. LUCAS. I have nothing further to say, unless some Senator desires to ask me a question on it.

The CHAIRMAN. Are there any questions?

Senator KERR. Mr. Lucas, does your statement deal with the belief or statement or possibility of discrimination as a result of this bill as between various elements of this industry?

Mr. LUCAS. Senator Kerr, I should say that 85 percent of this manuscript deals with the discriminatory features as we find them in this bill.

Senator KERR. Well, that is fine.

Mr. Chairman, I can only say this is a bad day for O'Keefe not to be operating.

Mr. LUCAS. Well, I assure you that he would like to be here, Senator Kerr.

Senator BENNETT. Senator, maybe the day is the reason he isn't operating.

(Laughter.)

Senator KERR. I had thought that such a possibility would be contemplated by all men of wisdom, but unreferred to by all men of good will.

(Laughter.)

The CHAIRMAN. The next witness——

Senator BENNETT. May I make one observation. It is early in the morning.

The CHAIRMAN. The next witness is Mr. Forrest Ray of Continental Service Life & Health Insurance Co.

Mr. Ray, please proceed.

## STATEMENT OF FORREST G. RAY, ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES, INC., AND TWO OF ITS LOUISIANA MEMBERS

Mr. RAY. My name is Forrest G. Ray. This statement is made on behalf of the National Association of Life Companies, Inc., and two of its Louisiana members.

I am a member of the executive committee of the National Association of Life Companies, which is a trade association under the laws of the State of Georgia, and having more than 120 member companies located in 25 States. I also particularly represent two of members of this association, the Continental Service Life & Health Insurance Co., and the Guaranty Income Life Insurance Co. of Baton Rouge, La., the latter of which I am also vice president and secretary. I am not a tax consultant, nor do I represent myself as an expert on tax law, but my regular work includes the preparation of both annual statements and tax returns for several small stock life insurance companies, and I have served as an executive officer of one for more than 30 years.

I am here in the recited capacities to oppose H.R. 4245, and to support as a substitute the "Total investment income" approach sponsored and filed by the National Association of Life Companies with this committee today.

When H.R. 4245 was adopted by the House it was considered as the only alternative to the 1942 formula of taxation, which formula proved unsatisfactory both to the industry and the Treasury.

In the words of Representative Curtis of Missouri, the industry did not fight the bill before the Committee on Ways and Means because, "the industry has been blackmailed by the 1942 law. If this bill does not go through, we would revert to the 1942 formula, which is a bad formula * * * It was actually used as a sledge hammer over the heads of the life insurance industry by both the Treasury Department and the Committee on Ways and Means."

The 1942 formula is not the only alternative to H.R. 4245, as we show by offering a substitute which is equitable, and one which we think will in the long run produce more revenue for the Government than will H.R. 4245.

In opposition to H.R. 4245 we will not belabor the many objections which have already been presented to the committee by the mutuals and the stock companies, but will discuss a few points which we feel have not been adequately emphasized.

To us, H.R. 4245 appears to have developed into a punitive type of legislation, which will destroy or seriously jeopardize all small stock companies, by placing them in an unbearable competitive position. This may have resulted inadvertently, in part, from a determined effort to be severe with a very minor element of the stock companies which have succeeded in having themselves classified as life insurance to take advantage of the sound principle of taxing only investment income of true life insurance companies. A brief provision can easily correct such abuses, and such a provision is included in the recommended substitute.

Next, we call attention to the fact that the mutual companies, largely concentrated in the Northeastern States, dominate the market and fix the competitive pattern of the business. This is clearly evident when we consider the fact that six of the giant mutuals have more than 50 percent of all the life insurance in force in the U.S.A., and much more than 50 percent of the assets of all the business, and that they secured more than 50 percent of all the new business written during 1957 in the U.S.A.

Stock and mutual companies sell a similar product to the same public and for identical purposes. But since the mutuals so completely dominate the field in one of the most fiercely competitive markets in America, any significant differential in the way of tax advantage to the giant mutuals will completely cripple the stock companies, especially the smaller one, and ultimately force them out of business. Incidentally, the proposed H.R. 4245 will also place small mutuals at a big disadvantage.

We know that it is not the intention of our Congress to kill the stock companies and feed their meat to the giant mutuals; therefore, we were shocked to learn of the success of a willful few representatives of the giant mutuals whose counsel and advice were used to so frame the provisions of H.R. 4245 that it would be a legal weapon for destruction of their small competitors, especially the stock companies.

We direct your attention to the great interest and concern which our Government has recently shown in the alleged strangulation of competition in certain areas of industrial manufacturing and service enterprises. Then why should the same Government foster and adopt H.R. 4245, the most effective weapon yet devised by those who would intentionally or unwittingly strangle competition in the life insurance industry?

We recite the fact that some of the large mutuals were once small stock companies, and the free enterprise system was fertile ground for their growth into such giant mutuals, but they now disregard the threatened permanent damage to that free enterprise system and seek to cut off the possibility of other small stock companies ever attaining a position which could challenge their position of superiority.

But, let us be brief, and summarize our objections to H.R. 4245, as follows:

(1) It abandons the well-established and proven principle of taxing each segment of the industry in the same way.

(2) It imposes a tax on stock companies which is not required of mutuals.

(3) It attempts by indirection to tax State and municipal bond interest.

(4) It grants tax freedom to the investment income from large pension funds, giving another tax advantage to the giant companies which are the only ones qualified to do such business.

(5) It imposes a tremendous and sudden tax increase on the industry as a whole.

(6) It involves a tax, measured by dividends to stockholders, imposing limitations and restrictions on management which are undesirable, and may form a precedent, spreading to other industries.

(7) It limits and restricts stock companies (but not mutuals) from building surplus for the greater protection of policyholders.

(8) It will drive capital from the industry.

Coming now to our reasons for supporting the substitute proposals filed by the National Association of Life Companies, we emphasize that there is no reason to tax mutuals and stock companies in a different and lopsided manner, because in the last analysis there is no difference between their sources of income and no difference in their distribution of profits.

There is no difference, except in name, between the mutual policyholders as a group and the stock company policyholders and stockholders as a group. When a great tax bite is taken from a mutual, its policyholders will receive less dividends; and when a great tax bite is taken from a stock company, its policyholders and stockholders will receive less dividends.

The only taxable income of the mutual companies is correctly held to be the investment income, for all other moneys they hold are capital deposits by policyholders or investment income previously accrued. One may as well argue for tax of bank deposits as to call for income tax on such insurance deposits. However, the same thing is true of the stock companies (except for a few specialty companies). The stock company must accrue from underwriting margins much more surplus per $1,000 of insurance in force on its low premium nonparticipating business, if it is to offer the public protection equal in safety and at a cost competitive with the business of the big mutual company.

The small number of exceptional companies where the principal source of dividends to stockholders may not be investment income, are so insignificant that no taxation of a life insurance company should even be considered. Such small element can easily be and is taken care of in our substitute proposals by a simple addition to the basic law under which we were all taxed alike in 1957.

By investment of the policyholder's funds which they retain in reserve and surplus, mutual companies make very substantial profits, especially since the guaranteed interest rate at which the reserves accumulate is usually very low compared to stock companies.

The mutuals make profits as any other investment concern does for those who supply the funds for investment.

A substantial amount of such investment profit is distributed to the policyholder in augmentation of, and as an unidentified part of the dividends paid policyholders.

This distribution of investment income, included in policy dividends, is and has been properly tax free to the recipient policyholders of both mutual and stock companies.

On the other hand, the portion of investment income which is paid as a dividend to stockholders is and has been fully taxed to the recipients. For instance, in 1957 the member companies of the American Life Convention paid dividends to stockholders of $77 million, and paid $78 million in income taxes, and the stockholders also paid income taxes on their $77 million of income. This remains unchanged in the proposals of the National Association of Life Companies, whereas H.R. 4245 levies an additional tax on the funds which are set aside by the stock company for payment to stockholders, which additional levy is discriminatory because no corresponding tax is levied on any funds which are set aside by mutual companies for payment to their policyholders, and it might well be noted here that scattered throughout the United States there are hundreds of thousands of such stockholders who would immediately note and resent the reduction of their dividends and the unfair and discriminatory tax which caused it.

In that connection, I have said above that capital will take flight from the industry, that is what I am emphasizing here. These stockholders will note any change whatever in their dividend rate and if a tax is placed there to make the stock of a life insurance company unattractive to the public, capital will take flight. It will be hard for us to retain enough capital or attract capital in the future.

The substitute proposals of the National Association of Life Companies preserve the equality of taxation throughout the industry, which has proven so satisfactory, while at the same time providing the additional revenue needed by the Government.

Also, these proposals will provide increased revenue with the growth and progress of the industry without wide fluctuations from year to year as would follow adoption of H.R. 4245, and would be susceptible of simple rate change to affect increase or decrease of taxes.

Further, these proposals would impose a tax on total investment income, which is the only true and readily ascertainable and calculable income of the peculiar business of insurance.

We respectfully urge that H.R. 4245 be killed and that the substitute proposals of the National Association of Life Companies be adopted.

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

Mr. RAY. Thank you.

The CHAIRMAN. Senator Kerr.

Senator KERR. You say, "Therefore, we were shocked to learn of the success of a willful few representatives of giant mutuals whose counsel and advice were used to so frame the provisions of H.R. 4245, that it would be a legal weapon for destruction of their small competitors or especially stock companies."

I wonder if you would give me the details of your knowledge on that.

Mr. RAY. Well, the thing that I have reference to there was that representatives of the major companies acted as advisers, so we were told——

Senator KERR. Now wait just a minute. Are you giving us the benefit of your knowledge or are you giving us a repetition of rumors?

Mr. RAY. Well, I am just giving you the information I have received by mail from various sources.

Senator KERR. Well, I want to know about the details of it.

I want to know, first, who the willful few representatives are, and how their advice comes to us in the form of a bill passed by the House of Representatives.

Mr. RAY. Senator, the feeling——

Senator KERR. I am not talking about the feeling now. I am talking about a statement you made in this record.

Mr. RAY. Well, this statement arose by reason of the way I felt about it. I was convinced that certain individuals in the life insurance business had influenced the trend of this legislation because only people inside the business will know the details well enough to know how to frame such an abominable bill as that H.R. 4245.

Senator KERR. That is a conclusion which you have a perfect right to arrive at. But you made a statement here which I either want you to substantiate or let it stand exposed as having been a conclusion of the witness and not a statement of fact.

You said, "We were shocked to learn of the success of a few willful representatives." Are you willing to give this committee the names of the representatives you referred to here?

Mr. RAY. No, sir; you can let it stand as my opinion.

Senator KERR. This is your opinion, then?

Mr. RAY. Yes, sir.

Senator KERR. And not the statement of a fact that you are able to substantiate.

Mr. RAY. I could substantiate it to my satisfaction but maybe not to yours, Senator.

Senator KERR. Well, would you give me the knowledgeable facts that are the basis of satisfying you?

Mr. RAY. I could file that with the committee. I am not prepared to name it.

Senator KERR. You do not know them now?

Mr. RAY. No, sir.

Senator KERR. You are aware of the fact that H.R. 4245 comes to us as an enactment by the House of Representatives?

Mr. RAY. Yes, sir; I am also aware of the fact, if I may say so, that of the gentlemen sponsoring it on the floor of the House, I believe all except one stated, according to the Congressional Record, that he did not—did not understand the bill but he thought it was a good one.

Senator KERR. Are you telling us, then, that the House of Representatives did not know what they were dong when they passed the bill?

Mr. RAY. According to a good many of them; yes.

Senator KERR. I am not talking about according to them. I am talking about according to you.

Mr. RAY. I think so, yes; that is my opinion.

Senator KERR. That is what you think?

Mr. RAY. That is my opinion; yes, sir.

Senator KERR. You also say, "the most effective weapon yet devised by those who would intentionally or unwittingly strangle competition in the life insurance industry."

To whom do you refer there?

Mr. RAY. I referred to the ones that are sponsoring and promoting H.R. 4245. There are a good many life insurance companies that like it. There are some of the very largest that appear to like it.

Senator KERR. I am sure you are aware of the fact that this bill was not passed by any group of insurance companies.

Mr. RAY. Yes.

Senator KERR. Then do your phrases "would intentionally strangle or unwittingly strangle" refer to two different groups, or of more than one group? In which group does the House of Representatives come under? [Laughter.]

Mr. RAY. I would say unwittingly.

Senator KERR. Unwittingly?

Mr. RAY. Yes, sir.

Senator KERR. But just the tools in the hands of those who would intentionally do it?

Mr. RAY. I wouldn't describe them as that.

Senator KERR. Well, where—in other words, then, the only status you can give them is that of being witless.

Mr. RAY. Well, I didn't describe them as "witless," either.

Senator KERR. Well, now, is there a great difference in your mind between "witless" and "unwittingly"?

Mr. RAY. Well, there is a difference between being misled when their intentions were good.

Senator KERR. Well, now, if they have no wit, how could they have intentions? [Laughter.]

I have always heard that where there was no brain there was neither pain nor purpose.

Mr. RAY. Maybe I have made an unfortunate selection of words there.

Senator KERR. I am just trying to get into this record the identity either of the knaves or fools to whom you refer.

I take it that the knaves are the willful representatives of the giant mutuals, and the fools are the membership of the House of Representatives.

Mr. RAY. Well, I haven't referred to any fools, Senator. I had no intention of implying anything of that nature.

Senator KERR. Well, what does "unwittingly" mean? Let me have a dictionary.

The only word you are willing to apply, then, to the House of Representatives is "unwittingly," is that it?

Mr. RAY. That is the only word that is printed here that I would——

Senator KERR. Well, we will find out. [Laughter.]

The reasonable assumption being that you mean the only word that is printed here or the only word that is printable? [Laughter.]

Mr. RAY. I believe I gave you another word, "misled."

Senator KERR. You did give me another word.

I want to get into the record what "unwittingly" means. I think that is of some interest. It is to me.

Mr. RAY. To me it means without being fully conscious of the significance of what was being done.

Senator KERR. Well, then, a man, a fullwit or a halfwit could be conscious, couldn't he——

(Laughter.)

Senator KERR. But it is immaterial if they are unconscious.

It just happens that I have the highest regard for both the integrity of purpose and the ability of the House Ways and Means Committee of the House of Representatives.

Mr. RAY. So do we, Senator, but our Representatives didn't get any chance to vote on any kind of amendment.

Senator KERR. Who are your Representatives on the committee?

Mr. RAY. I came from Louisiana. I don't know whether they were any of those.

Senator KERR. You said your Representatives didn't get a chance to vote.

Mr. RAY. I am talking about no Representative from Louisiana or any other State had a chance in the House to offer an amendment to make any type of correction.

Senator KERR. Well, they had a chance in the committee, didn't they?

Mr. RAY. In the committee, if they could have gotten to that committee.

Senator KERR. A deal that you have to get to, is that it?

Senator WILLIAMS. Don't you have Hale Boggs on the committee, a Representative from Louisiana?

Mr. RAY. I believe so.

Senator KERR. "Unwittingly, not knowing, unconscious, unaware; adverb, unwittingly."

Does that about represent what you had in mind when you referred to the House of Representatives part in the transaction?

Mr. RAY. I would say so.

Senator KERR. I was quite interested in your conclusion that "capital would take flight." To where?

Mr. RAY. Most any other type of investment. It is a foregone conclusion in our American way, that wherever a promise of future returns is best, capital will be attracted to it. If economic conditions or the law become such that any industry will suffer, and so on the way out, capital will fly from it. That is my conclusion.

Senator KERR. But you don't have a destination other than just a general destination in mind?

Mr. RAY. That is right.

Senator KERR. You also say:

> * * * because in the last analysis there is no difference between their sources of income and no difference in their distribution of profits.

Does that mean that a stockholder in a stock company is in no different position with reference to the dividends he receives on his stock than is a policyholder in a mutual company with reference to the dividends or adjustments in costs which he receives?

Mr. RAY. No, sir; that is not what I meant.

What I meant was taking the entire group, policyholders and stockholders in the stock companies, taking them as a group, and taking the policyholders in the mutual companies as a group, if you single out an individual, you can get a warped idea of what happens.

Senator KERR. You say there is no difference in their distribution of profits. I take it that the distribution of profits is made by the company; that if you refer to the part played by the policyholder or the stockholder, it is one where it is a situation of receiving of profits.

You don't mean that a distribution of a dividend by mutual companies is identical in source or specifications to the distribution of dividends on stock by a stock company, do you?

Mr. RAY. No, sir. Many stock companies write participating insurance, as well as nonparticipating.

Senator KERR. Now, you say:

One may also well argue for tax of bank deposits as to call for income tax on such insurance deposits.

Do not the banks pay a tax on the profits they make from the deposits they have?

Mr. RAY. Yes, sir; and that is what we are arguing for here. Insurance companies should pay the same kind of tax on the income that we get earned from the deposits of the public in buying insurance from our companies. That is the proper and the only proper source of tax.

Senator KERR. Well, you say, "One may as well argue for tax of bank deposits."

Mr. RAY. That is right. If you are going to argue for tax of insurance premiums that come in, you might as well argue for tax of the deposits that you make to your checking account in the bank.

Senator KERR. Well, if the bank's profit consisted of a percentage of the deposits made, would that not be a profit to the bank?

Mr. RAY. In a sense it does consist of a percentage of those, but that percentage is of earned interest rate.

Senator KERR. I thought it was a percentage on the deposits, not a percentage of the deposits.

Mr. RAY. It is a percentage on the deposits.

Now, what was your question?

SENATOR KERR. You said, "One may as well argue for tax of bank deposits."

Mr. RAY. If you are going to argue for tax of the premium deposits, I say it is just as reasonable——

Senator KERR. Now, is the position of the bank that reserve deposits identical with reference to those deposits——

Mr. RAY. No, sir.

Senator KERR. As is the insurance company with reference to the receipt of premiums?

Mr. RAY. They are very comparable. If they were identical they would have to have a license as an insurance company.

Senator KERR. Very comparable? I thought one was the creation of a trust and bringing about the status of a custodian and a depository and the other was in the posture of receiving a compensation for a service rendered and a commitment made.

Mr. RAY. That commitment made includes the accumulation of the face amount of that policy to pay as an old age endowment, and so forth.

Senator KERR. I thought that the commitment made was in accordance with the terms of a contract which was an agreement to pay a certain amount in case of certain eventuality.

Mr. RAY. It is.

Senator BENNETT. Will the Senator yield at this point for an idea in the same field?

Senator KERR. I must say it would be operating in a vacuum and I would welcome it. [Laughter.]

Senator BENNETT. Many banks make charges for services connected with deposits. They make profits on service charges for the handling of checks and other things.

Does the witness not feel if the bank makes a profit on that service, it should pay an income tax on it?

Mr. RAY. I had not considered that sufficiently, Senator, to discuss that point. I thought that the bankers claimed that they never collect enough service charges to cover the cost of operating; that they always have to take a portion of the income.

I am not a banker, but I couldn't talk successfully on that point.

Senator BENNETT. If they did not collect any service charges presumably they would have a substantial loss. So that the collection of service charges adds to their profit, if they have a profit.

Now it seems to me the insurance companies pay a fee to their agents for securing that business, and if they pay their agents less than it actually costs to secure the business, do they not make a profit on their dealings with their agent?

Mr. RAY. I would like to see that kind of a company. I have never seen one that did that yet.

Senator KERR. You have never seen a company that makes a profit?

Mr. RAY. It always costs us more to get the business on our books than the premiums they take in during the first year.

Senator BENNETT. I did not say the first year. You are arguing here about underwriting profits. You say they should not be taxed under any circumstances.

Mr. RAY. My reason for saying that, Senator, is that in my opinion the underwriting profit should be accrued as additional surplus for protection of these policyholders. That is done in the mutual company and the stock company should be permitted to do the same thing, and the only proper source of dividends to the stockholders of a stock company would be investment income.

Senator BENNETT. The insurance company does not always keep those underwriting profits for the benefit of its policyholders. Can they not make any contribution to the dividends that they pay to their stockholders?

Mr. RAY. Some specialty companies do.

Senator BENNETT. Then you want to tell us that no regular life insurance companies make any underwriting profits?

Mr. RAY. No, I did not say that.

It depends on your definition of profit there. We gain back some of the surplus that we put out in the first policy year.

It must be gained back in later years from underwriting profits if we are ever to stay in business, and continue to write business.

It is a proper source to regain our first year loss. So many policies lapse while we still have a loss on the books.

Senator BENNETT. But apparently over all the years you regain more than your first year loss because you have profits left over to pay to your stockholders?

Mr. RAY. That is mere rent on the money we are using. The stockholders have deposited money with us to protect policyholders, and they are the first to lose. If debt claims became excessive, the stockholders will lose their investment. All of the stockholders' money is there to protect the policyholder.

Now the company is due to pay a rent for that money that the stockholders put in there and it looks like some think that whenever we do pay our rent and do not get too far behind in the rent that we have done something wrong.

Senator BENNETT. Is there any difference in the rent that is paid for the use of stockholders' money in an insurance company and in a manufacturing company?

Mr. RAY. None that I know of.

Senator BENNETT. And we tax manufacturing companies at 52 percent of their profits before we allow them to pay any rent to their stockholders.

That is all I wanted to say.

Senator KERR. I appreciate the contribution that the Senator has made, and can only remark that he has dramatized the amazing statement or premise of the witness which he apparently seriously takes to the effect that a bank deposit owned by a depositor and handled as a trust by the bank, is identical in character with a premium paid by the policyholder to a stock company as a charge for a service rendered, a contract entered into, a commitment made and honored.

I am sure, in my own mind, that if the witness is serious in his position, that he is in the identical condition as he indicated he thought the House of Representatives was when they passed this bill.

[Laughter.]

Senator KERR. That is all, Mr. Chairman.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Ray, in your statement you state:

> We respectfully urge that H.R. 4245 be killed and that the substitute proposals of the National Association of Life Companies be adopted.

Now, what are your proposals?

Mr. RAY. Well——

Senator WILLIAMS. How would you tax them?

Mr. RAY. This substitute deals with the taxation of life insurance companies for the years subsequent to 1957. Under the proposed substitute the 1942 formula would be permanently eliminated and the current stopgap measure or Mills law would be made permanent with two modifications.

The first of these modifications would be to institute an overall decrease in the deduction provided against net investment income.

Under the present law insurance companies are allowed to deduct 87.5 percent of the first $1 million of investment income, and 85 percent of the remainder.

Under the proposed new formula a deduction of 90 percent would be provided against the first $250,000, and 81 percent the next $750,000, and 78 percent against all investment income over $1 million.

This new formula contains a slight additional break for small companies by increasing the deduction rate on the first $250,000 of investment income.

However, on all amounts of investment income above $250,000 the deduction rate is substantially decreased and the yield of the proposed bill would be $172 million greater than under the law in effect in 1957.

Senator WILLIAMS. You said it would be "substantially." What would it be, 1 percent, 5, 10, 20, or what? What is the definition?

Mr. RAY. I didn't compute the increase; $172 million compared to ——

Senator WILLIAMS. I mean what rate?

Mr. RAY. What percent would obtain there?

Senator WILLIAMS. Yes; when you said it would be substantially reduced, now what is the word "substantially"? What does it mean?

Mr. RAY. Senator, at which part, what question are you asking? I don't understand you, Senator.

Senator WILLIAMS. You just read the statement there and you said that the enactment of your proposal would reduce substantially — you used the word "substantially" and I wanted to know what you mean by "substantially" to be a little more accurate. What do you mean by it? How much does it amount to?

Mr. RAY. Are you speaking of this sentence:

> However, on all amounts of investment income above $250,000 the deduction rate is substantially decreased.

Senator WILLIAMS. Yes, sir.

Mr. RAY. Well, that is the percentages that I just read.

In place of 85 percent a company could deduct only 78 percent, and the difference would be fully taxable. At the present time the law assumes that it requires 85 percent of this investment income to maintain the reserves or to carry out the contract with the policyholder. This would reduce that percentage to 78 percent for all of those amounts above this $250,000.

Does that answer your question, Senator?

Senator WILLIAMS. Yes.

Mr. RAY. The second modification to the Mills law suggested is that the tax on specialty company income—one of the defects in the present Mills formula is that certain specialty companies, primarily those virtually exclusively engaged in the writing of credit life insurance, has little investment income but substantial and easily ascertainable underwriting profits.

The present formula misses this income almost completely.

Accordingly, it is proposed that a new category of income be established, namely, specialty company income.

A specialty company would be defined as a company whose net gains from operations after dividends to policyholders exceed three times its investment income and nonlife insurance income.

In the case of such a company, 25 percent of such excess would be considered as specialty company income and subject to tax at the regular corporate rates.

Net gains from operations is defined as that figure set out in the annual report of life insurance companies as net gain from operations after dividends to policyholders.

This is a standard widely recognized figure which is computed in the same manner by all companies on a form approved by the National Association of Life Insurance Commissioners.

An earlier Treasury Department recommendation in this area was based on using the same figure to determine total income on all life insurance companies.

Does that answer your question, Senator?

Senator WILLIAMS. Yes, but now I would like for you to clarify it.

You broke that down in different brackets. At what rate would you tax the first $250,000? Don't read all that over again. Just simple percentages, what rate would you tax the first $250,000?

Mr. RAY. Ten percent. There would be a deduction of 90 percent.

Senator WILLIAMS. That would be 10 percent?

Mr. RAY. Yes.

Senator WILLIAMS. And the next $250,000 you would tax at what rate?

Mr. RAY. Eighty-four percent would be deducted; that would be 16 percent.

Senator WILLIAMS. Repeat that answer again.

Mr. RAY. There would be an 84-percent deduction, leaving 16 percent to be the tax rate on that.

Senator WILLIAMS. Mr. McClatchey, who was testifying before the committee representing your same company on March 4, said that that rate would be taxed at 15 percent. Now, which of you is correct? That is 15 percent of the next $1 million would be taxed.

Mr. RAY. We changed that. We changed that in the form filed with the committee.

Senator WILLIAMS. You have changed that since his testimony?

Mr. RAY. Yes, sir; since his testimony.

Senator WILLIAMS. That was an unwitting error; is that correct? [Laughter.]

Mr. RAY. The change was an afterthought; I would rather put it that way.

Senator WILLIAMS. Well, I just have one more question:

You say:

> Such small elements—

referring to the change in the bill—

> can easily be taken and is taken care of in the substitute proposal by a simple addition to the basic law under which we are all taxed alike in 1957.

What is that just simple addition, just in layman's language? Just explain it; don't read it.

Mr. RAY. It is difficult to get this down in layman's language. There are plenty of people in the business that don't understand it.

Senator WILLIAMS. Well, do you understand it well enough to explain it without reading that paper, because that is the only way I can understand it. I just wonder about that simple addition, because you said it was a very simple thing because it is a change you are recommending, and how it affects——

Mr. RAY. After taking the figure from the annual statement showing the gain from operations, that that exceeds—I would rather file a statement, if I may, on that and put it in the record, Senator. I believe I can make it clearer if I am given time to word that and put it in the record, if I may.

Senator WILLIAMS. Well, yes; if you don't know the answer, that is all right. I hope you are not in the same position as the Members of the House were in that you don't understand your proposal, because we in the committee are.

Mr. RAY. There is a difference in the effect.

Senator WILLIAMS. That is all right; you can file a statement on that if you wish.

You represent a couple of companies, you mentioned here, in Louisiana.

Mr. RAY. Yes, sir.

Senator WILLIAMS. If you don't want to answer this question at this time, it is all right, but I wish you would answer it now or file it with the committee.

The amount of tax these companies paid under the 1957 law, the amount of your investment income or the amount of your underwriting gains or profit, as you describe them, and the amount of tax you would pay if there is no action taken and the 1942 law stays on the books, or the amount that would be paid under H.R. 4245.

Mr. RAY. I can answer part of that, but I can't remember what whole set of figures.

The Guaranty Income Life Insurance Co. had $26,000 and some hundreds of net income subject to tax. That was the net taxable income, and paid $8,420.90 in income taxes.

Under the 1942 formula, which we would very much prefer to this H.R. 4245, our tax would have been, I believe I have the figure here, $14,987, a 78 percent increase. But we would rather have that than to have this other bill.

Senator WILLIAMS. What would your tax be under this other bill?

Mr. RAY. Under this bill?

Senator WILLIAMS. Yes, H.R. 4245.

Mr. RAY. I have had three tax experts try to help work it out. No two of them arrived at figures that were similar and I just wouldn't know, but it looks like it could run anywhere from three to eight times.

Senator WILLIAMS. What would it be—excuse me.

Senator BENNETT. If you had a $26,000 income, 8 times $8,000 is $64,000.

Do you want to tell us that you are going to pay $64,000 taxes on a $26,000 income?

Mr. RAY. Senator, I didn't refer to—I am sorry, it is my error. I didn't refer to the 1957. I was asked about our 1957 tax paid. I was talking about what we would have paid on 1958 income.

Senator WILLIAMS. I want the years comparable. My question would be, don't jump from one year to the others.

Mr. RAY. I didn't apply and haven't tried to compute on 1957 business the tax under this new proposed act.

Senator WILLIAMS. What would the tax be on either your 1957 or 1958 income under your proposed formula after you get that simple recommendation which we don't either understand at this time but include, what would your tax be?

Mr. RAY. Well, incidentally, my company would not have that deduction; it is not in that class.

Senator WILLIAMS. I see. But what would it be?

Mr. RAY. The tax would be substantially more than we paid in 1957; but slightly under what it would be under the 1942 formula, which was $14,000 and something.

Senator WILLIAMS. Well, we are back again to the words "substantial" and "slightly under," and would you furnish the exact figures for the committee?

Mr. RAY. I don't have them.

Senator WILLIAMS. I realize that, and I asked the question with that thought in mind.

Mr. RAY. Yes, sir.

Senator WILLIAMS. Would you furnish the figures to the committee both for 1957 and 1958 as near as you can on each of the two companies you represent?

Mr. RAY. Yes, sir.

Senator WILLIAMS. Comparison.

Mr. RAY. Yes, sir.

Senator WILLIAMS. That is all.

(The following information was subsequently submitted by Mr. Ray in response to the question by Senator Williams:)

Guaranty Income Life Insurance Co. paid $8,420 taxes on 1957 operations. Would have paid $20,211 under 1942 formula. Would have paid $33,863 under my interpretation of H.R. 4245. Would have paid $16,304 under substitute recommended by National Association of Life Companies.

The CHAIRMAN. Senator Frear.

Senator FREAR. Just one question: Do you think that the insurance companies as a whole should be taxed by the Federal Government on a similar basis with that of any other industry, after reasonable allowance has been made for reserves to policyholders?

Mr. RAY. I don't think that you can call it similar. The business is so dissimilar from any other industry.

Senator FREAR. Well, then, your answer is "No"?

Mr. RAY. Yes, sir.

Senator FREAR. Thank you.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. I don't think I have any more questions.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. I see you state that you represent the Continental Service Life & Health Insurance Co., and the Guaranty Income Life Insurance Co.

I have a copy of Best's Insurance Report for 1958. Where would I look in that for these companies?

Mr. RAY. Look under the name Guaranty Life.

Senator ANDERSON. Would you like to look with me and see if you can find it?

Mr. RAY. Yes.

Senator ANDERSON. I found the Guaranty Mutual, but I can't seem to find your company there in the first part. Could you help me?

Mr. RAY. Yes; your pages were just stuck together, Senator. It is on page 733.

Senator ANDERSON. 733. What type of life insurance do you write, all types of it?

Mr. RAY. Ordinary, both participating and non-participating; no other type, no health and accident.

Senator ANDERSON. Do you feel that there might be a flight of capital away from this industry if this bill is passed?

Mr. RAY. Yes, Senator, and I might say that we are trying to raise additional capital right now, and we are offering to our present stockholders additional stock, and notices are already in the mail, and we are going to have a great difficulty in getting them to put their money in the business to help us grow, build it like we should, if a tax measure such as this should be passed.

Senator ANDERSON. Well, I repeated some figure here on it the other day on the information of a number of companies; the State of Arizona had three companies in 1950 and has 81 today.

Would you think there has been quite a flight of capital into the life insurance business?

Mr. RAY. Yes, due to the fact this bill was not in effect.

Senator ANDERSON. Then there was a tax advantage that made it attractive, was there not?

Mr. RAY. Not necessarily tax advantage, but good business.

Senator ANDERSON. You don't think they got in because this was a flourishing field for a short time?

Mr. RAY. No, sir.

Senator BENNETT. Would the Senator yield?

Senator ANDERSON. Yes, sir.

Senator BENNETT. I hesitated a minute or two ago to raise this question, but since the Senator has raised it, would you be interested to know within the period of time we have been studying this bill I have been approached by a man for an underwriting company that is underwriting a new company, telling me this was the last remaining tax shelter in the United States, and urging that as my reason for purchasing his stock.

Senator ANDERSON. A good many people have faced this situation.

Mr. RAY. I think that is only a myth.

Senator ANDERSON. You think it is only a myth? Well, I was looking at capital paid in.

Senator KERR. Would the Senator yield there?

Senator ANDERSON. Certainly.

Senator KERR. He said it was only a myth. Is a myth something that was and ain't, or something that never was? [Laughter.]

Senator ANDERSON. That question, I take it, is addressed to the witness.

Senator KERR. What is a myth? Is that a mental reaction of the unwitting? I mean, you know, a myth—well, I thank the Senator. I didn't get very far.

Senator ANDERSON. Well, I was looking at a company organized half a century ago, I admit, in the State of the able Senator from Tennessee, with a total amount that was paid into it of $65,500. They have paid cash dividends through 1957 of $23,365,000. They have paid stock dividends of $24,934,000. They still have a capital of $25 million, even though they only paid in $65,000, and they have got a surplus of $75 million.

Would you say that was reasonably good rent?

Mr. RAY. Yes.

Senator ANDERSON. That is the kind of rent you want remaining in this business.

Mr. RAY. That is a special type of operation, though.

Senator GORE. Wait a minute——

Senator ANDERSON. You are in for trouble if you take the Senator from Tennessee on.

Senator GORE. This company does not agree with all my views, but we are in thorough agreement it is not a speciality company.

Mr. RAY. I apologize, Senator.

Senator ANDERSON. Well, to go back to this Arizona situation. Do you think from 3 companies to 81 companies in 10 years in a State as small as Arizona financially, is just normal, natural growth in a business?

Mr. RAY. I think it is very unreasonable.

Senator ANDERSON. Well, you then are quite critical of the House of Representatives. I didn't quite get the statement you made to the Senator from Oklahoma about Members getting on the floor and saying they didn't understand the bill. Did I understand you to say that sponsors of the legislation said that?

Mr. RAY. Those who were favoring it, promoting it; yes.

Senator ANDERSON. Sponsoring it. Did that include the able Congressman from Arkansas, Mr. Mills?

Mr. RAY. No, Mr. Mills, I believe, was the only one who said he understood it.

Senator ANDERSON. I am happy to have you say that, because I served with Mr. Mills on the Ways and Means Committee. My impression of him was that he would likely understand anything that he sponsored.

Mr. RAY. I think so.

Senator ANDERSON. Well, then, only Mr. Mills. No Republicans on the committee that you can think of? [Laughter.]

You see, we Democrats get accused of being wasteful spenders and lavish with money, and I just wonder if there were any good, sound, financial minds on the Republican side of it.

Mr. RAY. Apparently none of them understood the measure.

Senator ANDERSON. I am glad to have that contribution. You will find out there are probably some Republicans here that understand it, and I would assume that took place in the House.

You answered Senator Kerr about the success of these few representatives of the giant mutuals, you didn't name any of those giant mutuals. You represent a hundred and some companies. Have you furnished us a list of those 120 member companies?

Mr. RAY. We can file it.

Senator ANDERSON. Would you do that?

Mr. RAY. Yes, I would be glad to.

(The information referred to follows:)

MEMBERS OF THE NATIONAL ASSOCIATION OF LIFE COMPANIES, AS OF JANUARY 1, 1959

Acme Life Insurance Co., Springfield, Ill.
Acme National Life Assurance Co., Shreveport, La.
Alaska Western Life Insurance Co., Anchorage, Alaska.
American Buyers Insurance Co., Phoenix, Ariz.

American Capitol Insurance Co., Houston, Tex.
American Home Life Co., Spencer, Iowa.
American Insurors General Insurance Co., Laurel, Miss.
American Foundation Life Insurance Co., Little Rock, Ark.
American Life Savings Insurance Co., Miami, Fla.
American Security Life Insurance Co., Fort Wayne, Ind.
American Standard Life Insurance Co., Fort Worth, Tex.
American Travelers Life Insurance Co., Indianapolis, Ind.
American Trust Life Insurance Co., Wichita Falls, Tex.
Atlantic National Life Insurance Co., Montgomery, Ala.
Bankers Fidelity Life Insurance Co., Atlanta, Ga.
Bankers Service Life Insurance Co., Oklahoma City, Okla.
Beacon Life Insurance Co., Oklahoma City, Okla.
Capitol Co-operative Life Insurance Co., Denver, Colo.
Capitol National Life Insurance Co., Houston, Tex.
Cardinal Life Insurance Co., Louisville, Ky.
Charter Oak Life Insurance Co., Phoenix, Ariz.
Citizens National Life Insurance Co., Indianapolis, Ind.
Citizens Standard Life Insurance Co., Corpus Christi, Tex.
Coastal States Life Insurance Co., Atlanta, Ga.
Commercial Travelers Life & Accident, Dallas, Tex.
Continental Service Life & Health, Baton Rouge, La.
Cotton States Life Insurance Co., Tuscaloosa, Ala.
Crown National Life Insurance Co., Indianapolis, Ind.
Dixie Life Insurance Co., Little Rock, Ark.
Early American Insurance Co., Atlanta, Ga.
Empire Life of America, Little Rock, Ark.
Estate Life Insurance Co., Amarillo, Tex.
Farmers National Life of Georgia, Atlanta, Ga.
Farm & Ranch Life Insurance Co., Houston, Tex.
Federal Old Line Insurance Co., Federal Way, Wash.
Fidelity Reserve Insurance Co., Little Rock, Ark.
Fidelity Standard Life Insurance Co., Baton Rouge, La.
Fireside Commercial Life Insurance Co., Alexandria, La.
First National Life Insurance Co., Atlanta, Ga.
First National Life Insurance Co., Phoenix, Ariz.
First Pyramid Life of America, Little Rock, Ark.
First United Life Insurance Co., Gary, Ind.
Freedom Life Insurance Co., Greenville, S.C.
General Life of Arkansas, Little Rock, Ark.
Georgia Life & Health Insurance Co., Atlanta, Ga.
Girardian Insurance Co., Dallas, Tex.
Golden Rule Life Insurance Co., Lawrenceville, Ill.
Great Commonwealth Life Insurance Co., Dallas, Tex.
Great Plains Life of Wyoming, Casper, Wyo.
Great Southwest Life Insurance Co., Phoenix, Ariz.
Great Western Life Insurance Co., Oklahoma City, Okla.
Guaranty Income Life Insurance Co., Baton Rouge, La.
Guaranty Savings Life Insurance Co., Montgomery, Ala.
Gulf Union Life Insurance Co., Baton Rouge, La.
Hamilton National Life Insurance Co., Indianapolis, Ind.
Harrison National Life Insurance Co., Indianapolis, Ind.
Home Trust Life Insurance Co., Montgomery, Ala.
Illinois Mid-Continent Life, Chicago, Ill.
Illinois Security Life Insurance Co., Sterling, Ill.
Independent Life Insurance Co., North Little Rock, Ark.
Intercoast Mutual Life Insurance Co., Sacramento, Calif.
International Fidelity Insurance Co., Dallas, Tex.
International Life Insurance Co., Austin, Tex.
Life Insurance Co. of Alabama, Gadsden, Ala.
Liberty Life & Casualty Co., Goodland, Kans.
Lee National Life Insurance Co., Shreveport, La.
Life Insurance Co. of Alaska, Anchorage, Alaska.
Life Insurance Co. of Kentucky, Louisville, Ky.
Life Insurance Co. of South Carolina, Columbia, S.C.
Mid American Life Insurance Co., Houston, Tex.
Mid-Continent Insurance Co., Shreveport, La.

Mid-Continent Life Insurance Co., Fort Worth, Tex.
Mid-Western Life Insurance Co., Enid, Okla.
Mountain States Life Insurance Co., Colorado Springs, Colo.
National American Life Insurance Co., Baton Rouge, La.
National Bankers Life Insurance Co., Dallas, Tex.
National College & University Life, Atlanta, Ga.
National Educators Life Insurance Co., Fort Worth, Tex.
National Investors Life Insurance Co., Little Rock, Ark.
National Life & Casualty Insurance Co., Phoenix, Ariz.
National Old Line Insurance Co., Little Rock, Ark.
National Security Life & Accident, Dallas, Tex.
National Security Life Insurance Co., Indianapolis, Ind.
New Mexico Life Insurance Co., Albuquerque, N. Mex.
Oil Industries Life Insurance Co., Houston, Tex.
Old Equity Life Insurance Co., Evanston, Ill.
Permian Basin Life Insurance Co., Odessa, Tex.
Perpetual Life Insurance Co., Denver, Colo.
Pioneer Life & Casualty Co., Gadsden, Ala.
Preferred Life Insurance Co., Dallas, Tex.
Professional & Business Mens Life, Denver, Colo.
Reliance Life Insurance Co. of Georgia, Atlanta, Ga.
Security National Life Insurance Co., St. Louis, Mo.
Security Savings Life Insurance Co., Montgomery, Ala.
The Service Life Insurance Co., Fort Worth, Tex.
Southeastern Life Insurance Co., Hattiesburg, Miss.
Southern Christian Life Insurance Co., Oklahoma City, Okla.
Southern United Life Insurance Co., Montgomery, Ala.
South Atlantic Life Insurance Co., Tampa, Fla.
Southern Colonial Life Insurance Co., Columbia, S.C.
Southern Equitable Life Insurance Co., Little Rock, Ark.
Southwest American Life Insurance Co., Houston, Tex.
Southwest Union Life Insurance Co., Dallas, Tex.
Standard Union Life Insurance Co., Montgomery, Ala.
State Life of South Carolina, Columbia, S.C.
State Mutual Insurance Co., Rome, Ga.
Tennessee Life & Service Insurance Co., Knoxville, Tenn.
Tennessee Valley Life Insurance Co., Jackson, Tenn.
Tidelands Life Insurance Co., Bunkie, La.
TranSouth Life Insurance Co., Columbia, S.C.
Treasure State Life Insurance Co., Butte, Mont.
Union Bankers Insurance Co., Dallas, Tex.
Union National Life Insurance Co., Atlanta, Ga.
United Bankers Life Insurance Co., Dallas, Tex.
United Federal Life Insurance Co., Houston, Tex.
United Founders Life Insurance Co., Oklahoma City, Okla.
United Security Life Insurance Co., Birmingham, Ala.
Universal Life & Accident Insurance Co., Bloomington, Ind.
Wabash Life Insurance Co., Indianapolis, Ind.
Washington Life of America, Lafayette, La.
Washington Standard Life Insurance Co., Little Rock, Ark.
Western Bankers Life Insurance Co., Dallas, Tex.
Western Fidelity Life Insurance Co., Fort Worth, Tex.
Western Mutual Life Insurance Co., Moline, Ill.
Western Security Life Insurance Co., Oklahoma City, Okla.
Western & Southern Life Insurance Co., Cincinnati, Ohio.

Senator ANDERSON. Do you have in mind any of the giant mutuals that had these representatives that helped the Ways and Means Committee write this bill?

Mr. RAY. I couldn't name them. I can't name the gentlemen, but——

Senator ANDERSON. Do you believe that this committee will probably write its own bill without any help from the giant mutuals or small companies when it gets to it?

Mr. RAY. I hope you won't. I hope you listen to the advice as a whole.

Senator ANDERSON. You hope we will not use independent judgment?

Mr. RAY. Yes, I hope you use independent judgment; but at the same time listen to the entire industry. I think in our American way every branch of the industry has a right to be heard and should be heard, and not be just ignored.

Senator ANDERSON. The only thing that worries me is your lack of faith in what the House of Representatives did and what the Ways and Means Committee did. Having served with Seantor Gore in the House of Representatives, some of us have a reasonably high respect for it. The Ways and Means Committee is, I think, a highly respected committee in the Congress, not only just in the House of Represnetatives, but highly respected in the Congress. I am disappointed that you feel they didn't understand the bill when they got through with it.

Mr. RAY. I am taking their own words in the Congressional Record, Senator. They stated in that——

Senator KERR. Why don't we put those statements in the record?

Senator ANDERSON. I wish you would give me some of them. Can you recite what they said?

Senator KERR. And who said it?

Mr. RAY. I can file a copy of that Record here for you.

Senator ANDERSON. Do you have in mind anybody who made this sort of statement?

Mr. RAY. I can't recall their names; I don't know the gentlemen personally.

Senator ANDERSON. Did you, yourself, read the Congressional Record where they said they had no knowledge of what was in the bill and yet they were sponsors of it?

Mr. RAY. Quite a part of it. My counsel helped me read it; it is too long.

Senator ANDERSON. You recognize that in the House of Representatives only one man can sponsor a bill. They do not have the same flexible rule that the Senate has where a dozen men can join. So the sponsor of the bill was just one man, Wilbur Mills.

Mr. RAY. I didn't understand that, Senator. I don't know the rules of the House.

Senator ANDERSON. Well, you must have read the record. You said these men were the sponsors of it.

Mr. RAY. Well, they were attempting to speak for it; is what I had in mind.

Senator ANDERSON. Attempting to support it?

Mr. RAY. They were supporting the measure.

Senator ANDERSON. I see.

Mr. RAY. Now, whether that means sponsoring it, well, maybe I am wrong.

Senator ANDERSON. I don't want to go into details, but I will just say to you that for somebody who has been over there for just a short time, I think pretty highly of the Ways and Means Committee of the House. I don't always agree with it and it doesn't always agree with me, but it is a pretty good group of folks. And I can't believe that they would pass a piece of legislation that was going to destroy all the stock companies, and allow only a few giant mutuals to take over the field.

Mr. RAY. Like I have said in this, I don't think it was their intention to do that, but I believe the product they turned out will have that result.

Senator ANDERSON. Well, let me predict that I do not believe it will. After some years have passed, I hope you check up on it. Many groups have said this or that will destroy us, and yet they have survived.

You speak in your statement about the great increase in taxation. How much is involved in this bill over the existing law?

Mr. RAY. I have seen it estimated anywhere from 75 to 105 percent on the industry.

Senator WILLIAMS. Would you yield for a moment?

Senator ANDERSON. Yes.

Senator WILLIAMS. Over the existing law? Is that over the existing law?

Mr. RAY. That is over the 1957 formula.

Senator WILLIAMS. What is the comparison under the existing law?

Nineteen hundred and forty-two is what we revert to, because the stopgap legislation is not in effect.

If I understand, the Senator's question was, How does it compare with the existing law?

Senator ANDERSON. In your statement, you say, "It imposes a tremendous and sudden tax increase on the industry as a whole."

Now, the law of the land, is going to bring in about $500 million, and this bill will bring in about $540 million or so. Is that your idea of a tremendous and sudden tax increase on the industry as a whole?

Mr. RAY. No, sir. The increase I am talking about——

Senator ANDERSON. What does your statement mean?

Mr. RAY. My statement means that compared to what the companies made in 1958, the amount they would have to pay in 1959 would run from 75 to 105 percent increase.

Senator ANDERSON. Well, I know, but you recognize there were some of us who believed they didn't pay enough the last time. We thought that there was a sudden and tremendous reduction in their taxes last year, and the Lord giveth and the Lord taketh away. Blessed be the name of the Lord.

They went way down one year and they are going to come way up next year. Don't you think that is an equalizing process?

Mr. RAY. I don't know of any company that had a decrease this last year.

Senator ANDERSON. Well, I pointed out that some one company got a $20 million decrease last year. Is that a sudden and tremendous decrease? Did you protest about that?

Mr. RAY. I don't know of that, Senator. I am not familiar with that.

Senator ANDERSON. Since you worship without knowing, one company last year got a reduction from $64,031,000 of taxes to where it paid $44,743,000 taxes.

Did you regard that as a tremendous and sudden tax increase?

Mr. RAY. I would, and Senator, I will tell you this——

Senator ANDERSON. Did you protest it since you would, or did you support that?

Mr. RAY. I haven't had a chance. This is my chance to hear about it.

Senator ANDERSON. Did you support the tax legislation last year that brought about this sudden and tremendous decrease?

Mr. RAY. No, sir.

Senator ANDERSON. You did not support the Mills bill last year that was stopgap legislation?

Mr. RAY. I didn't take any part in it.

Senator ANDERSON. You were happy about it, were you not?

Mr. RAY. So far my company is concerned; yes, sir.

Senator ANDERSON. And as long as it got the benefit of the tax reduction, you thought it was all right?

Mr. RAY. I am not objecting to an increase in taxes now. But I am just telling you that we think we should have a fair spread of that tax over all the industry, and not directed toward the stock companies.

Senator ANDERSON. That is what I am getting at. You think the bill this time puts it directly on the stock companies and does not spread it over the industry.

Mr. RAY. It reduces the tax for the major mutuals and increases it greatly for the stock companies.

Senator ANDERSON. I am trying to find out, if you think it is a fair spread on the industry?

Mr. RAY. No, sir; it is not.

Senator ANDERSON. Can you pick out companies that you think are unjustly treated?

Mr. RAY. Senator, and furthermore you are speaking of a decrease there that some company had last year. You will find in the future many such decreases because this bill lets the mutual companies so manage their affairs that it can determine in advance very largely what level of tax it will pay.

Senator ANDERSON. Is the New York Life a mutual company?

Mr. RAY. Yes, sir.

Senator ANDERSON. It would pay under the 1942 tax, $25 million; on its 1957 business, and under this bill, it would pay $29 million. I am not trying to tell the New York Life what it is going to pay, but that is the best calculation I have been able to get.

Do you regard that as a sweeping reduction to the New York Life Insurance Co.?

Mr. RAY. It is a very modest increase compared to what the increase would be to my company and many others. Again there are provisions in that act that would let them greatly reduce it by the way they manage their affairs from here on in.

Senator ANDERSON. The fact that a man could, if he wanted to, change the way he does business in order to escape taxation is not necessarily confined to the life insurance industry, is it?

Mr. RAY. No.

Senator ANDERSON. I wonder if you think these companies that have built the sort of reputations they have built, like the New York Life, Penn Mutual, Metropolitan, and others, are going to suddenly change their whole way of living just to get a chance to save a few dollars. Haven't they been able to do that previously?

Mr. RAY. Not under the present law to the extent they would be under this new one.

Senator ANDERSON. For instance, what gives them that advantage in the new bill?

Mr. RAY. They can use the industrywide interest, reserve interest rate in place of their own.

Senator ANDERSON. Can't you do that, can't a stock company do that?

Mr. RAY. A stock company can do that; a stock company is already up at that high level. There is no benefit there. But that benefit is very definite to the mutuals. May I give you an illustration, Senator?

Senator ANDERSON. Yes.

Mr. RAY. Assume that the corporation earns 4 percent on its invested assets, that it is paying 2 percent like the New York Life does that you mentioned on the reserve funds. But the industrywide rate of interest would be 3 percent. That leaves 25 percent, that is 1 percent on their investment income tax free.

No other branch of the industry gets that. The stock companies have no chance at that kind of thing. That is giving them a complete exemption of tax in that illustration which would give an exemption of 25 percent of their investment income tax free.

Senator ANDERSON. Well, now, your company has only $500,000 invested. Did it have $91,000 in net operating gain last year?

Mr. RAY. I didn't understand you, Senator.

Senator ANDERSON. Did it have $91,000 of operating gain last year?

Mr. RAY. Look at the investment, the gain from investment took up practically all of it. We got back a small portion that had been previously paid out to acquire business.

Senator ANDERSON. Well, you increased your surplus $90,000, did you not?

Mr. RAY. We put $98,000 to dividends to policyholders, Senator.

Senator ANDERSON. Well, you say dividends to stockholders $40,800.

Mr. RAY. Yes, sir.

Senator ANDERSON. Increase of surplus from $90,000, on $500,000 investment.

Mr. RAY. Not on a $500,000 investment, sir.

Senator ANDERSON. What is the capital of the company——

Senator WILLIAMS. Would the Senator yield at that point?

Senator ANDERSON. Yes.

Senator WILLIAMS. Did I understand you to say that there was, the book showed he paid $40,000 in dividends to stockholders last year?

Senator ANDERSON. Yes.

Mr. RAY. We paid 8 percent on the par value of the stock. The stockholder paid almost double that.

Senator WILLIAMS. In answer to one of my questions you answered you only made $26,000 profit. How did you pay $46,000 dividend if you only made $26,000 profit?

Mr. RAY. That was the net taxable income from investments.

Senator WILLIAMS. Well, what is the difference in the profit and your net taxable income? Now, you told me that you only had $26,000 profit last year, and——

Mr. RAY. I said net taxable income, Senator.

Senator ANDERSON. There is a substantial amount of income that you have not been putting in the taxable status, is that correct?

Mr. RAY. The recovery on first-year losses is not put in there, that is right.

Senator ANDERSON. How do you refund to your stockholders a recovery on the first-year losses, is that the $40,000? Is that refunded to your stockholders?

Mr. RAY. That is the dividend to stockholders, is rent on the money we are using of theirs and we write participating insurance, and that again from operation covers the loading in the premium which goes to the policyholders.

Senator ANDERSON. Forget all about where it comes from. But what does the rent, I mean, the dividend to the stockholders represent? It is a part of your profits, a distribution of part of your profits, isn't it, or are you distributing part of your capital assets and liquidating your company?

Mr. RAY. It is part of the gain from investment income.

Senator ANDERSON. It is a part of your gains?

Mr. RAY. It is part of the gain from investment income.

Senator ANDERSON. What is the difference between gains and profits?

Mr. RAY. Well, it is profit from investment income.

Senator ANDERSON. All right, it is a part of your profits from investment income.

Mr. RAY. That is right.

Senator ANDERSON. Then you distributed $40,000 to your stockholders as part of the profit from your investment income?

Mr. RAY. That is right.

Senator ANDERSON. Reconcile that with your statement to me before when you said you only made $26,000.

Mr. RAY. Senator, I don't have my tax return here.

Senator ANDERSON. I am not asking for your tax return.

Mr. RAY. Maybe I made a mistake in quoting that, but my recollection was that the figure was $26,000.

Senator ANDERSON. You don't think perhaps you are as confused as some of the Members you thought were confused in the House? [Laughter.]

Mr. RAY. Well, I can be confused.

Senator ANDERSON. Is it possible to distribute $40,000 as a part of your taxable income out of a $26,000 total income? You will admit you were totally in error when you made the answer to one of those questions, is that correct?

Mr. RAY. I guess I was, Senator. The $26,000 should be stricken from the record. I don't recall—but the amount of tax was $8,420.80.

Senator ANDERSON. I beg pardon, what was that?

Mr. RAY. That was the income tax.

Senator WILLIAMS. You paid $8,000 tax, you distribute $40,000 in dividends. What part——

Senator ANDERSON. And added $90,000 to your surplus.

Senator WILLIAMS. To your surplus.

Mr. RAY. Not out of dividends.

Senator WILLIAMS. Out of $26,000 total profits?

Mr. RAY. No, sir.

Senator BENNETT. Can we get this straight, Senator Anderson?

Senator ANDERSON. I would be happy to have this straight. I want to know why this capital is going to fly away from business. Best's says you increased surplus to $90,000. You didn't do that. Well, you either did or didn't.

Mr. RAY. Before dividend.

Senator ANDERSON. Did you increase surplus last year $90,000?

Mr. RAY. We put $98,000 as dividends to policyholders. We set up $55,000 out of the 90 you are talking about was set up for dividends to policyholders, and you will find it in that record, in Best's.

Senator ANDERSON. I am not questioning that. It says dividends to stockholders, $40,800.

Mr. RAY. Yes, sir.

Senator ANDERSON. Is that right or wrong?

Mr. RAY. That is right.

Senator ANDERSON. That is right.

Down farther it says increase in surplus $90,000.

Mr. RAY. I don't recall that figure.

In a telegram dated March 19, Mr. Ray wired:

In answer to question asked by Senator Anderson as to source of $90,000 increase in surplus during 1957 for Guaranty Income Life Insurance Co., it was all paid in by stockholders.

Senator ANDERSON. Well, it is what Best says.

Mr. RAY. You are reading that --

Senator ANDERSON. I am reading it, and I will be happy to have you look at it. I am just trying to find out about this rent and how capital is going to fly out of a business that does that well. It is pretty good, isn't it?

Mr. RAY. Not - it is not very good considering the length of time they have had their money in there, 33 years.

Senator BENNETT. Did they get dividends the year before?

Mr. RAY. They did the year before. They have for the last few years. But they went a good many years with none whatever.

Senator ANDERSON. Is it because of the life insurance business that caused them trouble, or something else? You had an underwriting profit on your ordinary life of $101,000. You lost $30,000 on supplementary contracts. I don't know what that is in the life insurance business, but you undoubtedly do.

Mr. RAY. Supplementary contracts are additional benefits included in the policies such as accidental death benefit and the provisions for payment to beneficiaries.

Senator ANDERSON. You made money on accidental death. So it was not that, was it?

Mr. RAY. It couldn't have been that.

Senator ANDERSON. No. You made money on disability, so it couldn't have been that, could it?

Mr. RAY. No.

Senator ANDERSON. But on supplementary contracts, anyhow.

Mr. RAY. That includes annuities that arise out of policy payments.

Senator ANDERSON. I will let somebody else ask questions. That is all.

The CHAIRMAN. Senator Gore.

Senator GORE. No questions.

The CHAIRMAN. Did I understand you to say mutual companies pay much less increase in taxes than the stock companies.

Mr. RAY. Yes, sir.

The CHAIRMAN. In some cases they would pay less taxes?

Mr. RAY. Yes, sir.

The CHAIRMAN. Now, the Equitable Life Assurance Co. paid $27.1 million last year, and under this bill will pay $48.5 million. That is about 75 or 80 percent increase, is it not?

Mr. RAY. Yes, sir. They would be entitled to a deduction on their pension business from year to year.

The CHAIRMAN. These are official figures which have come to the committee from the Treasury Department as to the total taxes paid by both stock companies and mutual companies. It is not subject to any deductions, as I understand it.

The John Hancock Mutual Life Insurance Co. of Boston paid $14.632 million last year, and this year they will pay $27.124 million, which would be 100 percent, would it not?

Mr. RAY. They can so manage their affairs to greatly reduce it under this new measure, Senator.

The CHAIRMAN. These are the figures received this morning from the Treasury as to the total taxes that would be paid under this bill.

Mr. RAY. For 1 year. What would they pay 3 years from now when their pension plans----

The CHAIRMAN. That depends on their business 3 years from now. But I understood you to say that this bill, itself, would reduce the taxes----

Mr. RAY. It is a 3-year reduction, Senator; it is a stepdown reduction from the pension business. One-third of the tax on it goes off the next year, and a third more the following year, and a third more the third year.

The CHAIRMAN. You think, then, we should get the figures for 3 years?

Mr. RAY. That is right, to make the proper comparison.

The CHAIRMAN. You think the figures for this year are not sufficient? Metropolitan Life Insurance Co. paid $17.976 million last year, and this year they will pay $72 million, if this bill is passed.

Mr. RAY. Senator, if I may say, that is one of the greatest objections to that measure. There is such an unfair and very wide range in the tax that will be required of the companies just due to some little feature of their management, their bookkeeping affairs, and the rates of interest that they have guaranteed these various types of contracts, and that wide variation is unfair.

The CHAIRMAN. If these figures are correct for 1 year, at least, the proportionate increase of the mutual companies is about the same as the stock companies, isn't that right?

Mr. RAY. Approximately.

The CHAIRMAN. There are some few mutual companies here that apparently would have a smaller tax.

Mr. RAY. If you take the average over the industry as a whole, the change is not so great. But for these small companies that I am pleading for, there is a tremendous increase.

The CHAIRMAN. Well, now, the Columbian Mutual Life Insurance Co. of Binghamton, N.Y., paid $38,000 last year, and this year they will pay $30,000. They have a reduction.

Mr. RAY. That is just a fault in the bill. It shouldn't permit that, it shouldn't provide for that kind of a variation.

The CHAIRMAN. Banker's Life Insurance Co. of Lincoln, Nebr., if this chart is correct, paid $207,000 last year, and will only pay $1,000 under this bill. But all the larger companies apparently have increases approximating those of the stock companies. The National Life Insurance Co. of Montpelier, Vt., paid $2.2 million last year, and they will pay $4,280 million this year.

Mr. RAY. The very figures you are reading condemn the bill.

The CHAIRMAN. But the same variations will occur with respect to the stock companies.

Mr. RAY. No, sir.

The CHAIRMAN. Can you devise a way whereby you can make it the same?

Mr. RAY. No, sir; I can't do anything to that bill to improve it. Just throw it out the window.

The CHAIRMAN. I am seeking information. My question is, do you think that these figures should be extended for 3 years instead of for 1 year?

Mr. RAY. Yes, sir; if they would go ahead and take the pension plans out and revise those figures after the pension plans are out, then take a look at it.

The CHAIRMAN. Of course, you have got to recognize the fact that the business will increase from year to year. It is not going to be stationary.

Mr. RAY. That is right. And they can further manage it just like you have read the figures for some companies that were almost tax free there. These others can do the same thing, and this tax will go off the board and the first thing in a few more years we would be right back here arguing this same thing that you are escaping tax. That is one reason it is such a bad bill.

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

The next witness is Mr. Manton Eddy of the Connecticut General Life Insurance Co.

## STATEMENT OF MANTON EDDY, VICE PRESIDENT AND SECRETARY, CONNECTICUT GENERAL LIFE INSURANCE CO., BLOOMFIELD, CONN.

Mr. EDDY. Mr. Chairman and members of the committee, my name is Manton Eddy. I am vice president and secretary of the Connecticut General Life Insurance Co., Bloomfield, Conn. Connecticut General is one of the largest stock companies in the country but is still quite small compared with the largest mutuals.

Connecticut General is engaged in the business of life insurance, accident and health insurance, and annuities, both on an individual and on a group basis. It writes individual life insurance policies both on a participating and on a nonparticipating or guaranteed cost basis. We do a substantial amount of life reinsurance of individual risks with other companies, large and small, stock and mutual. This gives us a more than average exposure to the problems of all types of companies.

I am appearing here today on behalf of Connecticut General. However, I do know that there are many other companies, particularly stock life insurance companies, which share the views I will express here.

There are some who think that in past years life insurance has enjoyed shelter from the burden of the Federal income tax. This has been true to a degree because companies with high apparent earnings but small assets have paid little in Federal income taxes. This has not been true of Connecticut General. We have been paying substantial Federal income taxes. For 1957 we paid $5,265,000. Under H.R. 4245 we would pay $10,800,000 on 1958 business. Under the 1942 law, applied to 1958 business, we have estimated out tax would be $9,070,000.

We are naturally concerned at this sharp increase in our tax. Connecticut General is taxed largely under phase 1 which means that we pay a tax immediately and at the full 52 percent corporate rate on most of our gain in surplus. In fact, phase 1 accounts for well over 95 percent of our tax.

While our major tax is under phase 1 there is also additional tax under phase 2 after deducting the credit we receive on account of nonparticipating insurance and group insurance. We pay a tax immediately at the regular 52 percent corporate rate on one-half of the balance, and at a later date the remaining half would be taxed under phase 3 at the regular 52 percent corporate rate before it could ever be released to stockholders.

The allowances made in H.R. 4245 to stock life insurance are, I believe, just about the minimum. The mutuals will, in general, pay only under phase 1. The stocks pay not only the tax under phase 1 but they also, generally speaking, pay under phase 2 as well. This raises the percentage which the stock companies will pay from the traditional 25 percent to more than 30 percent of the total tax. The percentage payable by stock companies will be about 32 percent in the event that the 5-year average interest rate is substituted in phase 1, which is a change generally supported by both stocks and mutuals. We believe that the shift in the burden of taxation from 25 percent to 32 percent is just about as much as the stock companies can bear, and any further shift might well prove disastrous to stock life insurance. The increase of 7 percentage points from 25 percent to 32 percent may appear to be a small increase, but percentagewise it is 28 percent which is a very large increase especially when applied to a much enlarged tax base.

Section 802(b)(1) allows a company the aparent privilege of reducing its phase 1 taxable income by phase 2 negatives. However, the practical effect of the limitation of section 809(g)(1) is to take away any real relief from mutual compansies and also from most stock companies of any considerable size. Such stock companies write participating insurance or group insurance and are thereby effectively prevented from reducing their phase 1 taxable income by phase 2 negatives. For example: There is little likelihood that Connecticut General could ever reduce its phase 1 tax by phase 2 negatives as the bill now stands. We would first have to cancel off more than $30 million in policyholder dividends, rate credits and the like.

A reasonable solution would be to permit companies to apply phase 2 negatives, to the extent they are not alowable to reduce phase 1 taxable income, to reduce phase 2 gains of other years. Such phase 2 negatives would be applied to phase 2 taxable income of other years under appropriate carryover and carryback provisions. Thus all companies which in good years are paying taxes under phase 2 would have an equitable offset resulting from a poor year.

The fear of stock life insurance concerning the pending legislation is perhaps as great in connection with competitive aspects as it is with the general level of taxation. Of course, it is not pleasant to see the general level of taxation increased by 75 percent or more from one year to the next, and we are very deeply concerned because life insurance is only one savings medium of many; and no other savings medium is so heavily taxed at the State and Federal levels. It is quite true that the $300 million State tax bill is paid by all life insurance companies, stock and mutual, but there is no comparable burden on mutual savings banks, savings and loan associations, nor on the so-called nonprofit groups who provide benefits in the health field. Their burdens are relatively low, and they do compete with us for the savings dollar or the insurance dollar.

The stock life insurance companies must not only compete with each other, but they must also compete with the mutuals which are the biggest factor in the life insurance business. Stock companies must guarantee rates for the life of the contract. Their rates must be reasonably competitive with the premiums charged by the mutual companies less the dividends which are paid. This has not been easy for the stock companies to do and would be next to impossible to do without substantial tax equality at the Federal level. The guaranteed rates must be fixed so low in many cases that they are less than the valuation premium necessary to accumulate reserves on the basis of the 1941 CSO mortality table at an assured rate of interest of 3 percent. In other words, all expenses, plus any margins for surplus and contingencies must result from having a mortality better than that indicated in the mortaliy table, and interest better than that assumed in the valuation basis. Whenever rates are below the valuation premium, we must set up what is known as a deficiency reserve, and currently most of the large nonparticipating companies must set up these reserves each year.

Because of this intense competition with the mutuals, we must not only fix our rates at a low level but we must also retain most of our gains in surplus and distribute relatively little in cash to our stockholders. If we followed any other course we would soon be out of the competitive race. The new tax bill as written takes more of the money which would otherwise move into surplus and, hence, makes a difficult task even more difficult.

The allowances on account of nonparticipating insurance and group insurance and the deferment of a portion of the tax under phase 2 are absolutely essential and a bare minimum to fit the corporate income tax law to the peculiar problems of life insurance and to maintain the competitive balance between stocks and mutuals.

Historically the stock life insurance companies have considered it essential to develop surplus or contingency funds equal to at least 10 percent of their nonparticipating reserves. Several years ago in connection with life insurance income tax hearings, the president of our company made the following statement relative to stock life insurance:

> A well-managed life insurance company is required by necessity as well as by traditions of the business standards to maintain a large surplus. Such a surplus by normal corporate business standards seems excessive. We in the business know that our surplus funds—far from being excessive—are on the low side. Those of us who were in management from 1929 to 1933 have not forgotten.

We saw larger surpluses proportionately than we now have wiped out. Out of gains in the business in the years when we are lucky enough to make them, we must and will assign to surplus account an amount which will maintain at least a proportionate surplus increase to the increase in liabilities for that year. Because the well-managed companies cannot distribute this surplus to stockholders, anyone who purchases stock on the basis that they will, may be disappointed.

The needs for substantial margins are evident even in such times as these days which are considered prosperous. Connecticut General's funds which it holds as additional security to policyholders at the end of 1958 aggregated slightly more than $136 million. At the same time the market value of bonds in our portfolio was $75 million below the statement figure at which the bonds were carried. In other words, if the life insurance companies carried their bonds at market as do other corporations, a very large part of what is presently identified as surplus would disappear.

Senator ANDERSON. May I interrupt there, Mr. Chairman?

The CHAIRMAN. Yes.

Senator ANDERSON. Would you be able to tell us about how much of that $75 million shrinkage is in Government bonds?

Mr. EDDY. I am afraid I could not, sir. I can supply it for the record, if you wish.

Senator ANDERSON. It is not necessary for the record. I would just be happy to know it myself.

I find that is what I regard as one of the difficult problems that a life insurance company trying its very best to protect its policyholders faces. It buys what ought to be the safest investment in the world, Government bonds, and has to write off a tremendous slice of its money if it looks at market values because it bought Government bonds. I think it is too bad.

I certainly join with the chairman in hoping that we get this budget in balance some day. I do not know when, but some day, at least, so that the Government bond can be protected. I think it is unfortunate.

If you would not mind furnishing that to me, I would appreciate it. I do not care if it goes into the record, but I would like to have the amount that that represents Government bonds.

I talked to a banker not long ago who showed me his actual portfolio. He showed me that if he wrote his Government bond values on the basis they then were, it wiped out a good deal of the capital of his bank, which I thought was tragic.

I do not believe he is ever going to have to take these prices on his Government bonds.

Mr. EDDY. Senator, I would not wish the record to even give the inference that I felt that Government bonds were responsible for that $75 million figure.

It is true of any bonds which were bought at an earlier time when interest rates were low.

As general interest values change, the bond market changes, and older bonds which were bought with a lower coupon rate naturally respond to market changes. That is true of corporate bonds, industrial bonds, as it is of Government bonds; and my intent was not, Senator, to point a finger at the integrity of any bonds.

It is merely to show that we are a long-term business. We have to look at our assets in that way, and we have to look at our liabilities in that way, and we hope you gentlemen will permit us to look at our surplus in that way.

Senator ANDERSON. Will you mind, Mr. Chairman, if I just asked one more question?

The Senator from Oklahoma has kindly called my attention to your general statement showing that you have only $130 million in U.S. Governments, so naturally the whole shrink is not in that. You have $757 million of other bonds.

Mr. EDDY. Yes, sir.

Senator ANDERSON. And if they are utility bonds, I assume your experience has been the same as my little insurance company, which is badly off on its utility bonds, but you have only $20 million, and $26 million in common stocks, and the temptation certainly is to say to yourself, "We have to put more of it in that if we are going to try to do all the things that have been indicated."

I only broke in, Mr. Chairman, because I was impressed by the calm and considered way in which this witness was commenting on the bill. I want to commend you for it and say to you, in advance, that I may not agree with your final conclusions, because I do not know what they are going to be, but I did like the way you were approaching the subject. I wanted to express my conviction of what you have said here about a shrinking market value over what you have to carry these or are allowed to carry them in your statement. That points up the need to maintain very sound surpluses on the parts of these insurance companies, and if we were persecuting or destroying them by this bill, I would not be in favor of this bill.

Mr. EDDY. Thank you for your comment, Senator.

Senator ANDERSON. I apologize for interrupting you.

Mr. EDDY. I think I just said that our bonds were $75 million below the statement figure.

The life insurance business is a different business and its own accounting methods have developed over the years on a basis that is sound and conservative and necessary for such a different type of business. Because the obligations of a life insurance company are long-term obligations, they are evaluated on that basis and the assets of the companies are valued with respect to the long term rather than to immediate market quotations which are significant only in the event of complete and rapid liquidation.

The reason for the deficit in market value is that many of these bonds, Government and others, were purchased 10 or 15 years ago yielding perhaps 2½ percent or a little more. If we had to sell these bonds to meet unusual losses or for other reasons we would have a loss in surplus; but, of course, these bonds are amply secured and will be paid at maturity and we intend to hold them until maturity. In the meantime they will result in a drag on earnings for many years as compared with bonds which could be purchased if the funds were currently available to us.

A life insurance company cannot rely on its reserves alone to bring it through bad times. It must have a substantial cushion in the form of surplus. The current trend in reserves is to make them less conservative and the trend in premiums is definitely down and the trend in expenses up. As a result, without substantial surplus the stock life insurance companies particularly would face greater difficulties in times of stress. During the 1930's we suffered because of a decline in interest rates which continued also through the next decade. We also had several capital losses in those years and we had losses on account of disability provisions which had been issued at guaranteed rates which proved to be inadequate.

I might interpolate, grossly inadequate. We had guaranteed rates for life insurance which could not be increased. The need for sizable surplus funds was well demonstrated during that period.

Pension relief has been provided in the bill and will be most helpful in our competition with those who pay no taxes on investment income from pension funds. Of course, deferred relief is not as satisfactory as immediate relief and removal of the discrimination as speedily as possible would be most desirable. To facilitate making the relief immediate, it might be provided that those companies receiving such immediate relief be required to pay in one sum or in two or three installments, starting now, the tax due to changes in method of accounting. Under the bill, this particular tax is payable in 10 installments, but not starting until a year from now.

If I might interpolate, Mr. Chairman, I would like to add this: The pension business does not create much surplus; that is contrary to the opinion which I heard one witness express, and I fear that his concern arises from lack of knowledge rather than from knowledge.

It is very difficult for a company in the pension business to build surplus.

The improvements in mortality that are occurring run against this, just as they are in our favor in life insurance.

It seems to me that it would be well to urge consideration of an additional allowance in phase 2 of 2 percent of the increase in reserves for qualified pension funds or plans, either stock or mutual, so that the companies would be enabled to establish a very minimum, but a very necessary, contingency fund before tax.

It would, of course, be perfectly in order, and warranted, to provide that in the event such contingency funds were reduced in the future, the amount withdrawn would be added to the gains in phase 2 and subject to tax at that time.

Senator ANDERSON. Would you put any limit on how much you can put into that contingency?

Mr. EDDY. Well, 2 percent of the increase in annuity reserves in a given year would never give a company in the aggregate more than 2 percent of its annuity reserves in total which is, I submit, gentlemen, a very minimum protection in the annuity field, and yet I will also admit that my company finds it difficult in handling our pension funds to establish contingency funds much larger than that on this type of business.

In conclusion, Connecticut General definitely favors the general pattern of H.R. 4245 as it passed the House. We feel that in its present form the bill maintains reasonable balance in taxation between stock and mutual companies. Elements that are vital in the present bill are pension relief, the allowances on account of nonparticipating insurance and group insurance, and the deferment of a portion of the tax from phase 2 to phase 3.

In modification of the bill we think that the 5-year average interest rate should be substituted for the artificial mean which is now in the bill and which is based in part on an industry or so-called global average. Also we suggest that consideration be given to the carry-backs and carryovers of phase 2 negatives which we have outlined. Finally we think that further relief for small and young companies such as others have suggested in their testimony would be most beneficial and desirable.

Mr. Chairman, this concludes my prepared statement, but with your permission I would like very much at this point to correct what might be an erroneous impression created by an inadvertent statement of a previous witness on March 5.

The CHAIRMAN. Go ahead, sir.

Mr. EDDY. This witness, testifying in behalf of a group of mutual companies, had been speaking of pension funds as handled by a mutual company.

In response to a question, he said:

> We do have a surplus account, but when policyholders terminate, that part of the surplus that is determined to be theirs goes with them.

The question was then asked: "Would that be true in a stock company?"

The witness answered: "Well, no, sir. When a policyholder terminates in a stock company, he does not get settlement dividends as we pay in a mutual life insurance company." That is the end of the quotation.

That statement, I am very sure, was inadvertent, and it does not create an accurate understanding of what are the facts.

A stock company handles group pension funds under contracts that pay out rate credits under contractual experience rating provisions.

A mutual company handles group pension funds under contracts that pay out dividends under contractual participating provisions. The differences are in the words rather than in reality.

I do not think that my mutual colleagues would disagree with me when I say that stock and mutual companies in their handling of group insurance and group pensions are just as much alike as peas in a pod.

Connecticut General continues to experience rate its group annuity contracts after discontinuance just as fully as before discontinuance.

While I am speaking of Connecticut General, I know from competitive experience that other stock companies do likewise, but I can speak only for Connecticut General.

Since these contracts provide paid-up benefits, which are still payable after discontinuance, these rate credits develop over a long period of time, and the experience rating processes would continue until the last benefit had been paid.

We have been fortunate in having very few cases discontinue, but unfortunately some cases have discontinued. On a number of these cases we are currently paying substantial rate credits. In fact, on one case recently, the entire reserve fund was paid out in cash to the trustee who succeeded us, and at the same time, the surplus remaining in our funds after this cash payment was paid over by us to the successor trustee.

Gentlemen, we could not continue to compete in the pension business and deal with the large corporations in this country, if we showed any attitude that would seem to be acquisitive beyond the point of a marginal profit which would be normal for the services we are rendering, and that margin of profit is very, very minor.

The CHAIRMAN. Thank you very much, Mr. Eddy, for your clear statement.

Are there any questions?

Senator KERR. Mr. Eddy, I want to thank you for the last statement that you made. I believe it relates to the conversation in which I participated.

I would like for you to explain for my benefit a part of the statement you make on page 6: "Pension relief has been provided in the bill, and would be most helpful in our competition with those who pay no taxes on investment income from pension funds."

Now, on the basis of my impression of what the facts are, I agree with you, but I must say that my ability to understand is of such an inadequate nature that either I have not been able to understand what other witnesses have told me, or they have not gotten it over in words that I can understand; that is, the situation to which you refer.

As I understand it, trust companies pay no taxes on this kind of business or profits from this kind of business, and yet I have been told that trust companies handle it so that there is no profit on it other than that which goes to the group for whom the investment was made.

Then I have been told that if either the provision in the bill is carried out or the suggestion you make that the relief provided over a term of years by the bill be made immediate, that insurance would then be making a profit off of this kind of business that would be freed from taxes.

Now, it is very likely that my statement to you has not contributed any to the elimination of confusion, but if it has gotten over to you that this is a field in which I am confused, it might be, with the great knowledge you seem to have of this, that you could relieve my confusion.

Mr. EDDY. Senator, let us start with the pension fund held by a trust company of ——

Senator KERR. Let us get specific.

Tell the committee the specifications of such a deal in terms of assumed amounts.

Mr. EDDY. A small trust fund which is creating $1,000 of investment income; does that approach it the way you wish?

Senator KERR. If that is one that will be illustrative.

Mr. EDDY. As I understand it, sir, and I am not—I have had no initimate experience with trust companies, but as I understand it, $1,000 of income in a given year——

Senator KERR. Let us talk about the principal, rather than the income, because as I understand it, the difference arises by the way the income from the prinicipal is treated.

Mr. EDDY. The difference arises out of the differences in treatment of the income. The principal is intact.

Senator KERR. All right.

Now, let us say that a company puts $1 million with "A" trust company. What does the trust company—how does the trust company handle that $1 million?

Mr. EDDY. It will invest it.

Senator KERR. Why do they want it? Why do they want it? Do they carry on that operation for a fee?

Mr. EDDY. They carry on the operation for a fee, and if the fee——

Senator KERR. What is that fee on? Is that a certain percent of the $1 million or a certain percent of the income on the $1 million, or what is it?

Mr. EDDY. Generally speaking, I believe the fee is a percentage, a very small percentage, of the investment income which is accruing from the principal in the trust.

Senator KERR. That is the compensation the trust company makes for handling the transactions?

Mr. EDDY. That is the compensation of the trust company and, presumably, it is sufficient to pay its expenses and create a profit.

Senator KERR. Does the trust company pay any tax on that profit?

Mr. EDDY. Yes, sir; at normal corporate rates.

Senator KERR. What is the advantage the trust company has over the insurance company?

Mr. EDDY. The advantage the trust company has is that it can add the full amount of investment income to the trust without there being any Federal income tax deducted from that investment income.

Senator KERR. In other words, if the trust company takes the $1 million, and puts it into some investment permitted by the trust, and makes a profit, that profit is added to the principal?

Mr. EDDY. Yes, sir.

If it, for example, buys a bond at one figure and sells it later at a higher price, the profit on that bond would be added to the principal.

Senator KERR. For the benefit of the beneficiaries of the trust fund?

Mr. EDDY. Yes, sir.

Senator KERR. Well now, what is the difference in what happens to an insurance company?

Mr. EDDY. I think, sir, the main difference, the important difference, and the difference which this bill proposes to correct, after a period of 3 years——

Senator KERR. Over a period of 3 years.

Mr. EDDY. Over a period of 3 years.

Senator KERR. I thought it was actually accomplished in 2 years.

Mr. EDDY. It is accomplished in the third—the third bite is in—you are right.

Senator KERR. Is it accomplished in the third year or after the third year?

Mr. EDDY. It is accomplished in the third year.

Senator KERR. Yes.

What is accomplished?

Mr. EDDY. The removal of any tax on the investment income coming out of the invested reserves held by a life insurance company for a qualified pension plan.

Senator KERR. All right.

Now, let us say that the insurance company then makes a profit on that investment account. Is that an accurate way to describe the situation?

Mr. EDDY. Would you be willing, sir, to say the insurance company creates surplus?

Senator KERR. Well, now, you see I would be willing to, but I must say to you frankly, that it would be a statement that I do not believe I would understand as well as I would if it were made the other way, if the other way is accurate.

Mr. EDDY. Could I say and describe it to you this way, and the reason I make the distinction is that I feel it is a real one. If we, as an insurance company, make a profit on our pension plans, the profit will be a very minute amount of interest which we would deduct from the fund, just as the trust company deducts a fraction of the interest to take care of its expenses, and under this bill that profit to us, that margin of interest which we did not credit the fund, would be taxed to us.

Senator KERR. Under this bill or under existing law?

Mr. EDDY. Under this bill, not under existing law; under this bill.

Senator KERR. What do you do in handling a trust fund different from what a trust company does?

Mr. EDDY. We make basically guarantees of the annuities that will be purchased in the future.

We guarantee that if we are unwise in our investments, we still guarantee we will not lose a dollar of principal, and we guarantee that regardless of the future we will earn a certain minimum rate of interest on the funds at hand.

Senator KERR. Well now, the trust company does not do that.

Mr. EDDY. The trust company does not make such guarantees.

Senator KERR. Is the competitive position then determined by whether or not those having these funds that they want to invest for the benefit of beneficiaries in the future, a situation where if they want a guaranteed return they would be disposed to deal with an insurance company; if they want the benefit of whatever the fund earns under good management they would do business with a trust company?

Mr. EDDY. I would quite willingly agree with the first, Senator. Those who wish the benefit of guarantees and guaranteed annuity rates will necessarily have to deal with insurance companies. That is particularly applicable to your small employers, to your small cases, who cannot afford to take a chance on the fluctuations, the hazards of the future, and the fluctuations that can occur in mortality in small groups of people.

The large employers covering large numbers of people can, without undue hazard, take a chance on the probabilities of the future, as do the insurance companies in their handling.

Senator BENNETT. The answer is yes.

Senator KERR. If you are going to compete for the opportunity to handle the pension funds or a benefit program, you have got to offer the opportunity of as attractive a return to the beneficiaries as is available to them from a trust company, do you not?

Mr. EDDY. Yes, sir.

Senator KERR. Does the company which is making this provision for its employees, and that is the situation that must arise in either case, is it not——

Mr. EDDY. Yes, sir.

Senator KERR (continuing). Does it, in dealing with an insurance company, pay over the same amount of money to put this program in operation to an insurance company as they would pay to a trust company?

Mr. EDDY. They could, but not necessarily.

Senator KERR. Is the deal with the insurance company a combination of benefits during life plus a benefit in the case of a death, while if it is handled with a trust company it is limited to the income from the actual money paid over, and it does not include both a life income and a death benefit?

Mr. EDDY. Yes, sir; your statement is correct.

Senator KERR. Probably the other members of the committee know just exactly what kind of a situation you are talking about. But, frankly, I do not, you see, and I wish you would assume that now, and explain it to me and, as I said to one man the other day, so that a sixth grader can understand it.

Mr. EDDY. Senator, you have already, in asking your questions, indicated an amount of knowledge which I think, I would say, is excellent and correct.

Senator KERR. But it is very limited. I still do not know what factor is in the mind of witnesses, including you, with reference to which insurance companies are now taxed, and trust companies are now free from taxation.

Mr. EDDY. Senator, if I hesitate in my answering, it is because the varieties of ways in which pension arrangements can be developed are very, very great, and it is hard to make a simple statement.

But in its larger aspects, just as General Motors' car or Chrysler's car will get one to his destination, but the motors are different and the bodies look different and so forth, pension programs——

Senator KERR. Well, you know, the thing I like about both of them is that they both burn gasoline. [Laughter.]

Mr. EDDY. I might say, more than they used to, Senator. [Laughter.]

Senator KERR. Yes.

Mr. EDDY. But essentially we have different sales talks to give.

Senator KERR. Well, I know, but you and I are getting down now so that I can understand it.

Mr. EDDY. But when we come down to the one fundamental problem, the way we have difficulty in competition has been that we have been taxed on the investment income we can earn on the money placed with us, and the trust companies have not been taxed on the investment income.

Therefore, we return to our policyholder a slightly less effective rate of interest than a trust company could return.

Senator KERR. But you, I got the impression that in lieu of that, you give him certain guarantees that the trust company does not give him?

Mr. EDDY. It is not in lieu of that.

Senator KERR. What was that?

Mr. EDDY. They are, we think, valuable, but the trust companies have a great deal to say on their side.

They have a flexible fund, they have a wider range in some respects in investments.

It has been very popular in recent years to have an increasing percentage of equities in the portfolio, and because equities have increased in value, it has given a very effective sales talk to the trust company.

Senator KERR. And you do not hope to overcome that by—I mean you do not hope to remain a nonspeculative investor and have all of the appeal that another might have that is a successful speculator, do you?

Mr. EDDY. No, sir. We do not wish to change our stripes.

Senator KERR. Is it a fact, as has been alleged to me, that under existing law the only thing you pay tax on is the profit you make and keep or would want to keep?

Mr. EDDY. Oh, no, sir.

Senator KERR. And in such a way as to withhold it from the people who furnish you the money on which you earn this profit?

Mr. EDDY. Under existing law, the 1942 law——

Senator KERR. Well, under existing law.

Mr. EDDY. Under existing law, the 1942 law, the insurance companies are taxed, would be taxed, on approximately very close to 25 percent of their investment income. They would be taxed at the 52 percent rate.

Senator KERR. Now, you see, that is where you lose me again. This money that you get belongs to the people for whom the trust is created, does it not? I mean, they turn this money over to you to invest?

Mr. EDDY. And it is set aside for them.

Senator KERR. Now, is it a situation where if the trust company does it, they give them all the profit on it, but where if you do it, you give them only a guaranteed amount, and what you get above that belongs to you?

Mr. EDDY. No, sir. We give them the full amount of income that we have left to us after taxes.

Senator KERR. If this tax is removed, who benefits; you or them?

Mr. EDDY. They do.

Senator TALMADGE. Senator, would you yield at that point?

Senator KERR. I would be glad to.

Senator TALMADGE. Perhaps I can help clarify this situation.

Who assumes the risk in each one of these cases? Suppose it is an insurance company; does the insurance company assume the risk to pay a fixed amount under certain conditions?

Mr. EDDY. Yes, sir.

Senator TALMADGE. Is that true also of a trust company under the same conditions?

Mr. EDDY. No, sir.

Senator ANDERSON. The loss comes out of the corpus of the trust?

Mr. EDDY. Yes, sir.

Senator KERR. Well, I thank you for trying. [Laughter.]

I want to make a public announcement, Mr. Chairman, that I am still looking for somebody who can explain this so that I can understand it.

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

We will adjourn until 2:10.

(Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 2:10 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will please come to order. The witness is John Wilkins of the Citizens National Life Insurance Co. Is Mr. Wilkins in the room?

The next witness is John A. Copeland, Progressive Life Insurance Co.

Mr. Copeland, will you come forward, please?

## STATEMENT OF JOHN A. COPELAND, PRESIDENT, PROGRESSIVE LIFE INSURANCE CO., ATLANTA, GA.

Mr. COPELAND. My name is John A. Copeland. I have been president of Progressive Life Insurance Co. of Atlanta, Ga., for about a year and a half. Prior to that I was vice president of a larger company for 3 years. Prior to that I was a consulting actuary for 17 years, and, in partnership with my father, provided actuarial service for some 40 or 50 small companies located in the Gulf and South Atlantic States. I am a charter member of the Conference of Actuaries in Public Practice.

My company has assets of about $6 million and approximately $100 million of insurance in force. It was organized in 1931, and is therefore a comparatively young company. It has been a very conservative company in respect to growth until a year and a half ago, at which time it adopted an aggressive expansion program.

We are opposed to adoption of H.R. 4245 in its present form because we believe that it is grossly inequitable in its application to various types of life insurance companies and probably creates a tax which is either retrospective in nature and/or an income tax on capital investments. We hold this viewpoint because we are looking to the future and not because of any present concern.

Our company would have paid no taxes for 1957 under H.R. 4245 and would have no tax liability for 1958 under the bill, whereas it would pay between $15,000 and $20,000 for each of those years under the 1942 law or under the 1955 stopgap legislation.

Our operating loss for 1958 will provide under H.R. 4245 a carry forward that would relieve us from tax under normal conditions for the next 3 years. Nevertheless, we think that this is a bad bill and I would like to make clear the basis of our opposition and to make some recommendations.

H.R. 4245 begins with the assumption that each life insurance company ended the year 1957 and began the year 1958 with a financial statement which truly reflected its assets, liabilities, capital, and surplus in the same manner and in the same meaning that would be shown at any year end by the statements of manufacturing, service, retailing, or other types of businesses and assumes that the activities of each life insurance company from that point forward will reflect true profits and losses through operating statements year by year thereafter. This assumption is grossly in error.

For a hundred or more years, the business of life insuance has been acknowledged by the Federal Government and the several States to be a totally different kind of business; one which cannot measure its profits or losses day by day, year by year, or even decade by decade.

It is a business that (through necessity) has been forced to maintain many of its asset accounts and 80 percent of its liability accounts as "nonledger" accounts—because the balances of these accounts change each second of the day and night.

For the purpose of an annual statement, these accounts are inventoried as of midnight December 31 of each year in an attempt to ascertain the financial condition of the companies on that date.

Some of the more easily understood deviations in the correctness of the January 1, 1958, surplus positions of the life insurance companies as compared to the concept of surplus in other companies, are items which have in prior years been charged to surplus because of the rules of the National Association of Insurance Commissioners, for example; furniture, fixtures, equipment, prepaid supplies and printing, advances to agents, etc.

Corporations other than life insurance companies would normally carry these items as an asset and in surplus.

Surplus as of January 1, 1958, is an extremely important item under the proposed tax bill, in that it will become the shareholders' surplus account from which dividend distributions may thereafter be made to shareholders without additional tax to the company.

Many life insurance companies now have amounts in excess of the amounts reported as surplus as of January 1, 1958, invested in the aforementioned nonadmitted assets, and to the extent that the fair value of these items are not included in the shareholders' surplus account as of January 1, 1958, the value of subsequent depreciation, recovery, or use of these items will reflect as an increase in the shareholders' surplus account, or should reflect such an increase in the shareholders' surplus account.

Unless adjustments are allowed and made for this type of item, the result will be an income tax on profits earned in years prior to 1958, a retrospective tax, if you please, occasioned by a sudden and complete change in the Federal concept of taxation of the life insurance business.

An attempt by the life insurance companies to correct this situation, if correction is permitted, will certainly result in gigantic confusion. It will certainly result in the odd situation of a supervised industry which is required to keep two sets of books, one for the purpose of State regulation and one for Federal tax determination.

During my 23 years in the actuarial and management end of the life insurance business, I believe my most difficult task has been to explain to boards of directors, bankers, brokers, and other people not directly connected with the operation of life insurance companies the mathematics of a life insurance premium dollar.

This is indeed a complex and mysterious problem for even those people in the life insurance business who have not had some actuarial experience.

To begin with, the old saying, "You must spend money to make money," is more true in the early years of a life insurance company than in any phase of any other business.

I believe that it will be accepted as fact by any actuary or technician of the life insurance business that the surplus of a company is reduced by $1.30 to $1.60 for each $1 of first-year premium collected by the company.

This surplus reduction is occasioned by the fact that the company must pay first-year commissions, bonuses and field expenses, medical examinations and inspection-report fees, home-office expenses directly connected with the issue of policies and collection of first-year premiums, set up reserves, pay claims, and reinsurance premiums, and so forth. We know that these surplus depletions will occur.

We provide in our premium rates that the excess costs will be recovered through the profits we expect to earn through premiums collected during the second and subsequent policy years.

In effect, we invest our moneys in the production of first year (new) business so that we may recover our investment and earn a profit from this business in later years.

Even though we have invested in this new business, we have no way of carrying the value of this investment on our balance sheets or in our annual statements, it appears only as a reduction of our surplus.

An analogy would be a corporation established for the purpose of acquiring rent incomes under sound leases for lump sum payments, having to charge off the purchase price of such leases as expense at time of purchase.

If such a corporation purchased enough leases, its statement would show a zero surplus or insolvency, but the true worth of the corporation would not be changed by those purchases, if fair prices were paid.

If H.R. 4245 becomes law, we in the life insurance business will find ourselves in such a position. The lease purchase corporation would have capitalized the purchase price of its leases and thereafter would have taxable income on only the difference between rents received and the charge-off for amortization of the leases.

The life insurance companies will pay income tax on the gross rent received with no consideration being given to amortization of purchase price of business produced prior to January 1, 1958. This, I believe, constitutes an income tax on capital investments.

My company, the Progressive Life Insurance Co., entered into an expansion program about August 1957 and continued that program through 1958.

As a result of this program, the company reduced its surplus by about $90,000 during 1957 and the recovery of this investment in new business through profits from renewal premiums collected on the business so produced will be taxed as income.

Fortunately for Progressive, approximately $270,000 invested in 1958 is subject to carryover for the next 5 years so that we will recover this surplus reduction tax free. Had our expansion program been carried out just 1 year earlier the total $360,000 invested in new business would have been subject to income tax under H.R. 4245.

I am personally familiar with several heavily capitalized new life insurance companies in the South, which have for the past few years (since their beginning), paid Federal income tax under the stopgap legislation while depleting their surpluses by 1½ to 2 millions of dollars each.

The prognosis for each of these companies is for losses in the hundreds of thousands during 1958 and the succeeding 4 years so that there will never be a chance for the tax-free recovery of their invested capital if H.R. 4245 is made the tax code for life insurance companies. I am sure many such cases exist in other sections of the Nation.

This recovery of investment principle exists in practically all companies, but the extent to which H.R. 4245 taxes this capital investment depends on the size of the company and the amount of new business placed on the books of the company in the last few years.

H.R. 4245 recognizes the principle of a return to surplus on a tax-free basis the large sums taken out of surplus prior to January 1, 1958, by the large, old and strong companies, which in prior years have strengthened their reserves.

This bill allows reserve interest requirements to be computed on the higher of the assumed rate of the company or the average of the industry.

The companies will receive a tax-free addition to surplus each year equal to the difference between the smaller assumed interest of those strengthened reserves, and the larger industry average interest on their reserves.

Again I say that it is impossible to annually determine the profits of a life insurance company. We have signed contracts with our policyholders extending over long periods of time to pay specified benefits in consideration of the payment of specified premiums.

We have invested our capital to obtain these contracts and must regain this investment and hope to make some profit during the terms of these policy contracts.

We cannot increase our premiums though rising administrative costs, added State premium taxes, and constantly increasing municipal taxes are thrown against these premiums. Until now the industry has met these added expenses, paid claims through two wars, paid extremely low cash dividends to stockholders, remained solvent and grown while decreasing our premium rates generally.

This bill which will take another 1 to 3 percent of a premium income originally calculated to yield about 5 percent to 7 percent profit will certainly cause our surplus to policyholders to decrease greatly in the years to come, even if no cash dividends to stockholders are paid.

Our ability to weather wars, depressions, and inflations will be decreased.

This bill seems to me to be a little less than equitable, a little less than fair, a little like changing the rules of a football game at the half. This bill may operate fairly well for the hundred largest companies, but it is as yet full of bugs for the hundreds of smaller companies.

It seems to have been constructed somewhat in the manner of an unskilled do-it-yourself furniture maker, trying to level the legs of a table, they have sawed here and they have sawed there, but it is still uneven and inequitable. It lacks any provisions for surplus requirements for individual accident and health business but provides for group accident and health surplus.

It confuses annual operating gains with profits in a fashion that is wholly unrealistic. If the total income approach to taxation is to be law, it should be accomplished in gradual steps over several years, so that the industry would have a chance to gear its long range programs to the shock of so drastic a change.

Since 1920 life insurance companies paid under one or another formulas based on investment income. Experimentation with the approach has refined the method of approach in successive bills. Every segment of the industry, each of the five national trade associations in the field, have agreed, at least through 1958, that the formula method devised in 1955–56 was the fairest and best.

It was pointed out last year at the Senate hearings of the renewal of this bill, at the House hearings last fall, and again at these hearings, that, if the deduction rate fixed did not measure accurately the industry profits, this could be simply and fairly adjusted.

While we do not believe that, at present interest rates, the solvency of any companies would be affected by the 10–15–20 formula endorsed here by many companies, I am inclined to think it slightly too high over a 25- or 30-year period.

But I am willing to accept it in view of the demands of the Treasury and the general attitude of the industry. It is the fairest, it is the best, and it is the simplest method of taxing life insurance companies.

By contrast, this bill is nothing but a law to prohibit mice from biting the feet of elephants. It is a bill to favor the big companies against the little companies. It is a bill which could create a monopoly within less than a score of companies in the group life and annuity and group accident and health field.

Let me illustrate from my own company's experience.

We have built one of the finest, perhaps the finest, group departments of any company of comparable size in the Southeast. It is a profitable department, but it is more than that; it is geared to handle vastly more business, its staff is competently trained, it has fine actuaries and admirable agency direction.

Apart from the value of business on the books, this unit is a very valuable property in personnel, experience, and reputation, that has a tangible dollar-and-cents value, plus an intangible and unmeasurable value.

If the so-called group annuity deduction—called the pension deduction by its advocates—is permitted to subsidize the large pension-writing companies in competition with the small companies, nonpension group business will not be worth a dime in 10 years, time and all of the small companies will be driven out of business in the group and group accident and health field.

Of course the advocates of this deduction are engaging in strange logic. They do not compare group annuities with the individual annuities purchased by trusteed pension plans or by individuals, because they realize that group annuities are insurance and not pension funds in any sense.

But, by drawing some kind of vague analogy from their deposit-administration pension funds, they hope to obtain a tax subsidy of $60 or $70 million a year.

Let me assure this committee that there are significant differences between pension operations by insurance companies and the operations of trustees.

In the first place, no trustee guarantees any rate of return upon the funds in his keeping. A bank or other trustee is not hazarding its surplus, its capital—and certainly not the money of its depositors—in guaranteeing a fixed return upon the pension funds. Insurance companies guarantee a fixed return, guarantee against capital losses and decrease in values; and those enormous mutuals that dominate the scene hazard the surplus that they build with "the dimes and quarters of widows and orphans," as they so often like to say, to secure their commitments.

From the point of view of its effect on the great majority of life insurance companies, the most inequitable provision of H.R. 4245 is the special 100 percent deduction for pension reserve income, or more accurately, group annuity reserve income, contained in section 805(c) of that bill.

This superdeduct provision grants, over the next 3-year period, an annual windfall attaining $60 million by 1961, 75 percent of which goes to eight of the largest companies in the industry—none of which is received by over 90 percent of the companies in the industry.

A built-in, permanent annual windfall of this magnitude will not only increase the future burden of taxation on every other life insurance company, but will provide a few industry giants with a terrifying competitive club to eliminate competition and tighten their domination of the industry. The time-honored principle of taxation according to ability to pay has been submerged in deference to a proposition of dubious merit.

While the proposal has been advanced as a means of eliminating a supposed tax inequality between the insurance industry and trusteed pension plans, this alleged justification must be strictly a cloak to create a competitive inequality within the life insurance industry in favor of the few pension-writing companies.

Its real effect is to provide a few large companies with a $60 million annual slush fund to subsidize a competitive war on the remainder of the industry.

What, therefore, is the justification for the superdeduct?

It cannot be that the pension reserves do not produce free investment income; it is obvious that such is not the case. The sole justification that has been advanced for the superdeduct is that the big pension-writing companies need that special treatment to compete with trusteed pension plans set up by individual employers.

Even if this were true, which it is not, the remedy provided is worse than the disease. The fact that a corporation has tax-exempt competition has never before been deemed justification for providing that corporation with similar treatment.

Indeed, the trend is in the other direction. Tax exemptions have been withdrawn where they appear to be upsetting the competitive balance.

The superdeducts are particularly shameful in this industry where the only beneficiaries are a few of the very largest companies. Ability to pay as a criterion of tax justice is being junked with a vengeance.

Moreover, the record is perfectly clear that insurance companies are expanding their pension trust business at a faster rate than they are expanding any other portion of their business and no tax tinkering is needed to preserve their position.

This growth has not been accomplished at the expense of lower profits. Pensions have been among the most profitable lines written by the larger companies.

For example, in 1957 the Prudential Life Insurance Co. of America collected almost a billion dollars in ordinary life premiums and less than a quarter of a billion dollars in group annuity premiums. After dividends to policyholders, the ordinary life business showed a loss of approximately $930,000, while pensions produced a profit of over $17 million.

It is quite clear in this striking example that Prudential used at least some of its profits from its pension plan business to subsidize dividends to policyholders on ordinary life policies.

This is just a small preview of what Prudential and some of the other giants could do if they were given an extra $60 million a year to cut the throats of their competition in every other line of insurance activity.

Another leading pension-writing company is the Equitable Life Assurance Society. In 1957, it had a total gain of $11,300,000 on its pensions and only $10,250,000 on its ordinary life policies and yet the total premiums collected on ordinary life policies were 50 percent greater than the pension annuity premiums.

The Metropolitan Life Insurance Co., the largest company in the industry, nets almost as much on its group pension business—$21,680,000—as it does on its ordinary business—$24,867,000—on one-third of the total premium volume.

It is therefore clear that the so-called tax advantage enjoyed by trusteed plans has not impaired the ability of the pension-writing companies to hold and increase their business in this area.

Moreover, it is plain that the taxation of a small portion of the income from pension fund reserves is a minor item in the total competitive picture as between insurance companies on the one hand and trusteed plans on the other.

If the trustee is a bank or trust company, it makes a profit for its administrative duties and pays normal taxes on those profits. Trusteed plans must pay trustees fees and other costs of administration, which normally runs much higher than the cost of the same service rendered by an insurance company administering plans of like size.

The insurance companies writing participating pension policies have only to pay a minor increase in the policyholder's dividend to offset any net differential.

However, in the past the big insurance companies have apparently preferred to divert their huge pension plan profits into policyholders' dividends in more competitive lines or add them to accumulated surplus.

The fact of the matter is that any difficulty that insurance companies have had in competing with trusteed plans stem, not from the tax law, but from the relative freedom of the latter in their investment policy.

Life insurance companies are restricted by State law as to the various types of investments they can make and, by and large, are either prohibited or strictly limited as to holdings in common or preferred stocks.

Trustees, however, are not restricted by law in the investment of funds. Much of their money is invested in common and preferred stock. The increased yields and capital appreciation substantially cuts the cost of insurance. This inequality is not the concern of the tax law. Insurance companies must look to State law for relief in this particular.

The small life insurance companies of America, stock and mutual, are sincerely frightened at the use of the big pension-writers can, and most likely would, make of the proceeds from the superdeduct.

It is ridiculous and naive to believe that this windfall must or would be used to any substantial extent to reduce the cost of pension plans only.

As stated above, if the big companies had any notion of reducing pension costs, they could do so under their present high-profit structure. There is nothing in H.R. 4245 that conditions the grant of the superdeduct on the payment of increased dividends or premium reduction to pension plan employers.

In my opinion, the big companies can and probably would use this $60 million to reduce costs across the board in all lines of insurance with a view of driving all but the hardiest of their competitors out of business.

The delicate competitive balance of the insurance industry which rests on vitrual price equality would be totally destroyed. Small companies paying their full load of taxes would be faced with big company rates subsidized by tax-free money.

Thus, what the superdeducts accomplish is to substitute an insidious form of tax inequality for a relatively innocuous tax differential. Instead of the minor tax advantage that exists in favor of trusteed plans, which is probably more than offset by the higher administrative costs of the trusteed plans, the superdeduct proponents would substitute an important tax advantage in favor of large life insurance companies writing group annuities over small companies which do not engage in such business.

A life insurance company is a completely integrated underwriting and investment operation. It cannot be fragmentized into separate compartments. One cannot confer a benefit in one area and hope that its effect will not spill over into another.

While the small companies, for the most part, do not write pension plan business, they will suffer in the effects of the superdeducts in every area of insurance in which they engage.

As one who has been connected, as office boy, actuary, and executive, in the life insurance business for more than 23 years, and as one who believes that free competition is essential to the American economy, let me encourage you to substitute an investment-income approach that can apply fairly and equitably to all companies for this unfair bill.

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

Senator Kerr?

Senator KERR. Your last statement, Mr. Copeland, I take it, indicates that you think the tax bill should be changed to one to produce tax revenue only on investment income?

Mr. COPELAND. No, sir; I wouldn't limit the approach to investment income only.

Senator KERR. What is the meaning of the last sentence of your statement? Would you read that again from the last comma on?

Mr. COPELAND (reading):

> Let me encourage you to substitute an investment income approach that can apply fairly and equitably to all companies for this unfair bill.

Senator KERR. Does that not constitute a recommendation that we use this investment income as the source of revenues from the tap?

Mr. COPELAND. Yes, sir; without special deductions from pension plans or any other type of thing that would apply against one segment of business and not other segments.

Senator KERR. That is what I am asking, if you would recommend that we write this bill so as to tax investment income and investment income only.

Mr. COPELAND. Either that or make a large part of the tax revenue dependent on investment income; yes, sir.

Senator KERR. Isn't a large part of the revenue in this bill before us dependent on investment income?

Mr. COPELAND. From the companies that I have attempted to calculate on, I would say about 60 to 70 percent of the revenue produced by this bill would come from investment incomes; yes, sir.

Senator KERR. Is the representative of the Treasury here?

Give your name for the record.

Mr. SLITOR. Richard E. Slitor, tax analysis staff, Treasury Department.

Senator KERR. Phase 1 of the bill is for the purpose of taxing what?

Mr. SLITOR. It is for the purpose of taxing the net investment income which is in excess of the interest needed to meet policy and other contract obligations.

Senator KERR. Now, is there any true investment income other than that in excess of meeting obligations in connection with investments?

Mr. SLITOR. That is included in the tax base in step 1.

Senator KERR. Are there deductions in phase 1 producing investment income other than those in connection with the investments?

Mr. SLITOR. No, sir.

Senator KERR. Do you agree with that statement?

Mr. COPELAND. Not if the deduction for pension or group annuity is allowed because there is a very great area in there of tax-free interest that is not strictly allocatable to reserves, under the pension or under the group annuities that are now on the books.

Senator KERR. What amount of income is phase 1 calculated to produce?

Mr. SLITOR. Phase 1 is estimated to produce something over $500 million.

Senator KERR. Of a total of how much?

Mr. SLITOR. Of a total of roughly 550. So it accounts for approximately 90 percent of the total estimated yield of H.R. 4245.

Senator KERR. The 1942 act is existing law, isn't it?

Mr. SLITOR. Yes, sir.

Senator KERR. Mr. Witness, how do you feel about the 1942 act?

Mr. COPELAND. I would much rather see the 1942 act than H.R. 4245.

Senator KERR. Aside from rathers, how do you feel about it.

Mr. COPELAND. I believe it is an act that will produce for this country the income that this country wants. I think it is an act which will produce an income from insurance companies or a taxation from insurance companies which we can anticipate in amount and somehow lay in our ratemaking structures a great deal easier than we can with an act which will cause us in 1 year to pay large taxes and in another year have a loss, and which will run very uneven on small companies.

Senator KERR. Is the 1942 act basically an investment income tax——

Mr. COPELAND. Yes, sir.

Senator KERR. Are there deductions to which you refer possible under 4245 that are not possible under the 1942 act?

Mr. COPELAND. Those deductions could be placed in any sort of an act, but they are not in the 1942 act.

Senator KERR. They are not in the 1942 act?

Mr. COPELAND. No, sir.

Senator KERR. Do they account for 30 percent of the revenue that would be provided under the 1942 act?

Mr. COPELAND. I don't know, sir.

Senator KERR. You said that under phase 1 only about 60 percent of the revenue it produced would be what you referred to as true investment income or subject to tax. Isn't that what you said?

Mr. COPELAND. No, sir. Wait a minute, I don't think I made any such statement as that.

Senator KERR. What was the statement you made about 40 percent of the revenue not being tax on investment income revenue?

Mr. COPELAND. I believe I made the statement that of the revenue produced, I thought 60 to 70 percent or more would be produced under phase 1. The Treasury now says, a representative of the Treasury Department says, it is 90 percent.

Senator KERR. That is what the Treasury did say, and if you said that 60 or 70 percent of the total revenue under H.R. 4245 would be under phase 1, then I misunderstood you. I thought your statement was meant to convey the information to the committee that phase 1 does not consist of what you referred to as investment income that should be available to tax.

Mr. COPELAND. No, sir; phase 1 is very much investment income that should be taxed, in my opinion.

Senator KERR. Then is it your position that H.R. 4245 would be all right if it took phase 2 and phase 3 out of it?

Mr. COPELAND. That would be wonderful if you remove the deduction for group annuities.

Senator KERR. Where is that to be found?

Mr. COPELAND. That is in phase 1.

Senator KERR. Does that apply to stock companies at all?

Mr. COPELAND. Stock companies and mutual companies.

Senator KERR. In other words then the thesis of your remarks as I understand it is twofold.

Number one, life insurance companies that write group annuities—is that the same as a guaranteed or a trusteed pension plan?

Is that a similar thing?

Mr. COPELAND. It could or could not be. A pension plan may use——

Senator KERR. What are you referring to there in the last two lines?

Mr. COPELAND. What is that?

Senator KERR. You say the superdeduct proponents would substitute an important tax advantage in favor of large life insurance companies writing group annuities over small companies which do not engage in such business.

Now, what line of business, what classification of business, are you referring to there?

Mr. COPELAND. Group annuities which are the vehicles by which life insurance companies conduct pension business.

Senator KERR. I asked you if it was that field of operation and you said "No."

Mr. COPELAND. I misunderstood your question.

Senator KERR. I ask it again.

Mr. COPELAND. Group annuities are primarily pension plans insured in life insurance companies.

Senator KERR. And that is the field of operation with reference to which this current bill provides a termination of applicable tax.

Mr. COPELAND. That is right, sir.

Senator KERR. Now is that line of business open to any insurance company?

Mr. COPELAND. It is open to any insurance company, sir; but in order for a company to enter into that business, it is almost mandatory that the company be entered in many States in order to write the business involved.

Small companies hardly have the facilities for handling that business. They hardly have the assets and equipment and personnel to handle that business. It is a type of business that has been entered into probably by less than 100 of the larger companies to any extent.

Senator KERR. But there is no prohibition in any State laws against a company engaging in that business, is there?

Mr. COPELAND. There is not, sir.

Senator KERR. Don't big trust companies and little trust companies operate similar programs?

Mr. COPELAND. Yes, sir. I am sure they do, because they are writing a type of pension that they don't have to guarantee the corpus of the plan. They don't have to guarantee the income.

Senator KERR. Their experience has to be such that the beneficiaries have a reasonable expectation of the commitments' being honored or they would not stay in the business, would they?

Mr. COPELAND. Honoring a commitment is one of two sorts. One is to use best judgment and give you whatever I can produce from best judgment.

Senator KERR. If that didn't turn out generally as well for the fellow who puts up the money or the group for whose benefits is paid as those programs with the insurance companies, there would not be a situation where a larger and larger percentage of that business is going to trust companies, would there?

Mr. COPELAND. I am sure that the business will go toward the trust companies until such time as variable annuities are authorized to be issued by insurance companies. I have been in on many pension plan discussions——

Senator KERR. Is your recommendation one of authorization for a variable annuity?

Mr. COPELAND. Variable annuity has nothing to do with this type of problem.

Senator KERR. How did you happen to bring it in? I mean there is enough in this bill.

COPELAND. You asked did I think that more and more of the pension business would move from the insurance industry to the trustee plan?

Senator KERR. I asked you if the experience that people were having with the trust companies was not one to encourage and fortify confidence, how is it that a larger and larger percentage of the total of that business is moving or being handled, moving into or being handled by trust companies?

Mr. COPELAND. I think the feeling of a good many employers is that they would rather trustee their plans with a bank or their own trustee set up whereby they would have much more flexibility in investment of their assets.

If they wish to invest a little more in equity securities and stocks, both common and preferred——

Senator KERR. They wouldn't do that unless they thought the corpus was safe, would they?

Mr. COPELAND. I think so.

Senator KERR. You do?

Mr. COPELAND. Because there is nothing more variable in the world than a dollar. It goes up and down and sideways and every other way. I have worked on——

Senator KERR. Is that the reason so many people keep buying so much insurance which is payable only in dollars?

Mr. COPELAND. I think if you will examine the insurance industry you will find that a good part of our business is moving from the old forms of life and endowment insurance over to term insurance.

Senator KERR. But it is still dollars, isn't it?

Mr. COPELAND. It is paying off in dollars.

Senator KERR. Do they use a different dollar to pay the obligation under a term policy than they do under an ordinary life policy?

Mr. COPELAND. No, sir; but under an endowment policy——

Senator KERR. How could the argument be valid with reference to the value of the dollar against one unless it was against the other in view of the fact that it is the same dollar?

Mr. COPELAND. I think insurance companies are losing a good part of their pension annuity business and I think we are losing a good part of our endowment business because a man desiring——

Senator KERR. The companies you refer to here as being discriminated against are not losing more and more of the business they don't have any of, are they?

Mr. COPELAND. I am speaking of the industry as a whole. You asked basically was there a movement——

Senator KERR. I didn't ask was there; I asked how could there be unless those going to the trust companies had confidence in the integrity and validity of the commitments that were being created by giving them the business? I didn't ask if there were. The record is that there are.

Mr. COPELAND. I am sure of it. Yes, they have confidence in the abilities of the trust to handle their funds, just as much as they have for insurance companies to handle their funds.

Senator KERR. Well then how can you talk about their disadvantage that they are handling it isn't in such a way as to give the assurance of honoring the committees?

Mr. COPELAND. They are honoring the commitment, the commitment being to take the money, invest it, and return the corpus, except that the trustees in the banks are able to invest more moneys in common stocks and equity securities which will ride up with the devaluation of the dollar if you want to call it that, so that in purchasing power there is a larger return than the insurance company can give, granting only fixed dollar benefits.

That is the corpus plus a guaranteed rate of interest.

Senator KERR. If the situation is such then that insurance companies are losing that business under the environment they have to work, is there not justification for the position that the environment should be improved so that they wouldn't be competitively at a disadvantage and in a situation of the shrinking of that business? If that is true, how is it that the future holds such a terrible portent for some phases of the industry not in this business which is shrinking out anyway?

Mr. COPELAND. I think that business is shrinking percentagewise, that is the percentage of the total that is being held by insurance companies against that part which is being held by trustees. But the insurance companies themselves are experiencing gains in that business.

Senator KERR. Now what kind of gains did they experience?

Mr. COPELAND. Gains in volume of that particular business on their books year after year.

Senator KERR. Did you hear the witness that I was questioning here this morning about whether or not the gains an insurance company made in that field belonged to the insurance company or to those for whom the trust was established?

Mr. COPELAND. Yes, sir; I did.

Senator KERR. How did you understand him to answer that question?

Mr. COPELAND. He made the statement that both stock companies and mutual companies would return to the employer the principal in event of a termination, the principal, the guaranteed interest thereon and any profits that the company might have made on that particular group.

Senator KERR. Now, is that a correct statement?

Mr. COPELAND. I assume he made that statement in all honesty; yes, sir; and I assume he knows quite a bit about the business.

Senator KERR. If they do return the profit to the beneficiaries, then is not a tax on that profit a tax against the beneficiary and not against the company?

Mr. COPELAND. He is speaking of investment profits, I am sure, because most of the——

Senator KERR. What are you speaking of? I thought we were talking about the profit on the trusteed fund; is that correct?

Mr. COPELAND. If I have available to me as an employer the option to take either an insured group or trustee my own plan, and assuming I have a large enough group to trustee my own plan, the actuarial requirements of that plan are fixed either way at, say, $100,000 as being the cost of the benefits per year, I must add to that cost, if I go to the insurance plan, an additional 8 percent for administrative expense or 7 percent. That is loading.

Senator KERR. Is that of the principal or the income?

Mr. COPELAND. The annual premium, the annual amount contributed into the plan. That is the loading that the insurance company takes. That is where they get their expenses and that is where they get their profits.

Senator KERR. Does anybody handle it without getting their expenses?

Mr. COPELAND. No, sir. If, on the other hand, I go to a trustee, a trustee is going to charge me an administrative fee for handling my moneys, normally about one-half of 1 percent a year, which by the way is roughly equivalent to the tax on that pension income provided that the tax on the income on pension, provided the company is making about 1 percent over the guaranteed rate on the investment, plus the trustee plan.

The employer must employ actuaries, lawyers, and other people to keep his plan qualified. The ultimate cost of the two plans as far as the employer is concerned, that is his cost on the one hand against the insurance company loadings on the other are not going to be too far apart.

The only difference that I can see between the trusteed plan and the insured plan is that under a trusteed plan two of three things happen to make it attractive.

No. 1, it can invest in equity securities.

Senator KERR. They can go down as well as up, can't they?

Mr. COPELAND. That is all right. The employer would rather pay off in purchasing power dollars than in hundred-cent dollars in many cases.

Another thing that is causing the movement toward the trusteed plans is where the labor unions are involved. The labor unions would rather have three members on a 6-member board where they have some control over the money. If insurance premiums are paid, then the control on the money is fairly well lost.

Senator KERR. Aren't you describing to me a situation where the competition is between those in the insurance business issuing insured pension plans and trust companies handling trusteed fund plans or pension plans?

Isn't that where the competition is?

Mr. COPELAND. There is competition there, but whatever little tax is involved on the insurance companies reserves on those plans is one of the most minor items involved in the competition.

Senator KERR. But isn't the competition between the insurance companies and the trust companies, that is the insurance companies engaged in those programs?

Mr. COPELAND. Yes; there is competition there.

Senator KERR. If you have a right to do that and don't choose to do that, then is it a situation where you taking the position that you are not against the combine because it is wrong but just because you ain't in on it?

Mr. COPELAND. No, sir. I am against the relief of investment income from taxation on pension reserves for one reason and one reason only. The thought seems to be today that there shall be a certain tax placed upon the insurance industry as a whole.

Senator KERR. But you don't agree with that?

Mr. COPELAND. I do agree with that.

Senator KERR. You have just said that you did not believe in anything but the investment-income approach.

Mr. COPELAND. Regardless of what the approach is, there seems to be an amount of money which the Federal Government wants——

Senator KERR. I am talking about your position. You have taken the position that you are against attacks on underwriting profits.

Mr. COPELAND. I am not against attacks on underwriting profits if——

Senator KERR. Is that in the investment-income approach?

Mr. COPELAND. No, sir.

Senator KERR. I thought you had covered that to begin with and you said that was correct, what you said in this last sentence.

Mr. COPELAND. I said I favored that approach.

Senator KERR. That is what I am asking you.

Mr. COPELAND. I would not oppose another approach which gave these insurance companies a fair chance to recover some of the investments that they have to put into this production of business prior to January 1, 1958, which we must recover under a 48-cent dollar.

Senator KERR. Isn't phase 2 of this bill a tax on other than investment income?

Mr. COPELAND. Yes, sir; it is.

Senator KERR. But you say you would take every bit of that out? Isn't that what you said a while ago

Mr. COPELAND. I would be very happy to see it go out, but I would not be opposed----

Senator KERR. Then if you want that out, are you now telling me that you still favor it?

Mr. COPELAND. No, sir. I would want it out. I would not be opposed to it coming on, on some graduated scale which will let the companies get back some of the investment they have in first year premium without having to pay a tax on the recovery of the capital that we have placed in that business.

Senator KERR. But you are not against the principle of it. You are just against the way that it is put into effect?

Mr. COPELAND. The immediate application of it, yes,sir.

Senator KERR. Now do you want it postponed subsequently, or indefinitely?

Mr. COPELAND. A graduated scale would be acceptable, I think, to most of us.

Senator KERR. Then your position No. 1, is that you favor phase 1 with the one exception you have mentioned?

Mr. COPELAND. Yes, sir.

Senator KERR. You favor phase 2 if it is made applicable gradually instead of instantly?

Mr. COPELAND. I would rather see phase 2 made all phase 3 if we had our "druthers."

Senator KERR. I wish you wouldn't jump around.

Mr. COPELAND. You are asking for opinion, sir, or a preference?

Senator KERR. I do and you have given me one and then I asked you another and then you shift, and that is all right, that is your privilege, but I must say to you that in writing this bill the committee can't do that. You see when we get ready to do whatever we are going to do to this bill, we have got to put it down and then we have got to stand on it.

Mr. COPELAND. I am sure of that, sir.

Senator KERR. It would seem to me that for your evidence to be the most beneficial, that it should be done on the same basis. Now do you or do you not favor phase 2 if it is made applicable gradually instead of effective at once?

Mr. COPELAND. I would favor it, yes, sir.

Senator KERR. And then what about phase 3?

Mr. COPELAND. I would favor it.

Senator KERR. That is all.

The CHAIRMAN. Senator Carlson?

Senator Talmadge?

Senator TALMADGE. Mr. Chairman, I am sorry I wasn't here when the witness began his testimony. He happens to be an old classmate of mine from the University of Georgia.

Mr. Copeland, we have heard considerable testimony before this committee that these pensions plans have not been very profitable.

Many of them have testified that the competition with the trust companies has been such that the business has been gradually leaving the insurance companies and going to the trusteed plans.

You state, referring to the Prudential Life Insurance Co.:

> After dividends to policyholders the ordinary life business showed a loss of approximately $930,000 while pensions produced a profit of over $17 million.

What is the source of your information on that?

Mr. COPELAND. The "Best's Life Insurance Reports of 1958."

Senator TALMADGE. In other words, the profit that Prudential made was on this particular pension business.

Mr. COPELAND. The group annuity business, yes, sir.

Senator TALMADGE. Proceeding further:

> Another leading pension writing company is the Equitable Life Assurance Society. In 1957 it had a total gain of $11,300,000 on its pensions and only $10,250,000 on its ordinary life policies. Yet the total premiums collected on ordinary life policies were 50 percent greater than the pension annuity premiums.

Is that also taken from Best's?

Mr. COPELAND. Yes, sir.

Senator TALMADGE. Proceeding further:

> The Metropolitan Life Insurance Co., the largest company in the industry, nets almost as much on its group pension business, $21,680,000, as it does on its ordinary business, $24,867,000, one-third of its total premium volume.

Is that also taken from Best's?

Mr. COPELAND. Yes, sir.

Senator TALMADGE. So your assumption is that this pension business is profitable and there is no reason why they should not pay taxes on it?

Mr. COPELAND. It is profitable enough to where I don't see why some very minor percentage of profit, of excess interest, shouldn't be used in the tax base.

Senator TALMADGE. Your principal argument is that the large companies apply these large profits into the general operations of the company and further the competition on writing a single annuity would make it untenable or unprofitable for a small company to compete with them?

Mr. COPELAND. No, I don't think small companies are set up personnelwise. I don't think the small companies have the financial strength. I don't think small companies have any business in the pension business.

Senator TALMADGE. What I am trying to get you to answer now is what competitive advantage is the 2 percent factor which you are asking us to strike out of this bill going to give a company like Metropolitan Life over your company, Progressive Life?

Mr. COPELAND. The competitive advantage comes from the fact that the pension reserves of these companies are probably based on an assumed interest of 2 percent or 2¼ or 2½ percent. That the assets of the companies are earning 3½ percent or some higher figure than the assumed interest.

The exemption simply says that that portion of the companies' assets which represents pension reserves shall not be considered at all and the income of that shall not be considered at all when it comes to establishing a tax base on investment income.

There is no commitment of the company to pay the excess interest earned on those particular reserves back to the employer either in a stock or a mutual company.

My contention is that that is extra interest earned over and above the assumed interest or the differential between the interest assumed in those annuities and the industrywide average interest, or if there is any differential allowed in there, that that interest becomes available as a slush fund to use for other purposes, for increasing the dividends on ordinary policies or for lowering rates on ordinary policies or other lines in which we are competing with them.

Senator TALMADGE. The assumed interest rate, which you are referring to is in phase 1 of the bill, is it not?

Mr. COPELAND. Yes, sir.

Senator TALMADGE. Do you know from your knowledge of Best's report what Metropolitan's assumed rate is?

Mr. COPELAND. I can look it up.

Senator TALMADGE. Would you do that please, for the record?

Mr. COPELAND. Best's quotes that the reserves on new policies issues are calulated on the commissioner's standard ordinary mortality of 2½ percent interest valued on a net level premium method.

Senator TALMADGE. Then the company assumed rate is 2½ percent, is that correct?

Mr. COPELAND. Whether that applies to their group annuities or not, I don't know. I imagine it would or some lower rate would.

Senator TALMADGE. I was saying, as I understand your testimony——

Mr. COPELAND. Here it is. Annuities, they have some at 2 percent, some at 2¼, some at 2½, some at 2¾, and some at 3. The bulk seems to be at 2½ percent.

Senator TALMADGE. Fine.

Would not their assumed rate be approximately 2½ percent according to your best judgment?

Mr. COPELAND. That's right.

Senator TALMADGE. What was the company earning rate for 1958?

Mr. COPELAND. 1957 according to Best's, they show separations on bonds, stocks, and real estate. On bonds they made 3.63, on stocks they made 4.74, and on real estate 3.75.

Senator TALMADGE. Do they have an average?

Mr. COPELAND. I don't see that there is any average given.

Senator TALMADGE. Could you look and tell us approximately what it is?

Mr. COPELAND. Approximately two-thirds of the assets in bonds and it gives bonds as 3.63. The other assets seem to be at a higher yield, so I would assume that the average yield is something higher than 3.63.

Senator TALMADGE. Would you say 4 percent?

Mr. COPELAND. Not that high.

Senator TALMADGE. 3.85?

Mr. COPELAND. 3.85, or 3.9, something like that.

Senator TALMADGE. 3.85. Now what was the industry assumed rate of earnings last year?

Mr. COPELAND. I believe the man from the Treasury Department can give that answer better than I could.

Senator TALMADGE. Could you tell us what the assumed rate, for tax purposes, under this bill was last year?

Mr. SLITOR. The industrywide assumed rate?

Senator TALMADGE. Yes.

Mr. SLITOR. Will be between 2.75 and 2.80 percent.

Senator TALMADGE. 2.80?

Mr. SLITOR. The average industrywide assumed rate will be very close to 2.80 percent.

Senator TALMADGE. Could you take those figures and tell us what advantage if any Metropolitan would have in conjunction with your argument over other companies on this tax bill?

Mr. COPELAND. If they are assuming 2.5 and they are earning 3.8 say or to make it easy 3.7, they are picking up 1.2 percent on their annuity reserves. They have roughly $1,500 million of annuity reserves and they would be picking up 1.2 percent, about $18 billion.

Senator TALMADGE. Now will you tell us how that affects pension plan tax? You are asking us to strike out this 2 percent deduction as I understand it?

Mr. COPELAND. No, sir; I was asking that the strikeout be the removal of the exemption from the tax base of phase 1, the investment earnings on pension reserves.

Senator TALMADGE. I thought you said they were using these pension reserves, if they wer tax free, as a basis for competition and I was trying to discover what advantage if any there would be to them under this formula?

Mr. COPELAND. It would grant them $18 million.

Senator TALMADGE. Of tax free reserves?

Mr. COPELAND. Of tax abatement. It would grant them that much surplus increase that they would not have, had the investment incomes on pension or group annuity reserves been subject to the same tax as life insurance reserves or any other kind of reserves.

Senator TALMADGE. Is that the basis of your argument against this particular part of the bill?

Mr. COPELAND. Yes, sir; that is the basis for my argument.

Senator TALMADGE. Do I understand you correctly when you say that it gives them a competitive advantage not in the field of pension business but in the total field of insurance, which they will use as a tax advantage?

Mr. COPELAND. I would say that if they had $18 million of profits or $18 million less tax to pay by virtue of this deduction, that the $18 million could well be spread around to other things, it is certainly not necessary that it be put right into a return to employers. It is not necessary that anything be done with it. There is no policy commitment or rule that governs where the thing goes.

Senator TALMADGE. I have no further questions, Mr. Chairman.

The CHAIRMAN. Senator Butler.

Senator BUTLER. No questions.

The CHAIRMAN. Thank you very much, sir. The next witness is Mr. Leonard H. Savage, Standard Life & Accident Insurance Co.

Senator KERR. Mr. Chairman, Mr. Savage is one of the ablest citizens of Oklahoma. He is a very valuable constituent of mine and I am happy to say to this committee that he is an outstanding individual with great experience and in my judgment his opinions are worthy of very serious consideration and I am happy to present him to this committee.

## STATEMENT OF LEONARD H. SAVAGE, STANDARD LIFE & ACCIDENT INSURANCE CO.

Mr. SAVAGE. Thank you, Senator. My name is Leonard H. Savage. I am president of Standard Life & Accident Insurance Co. of Oklahoma City, Okla.

We write both participating and nonparticipating life insurance and now have in force in excess of $230 million. There are 25 similar life insurance companies in the State of Oklahoma, some larger and many smaller. We are all in substantial agreement as to our position with reference to this bill.

Much has been said during the course of these hearings about the burdens of taxation. If you will bear with me, I shall tell you our story based upon 1958 operations. Before payment of State gross premium taxes and Federal income taxes, our company had an operating income of $442,000. What has happened to that $442,000? We have paid, or will pay $238,466 in State premium taxes. We have set up a reserve liability item in our statement of $96,570, representing our estimate of what our income tax liability will be for 1959. Out of our net operating income before State and Federal taxes, of $442,000, we therefore have left the sum of $106,964 out of which to pay dividends to stockholders and increase our surplus to policyholders. In the meantime, our life insurance in force has increased more than $50 million.

This $106,964 of course is wholly inadequate to pay any return on our investment and add a reasonable amount to our policyholders surplus.

The first point I should like to raise has to do with subparagraph (3) of paragraph A, section 815. This relates to distribution to shareholders and is concerned with phase 3. It provides that the term "distribution to shareholders" shall be treated first as paid out of the shareholders surplus account to the extent thereof, then out of the policyholders surplus account to the extent thereof, and then out of any other account.

It then says that the distribution referred to, that is distribution to shareholders, includes any distribution in redemption of stock.

This is important because it means that if a company has preferred stock or a special class of stock which is subject to redemption and is redeemed and which was not necessary for organization, the full amount thereof is to be treated as coming first out of shareholders surplus and then out of policyholders surplus as defined in the bill.

In other words, that part which is paid out of the policyholders surplus is taxable income and subject to a 52-percent tax. This would be true in spite of the fact that the corporation is paying back the exact amount it received when the stock was issued.

We feel this arrangement is unfair. I cannot believe there is any intention of placing an income tax on a transaction of this kind.

I have in mind a specific example where a company issued a special class of stock for the sum of $500,000. This was done in order to put up reserves on business acquired through reinsurance. At the present time the $500,000 is not needed in the surplus of the company; however, under this bill, if that money should be repaid by redemption of the stock, although this company will be returning only the money that was received by it from the sale of the stock, a substantial tax will be incurred, as there no doubt will be earnings this year out of which a policyholders surplus as defined by this bill, will be created.

The tax will be 52 percent of whatever amount comes out of policyholders surplus. It could possibly amount to $260,000.

If the surplus should develop in that fashion, that is.

Now the example mentioned is not an unusual situation. The laws of many States provide a method by which contributions to surplus may be made. When the contributions are no longer needed, the company is permitted to repay them.

Generally the law will require that such contributions to surplus may be repaid after the company has accumulated a capital and surplus of a specific amount.

This is a vehicle by which small companies can acquire additional surplus to expand or to restore losses from excess mortality, investments, or other reasons, without selling additional stock. Generally, one or two stockholders will make such contributions.

Under the provisions of this bill, the repayment of such contributions cannot be made out of existing capital and surplus funds without first exhausting the stockholders surplus and then the policyholders surplus as defined by this bill.

I believe any capital funds in excess of the amount used for organization, paid in or contributed by stockholders, or others, should be available for repayment to them when such a stock, or stockholder contributed surplus, is no longer deemed necessary for the protection of policyholders and that it should be done without incurring any additional obligation.

In view of the foregoing, it is our recommendation that a provision be placed in the bill, if phase III is continued in it, which will permit a company to repay capital and also surplus contributions in excess of the amount used for organization, without the imposition of any tax thereon, when management feels such funds are no longer needed in the company.

This may be done by adding such funds to the shareholders surplus.

Secondly, we believe that if H.R. 4245 becomes a law, phase II should become effective gradually over a period of 5 years.

It is our suggestion that if this bill is to become a law, that only phase I be applicable for 1958 to companies actively engaged in the general life insurance business, or as an alternative, the 1942 act apply to 1958. In either event the income raised would be approximately the amount desired.

It is our further suggestion that 20 percent of any tax payable under phase II be paid on 1959 income; 40 percent in 1960, and increasing 20 percent each year until 100 percent has been reached at the end of the fifth year.

This recommendation is very similar to the suggestions made by the Secretary of the Treasury last year in his letter to the chairman of the House Ways and Means Committee and the chairman of this committee, relating to the new approach for taxing life insurance companies.

It will make it possible for the smaller companies to adjust their operations to meet the additional burdens imposed by this bill. Generally, a small company can fairly well estimate what it might expect in the way of net income in any given year if it has been in operation for several years.

If a stock company is increasing its business, management naturally is aware that it is desirable to increase the policyholders surplus in accordance with the increase in business. If a small company has geared itself to a certain level of operation based upon one tax concept, it requires a very substantial change in operation to readjust to a radical change in tax concept such as is provided for in this bill.

What I mean may be reduced to rather simple terms. If we expect to increase our life insurance in force during a given year in the amount of $50 million, we would expect to increase our surplus to policyholders by at least $200,000.

If we are confronted with an additional increase in taxes of 50 percent or more, as are most stock companies under this bill, then an immediate readjustment is necessary to maintain a satisfactory ratio of capital and surplus to business in force.

If this suggestion should be followed, admittedly the major benefit will go to the stock companies.

There would not be a substantial reduction in income to the Government, as the estimate of the total tax produced by phase II is only $40 million.

This plan is needed by the Oklahoma companies and many other small companies that may now be in a position to pay some tax under phase II. This type of an arrangement will be fair and will permit them to cushion the shock of this great increase in income taxes.

In addition to the need for a transitional period for companies now in the black, or that have a chance of getting in the black at an early date, there is still a greater need for a transitional period for those companies not yet in the black. It is common knowledge that a new life insurance company operating in a normal way is facing a severe competitive situation in the business. By the nature of the business, early acquisition costs are exceedingly high. It therefore does not have a chance of getting on a break-even basis in 5 years and in most cases it cannot be done in 10 years without almost unlimited capital and surplus.

In Oklahoma we have had a number of companies organized in the last 5 years. Without exception, all of these companies that are actively engaged in the life insurance business, have lost money from the beginning, and 90 percent of them will continue to do so for years to come. Under this bill, the losses already incurred by these companies cannot be carried forward. However, the companies that may be able to get into the black this year, next year, or during the next 5 years, will be given some relief as a result of the transitional period of 5 years in phase II if it should be adopted as I have suggested. It will enable them to partially restore their surplus to policyholders without incurring a burdensome income tax under phase II.

The industry figures indicate this bill, if enacted in its present form, will raise approximately $560 million in taxes. We feel the total amount should be reduced to not to exceed $500 million. This committee has before it many suggestions and will have many more, as to how the bill might be changed to bring about this reduction. Each interested group, of course, is suggesting that the savings, if any, be primarily to its own benefit and I might add that in this connection, I do not claim to be an exception.

It is agreed by all parties concerned that this bill provides for an increase of at least 70 percent in income taxes on the life insurance industry. It is also agreed that under the present stopgap law, the mutuals pay 75 percent of the tax and the stock companies 25 percent. According to the information we now have, if the proposed bill in its present form becomes a law, or which was the law prior to this year, the mutuals pay 75 percent of the tax and the stock companies pay 25, the amount to be paid by the mutuals will be reduced to 69.3 percent, with the stock companies paying 30.7 percent; therefore, percentagewise, a substantial increase on the stock companies. Now what are the particular features of this bill that have brought this situation about? First and most important, is the provision that eliminates the tax on investment income of pension trusts. The amount of this reduction over a period of 3 years being $60 million and practically all of it going to the mutuals and a few large stock companies.

Primarily, this same group that will benefit most by this pension trust windfall has suggested four other changes in the bill, all of which will increase the percentage of tax on the stock companies and reduce the percentage to be paid by the mutuals. Should the 5-year average proposal on investment income be placed in the bill, the stocks would then pay 32 percent of the tax and the mutuals 68 percent.

The companies getting the benefit of the windfall on the pension trust exemption are still asking for more by asking that the profits on pension trusts be excluded from income, as well as investment income from surplus that might be allocated to the pension trust business. This would work to the further profit of the mutuals and against the stock companies. This group further requests that they be given credit for dividends paid to policyholders under phase I, when they have no tax payable under phase II. We feel their arguments in this connection are fallacious. The only reason most of them are not taxable and will not be taxable under phase II is because they are returning part of their profits to their policyholders. It is entirely logical and proper that those profits should not be deductible under phase I.

Contrary to what a number of our mutual friends have said, there is no contractual obligation to pay any particular part of their profits from operations and profits from excess premiums to their policyholders. This is a matter that is determined each year by the board of directors just exactly like dividends paid to stockholders are determined.

We oppose, and the Oklahoma companies generally oppose, that part of the bill that excludes investment income on pension trusts from taxable income. Our information does not indicate that the situation is as these companies claim. We do not find upon investigation that the small employer is being penalized at this time.

The people in this business themselves admit that they are in it for a profit. True, they cannot compete with the banks for this business, in some situations, and the situation with respect to competition will not be materially changed if this provision stays in the bill and becomes a law. It will only mean they will have their tax reduced on business they now have and in which they are engaged for a profit.

It is our opinion that if this provision stays in the bill, that as a result of it, the tax on those of us who are not in the pension trust business will be increased 13.5 percent. It is just simple arithmetic to us. A certain amount of money has to be raised. What one group avoids, another must pay. We will assume there is a goal to raise $500 million in taxes from the life insurance companies. If $60 million is taken off of this $500 million by the exemption of pension trusts, that amounts to 12 percent of the goal, leaving $440 million. Those who pay the $440 million must have their taxes increased 13.5 percent in order that the Government will then receive a total of $500 million. We feel that if our tax is $100,000 now, then by this exemption our tax automatically goes up to $113,500 and all other companies will be increased in proportion unless they are the recipients of a part of the windfall resulting from the exemption of income on pension trusts. In addition, we feel that this exemption is discriminatory and puts the smaller companies at a greater competitive disadvantage than they are in at the present time.

We strenuously urge that no amendments be made to this bill that will put the mutuals in a more advantageous competitive situation. We respectfully submit that the bill is now discriminatory in favor of the mutuals and that such discrimination should be eliminated.

We feel that the bill is discriminatory against the small companies because it puts them in a competitive disadvantage with the large companies. We urge that the 10-percent deduction for additions to nonparticipating business reserves be increased to 12 percent. Our information is that this will be a fair adjustment and offset the advantages the mutuals have because of their excess premium charges.

We urge that this bill be amended to provide for a transition period under phase II so that it will not become fully effective until the fifth year. That the tax accruing under this phase be payable on the basis of 20 percent thereof in 1959 and increased the same amount each year until 100 percent is reached the fifth year. This will reduce the impact on the smaller companies. They cannot protect themselves by adjusting dividends to policyholders. It will permit those companies that have lost money in getting started to partially restore their policyholders surplus without such a terrific tax burden.

For the same reasons, the period to carry forward losses should be extended to 10 years because of the special nature of the life insurance business.

All companies should be permitted to redeem capital or surplus contributions in excess of the amount required for organization without incurring additional taxes. This is merely repayment of capital funds acquired for special use and there is no logical theory by which such repayment should be taxable.

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

Senator Kerr.

Senator KERR. Mr. Savage, you said:

> This recommendation is very similar to suggestions made by the Secretary of the Treasury last year in his letter to the chairman of the House Ways and Means Committee relating to the new approach to taxing life insurance companies.

Would you put a copy of that into the record?

Mr. SAVAGE. Will I?

Senator KERR. Yes.

Mr. SAVAGE. Yes, sir; I will.

(The information referred to follows:)

APRIL 10, 1958.

MY DEAR MR. CHAIRMAN: In our letter to you of January 10 concerning temporary legislation for the taxation of life insurance companies, the Treasury indicated that it would propose a method for more permanent legislation in this field. In accordance with this and subsequent statements made in the public hearings of the House Ways and Means Committee on various tax legislative matters January 16, and before the Senate Finance Committee on the stopgap extension legislation March 5, there are submitted for your consideration suggested approaches to the taxation of life insurance companies.

In developing these recommendations for a more permanent basis of taxation, we have approached the task with full recognition of the difficulties in this complicated area, which stem in part from the complex nature of the life insurance business as conducted on the level premium basis. We are also aware of the fact that we are dealing with institutions which are the custodians of the life insurance protection and savings of millions of American families.

The problem of developing a satisfactory long-range basis of taxation for the life insurance industry is not a new one. The problem has resisted solution since 1947, when the then-applicable formula, adopted in 1942, resulted in no tax whatsoever on the life insurance business, and was replaced by a series of stopgap formulas. You are familiar with the resulting extensive legislative history in this area and the long study which has been given to the question by your committee and the Congress over these years.

A subcommittee of the Ways and Means Committee on the taxation of life insurance companies was established in 1949 which conducted studies and recommended stopgap legislation, deferring a permanent solution of the problem to a later date. The temporary legislation subsequently adopted, termed the "1950 formula," was applied only to 1949 and 1950 income.

In 1951, further stopgap legislation was enacted, converting the reserve and other policy liability deduction under the 1950 formula into a reduced rate of tax on net investment income without deduction for required interest. The 1951 method was extended from year to year through 1954.

Late in 1954 extensive studies and hearings were conducted by a subcommittee of the Ways and Means Committee, leading to the adoption of the present law. This provided a reserve and other policy liability deduction of 87½ percent on the first $1 million of net investment income and 85 percent on net investment income in excess of $1 million. The 1955 law also provided certain structural improvements, including a broadening of the net investment income base, the correction of certain abuses, and a more adequate treatment of the health and accident business of life insurance companies.

The 1955 formula was originally made applicable to 1955 income only, subject to the provision that the 1942 formula would reapply automatically in any year if there were not an extension. The 1955 formula was subsequently extended to 1956 and more recently to 1957 income.

The Treasury has reviewed carefully the facts, issues, and alternative approaches developed in the course of these past deliberations. You are cognizant of the staff work which the Department has conducted cooperatively with the congressional tax staffs, and for a considerable period in 1955 and 1956 in consultation with a group of distinguished actuaries whose services were made available by the life insurance industry to the Treasury. While the technical assistance of these actuaries has been invaluable to our work, they do not, of course, have any responsibility for the policy suggestions which have been developed from it.

On the basis of our review and study, it seems evident that there are certain inadequacies in the present method of taxing life insurance companies. The present method does not recognize sources of net income other than investment income. Furthermore, it utilizes an averaging system, whereby the net taxable income of a life insurance company is measured by reference to an arbitrary or industrywide standard of interest deductions, not by the actual experience and requirements of the individual company.

Two possible solutions are presented herewith. The method of taxation to which it is suggested the committee give first consideration would provide a long-range basis of taxation for life insurance companies bringing their taxable income concept into closer conformity with that of other corporate business. Such a concept should be designed to reflect, to the fullest extent practicable, the full net earnings of life insurance companies. It should at the same time provide comprehensive deductions for all expenses, interest, and reserve requirements, and all amounts paid or made available to policyholders.

We suggest that the starting point for measuring the net earnings should be the figure for "Net gain from operations after dividends to policyholders" which appears in each company's annual statement to the State insurance departments and which summarizes the operating results for the year. This figure is based on carefully developed life insurance accounting practices which have general acceptance in the industry. Adjustments, such as those for tax-exempt interest, Federal income taxes paid, and depreciation on the insurance business property account, would conform it with general rules for computing taxable income.

The resulting tax base would include the margin of investment income above amounts needed on policy reserves, gain from better than assumed mortality experience, and profit arising from the difference between the expense "loading" portion of premiums and actual expenses. Deductions would be allowed for all dividends paid to policyholders and amounts added to policy reserves.

Under this suggested method, life insurance companies would be entitled to net operating loss carryovers. To assure the best possible long-range measurement of life insurance company earnings and to preclude taxing annual amounts which are not true net earnings because of uneven experience, a longer loss carryback provision should be provided for life insurance companies than for other corporations, ranging up to 10 or 20 years.

Consideration may also need to be given to some kind of special allowance or relief feature for small and new companies. Such a provision might be designed to recognize the special problems of the growing company. For example, a deduction might be allowed of 50 percent, or some other fraction, of amounts up to some specified amount retained by a company as contingency reserves for the protection of policyholders.

Provision should be made for a gradual transition to the new method over a 3- to 5-year period. During this transition, the tax would be computed as a weighted average of the tax under the new method and the tax under the present stopgap method, with gradually increasing weight to the new method.

The taxation of life insurance companies inevitably raises the question of its possible impact on policyholder savings, benefits and insurance costs. The tax base discussed above would exclude all amounts paid to, or set aside irrevocably for the benefit of any policyholder or group of policyholders. It would exempt additions to policy reserves including interest thereon; all cash insurance benefits made available to policyholders or their beneficiaries; and all policy dividends or similar rebates paid or refunded to policyholders.

In our studies and discussions with the consultants made available by the life insurance industry, we have given attention to possible adjustments in policy reserves and related items for tax purposes. The objective of such adjustments would be to take account of, or in some cases to neutralize, the effect of different methods of reserve valuation, varying reserve interest assumptions, past and future reserve strengthening operations, and certain other factors.

We believe that there is substantial merit in an adjustment for companies with reserves based on a preliminary term method of valuation. Such an adjustment would compensate for the fact that in the case of a company using a preliminary term method the addition to reserves on new business in the first policy year is substantially smaller than for a company which uses the net level premium valuation method.

Another adjustment which appears to deserve favorable consideration is one which would take account of deficiency reserves in existence on the effective date of the suggested plan. These particular reserves may be considered equivalent to an allocation of previously accumulated surplus, and in this light their recovery back into surplus would not constitute current earnings which should be subject to tax.

At this time we have no recommendations for or against other specific reserve adjustments. We recognize, however, that other possible refinements and modifications, including contingency reserves, adjustments for reserve strengthening, and special allowances for some segment of surplus, merit further review in the light of the expert views and comments of members of the life insurance industry which will be made available in the course of your future deliberations. However, every departure from the allowance for policy reserves used in determining the net gain from operations reported in the annual statement to the State insurance departments would represent a complication which could be justified only by persuasive equity and technical considerations.

The Treasury is fully aware that problems exist with respect to the plan just discussed. It will, of course, increase the tax paid by some companies, just as it will relieve others, resulting in shifts in burden as compared with the present stopgap method. This is inevitable in a change from a tax based on an industrywide formula to a tax based on the income of individual companies. Another problem is that the suggested method may result in a changed approach to policy reserves in order to reduce or eliminate tax.

We do not minimize the difficulties which your committee may encounter in its evaluation of the plan. Accordingly, you may wish to consider an alternative more in line with the present method of taxation of life insurance companies which will, nevertheless, make tangible improvements.

In this event, we suggest that you consider modification of the present law which will increase the portion of investment income subject to tax to accord more closely with the prevailing margin of investment income above required interest for policyholders, which margin is now about 30 percent for the industry as a whole. Such a revised formula should not only bring the deduction for interest needs into closer line with the current situation, but should also be responsive to future changes in industry conditions from year to year. Consideration should be given to a further refinement of the present type of special interest deduction for companies with substantially less than the average margin of investment income.

A second modification of the present formula which the committee might consider is one which would assure a more reasonable tax on those companies with relatively small amounts of investment income and substantial earnings from insurance or underwriting sources, now entirely exempt from taxation. It is suggested that this might be made effective by means of a minimum tax provision, which would require that the tax should not be less than the liability computed at regular corporate tax rates on a specified proportion of the net gain from operations after policy dividends.

Whatever tax formula is applied to the ordinary income of life insurance companies, their capital gains and losses should no longer be disregarded for tax purposes.

A fair and more lasting method of taxing life insurance companies to replace the series of temporary formulas will fulfill a long-standing need in our tax structure.

Sincerely yours,

ROBERT B. ANDERSON,
*Secretary of the Treasury.*

Senator KERR. I believe that is all, Mr. Chairman.

The CHAIRMAN. Are there any questions?

(No response.)

The CHAIRMAN. Thank you, Mr. Savage.

The next witness is Mr. A. M. Walker of the National Insurance Association.

Mr. WALKER. Thank you, Mr. Chairman.

## STATEMENT OF A. MACEO WALKER, APPEARING FOR THE NATIONAL INSURANCE ASSOCIATION; ACCOMPANIED BY N. H. BENNETT AND JESSE HILL, JR.,

The CHAIRMAN. You may proceed.

Mr. WALKER. First, I would like to thank The First Pyramid for relinquishing their time to us.

My name is A. Maceo Walker. I am president of the Universal Life Insurance Co., our home office is in Memphis, Tenn. My appearance here is in behalf of the National Insurance Association. I have with me the actuaries of two of our member companies, Mr. N. H. Bennett, who is also a vice president of our association, and Mr. Jesse Hill, Jr.

This statement is pursuant to a resolution unanimously adopted by the executive committee of our association..

The National Insurance Association has a membership of 53 companies; 7 of our member companies have their home offices in the State of Alabama; 1 domiciled in the State of California; 1 in the State of Colorado; 1 in the District of Columbia; 2 in the State of Florida; 3 in the State of Georgia; 4 in the State of Illinois; 1 in the State of Kansas; 2 in the State of Kentucky; 12 in the State of Louisiana; 4 in the State of Michigan; 1 in the State of Mississippi; 1 in the State of Maryland; 2 in the State of North Carolina; 1 in the State of New York; 2 in the State of Ohio; 2 in the State of Pennsylvania; 3 in the State of Tennessee; and 3 in the State of Virginia. The number of policy owners and insureds of our companies total approximately 4 million.

We are grateful for the opportunity of presenting our point of view before a subcommittee of the senior counterpart of what we consider to be the most important body of men in the world, the Congress of the United States of America.

During our deliberate study of the Life Insurance Company Income Tax Act of 1959, H.R. 4245, we note the efforts of the authors of the bill to recognize and reconcile the differences and inequities between companies that arise in any tax basis that attempts to tax the total earnings of a life insurance company. We contend that the efforts to equate the differences and unfairness of the proposed law are incomplete. We could cite several points where due provisions and allowances are not made, but we think they would tend to further add to the unfitness of any effort to abruptly tax total earnings of life insurance companies, which places sharp immediate burdens on smaller institutions of the industry.

We register our thinking on this matter directly behind the following resolution unanimously adopted by the executive committee of our association:

Resolution adopted on November 14, 1958, at a meeting of the executive committee of the National Insurance Association:

"Whereas the present basis of taxation for life insurance companies in the United States by the Federal Government recognizes the fact that premiums received by life insurance companies are not income in the same sense as the income of a regular commercial corporation but rather are deposits creating a liability; and

"Whereas the real income of a life insurance company is its investment income, a large part of which is required to enable the company to meet liabilities; and

"Whereas the total income approach for taxing life insurance companies which was in use prior to 1921, because it did not recognize the fundamental nature of the life insurance business, provided to be very unsatisfactory and led to wide fluctuations in the amounts of taxes collected from year to year: be it

"*Resolved*, That this association hereby makes known its support of the net investment income approach to the Federal income tax problem; and be it further

"*Resolved*, That it be brought to the attention of the proper congressional committees the attitude of this association."

The undersigned, duly elected secretary of the National Insurance Association, does hereby certify that the foregoing is a true and correct copy of a resolution unanimously adopted on November 14, 1958, at a meeting of the executive committee of the association held in Chicago, Ill.

W. A. CLEMENT.

The member companies of our association are small and all are owned and operated by Negroes. As small as we may be, our efforts in the life insurance industry represent the greatest contribution our minority is making to the economy of this country in the area of business management and ownership.

In order to continue to exist and compete in the industry, our member companies are faced with the problem of planning to reduce unit costs by mergers, expansion, and overhauling operational systems.

We are greatly concerned and discouraged by the proposed law that asks the industry for an overall increase of 70 to 75 percent in taxes, but calls upon members of our association as well as other small companies in the industry to pay very sharp increases of 200, 300, and as high as 500 percent in some instances.

We wish to conclude our statement by directing attention to a perennial problem that confronts our country and Government, the task of providing decent housing for all our citizens. It is in this area that we are especially proud of our contribution. We find that as a result of our successful mortgage activity in many communities throughout the country demonstrating to builders the availability of a sizable market of good credit risks among Negro citizens, that banks and insurance companies, routinely make home loans to these citizens.

We are afraid that this progress will be seriously injured if this bill, H.R. 4245, is passed into law.

We have attached herewith a list of the member companies of our association.

The CHAIRMAN. Thank you, Mr. Walker. The list attached will be inserted in the record.

(The list referred to is as follows:)

MEMBER COMPANIES

Afro-American Life Insurance Co., Jacksonville, Fla.
American Woodmen, The Supreme Camp, Denver, Colo.
Atlanta Life Insurance Co., Atlanta, Ga.
Beneficial Life Insurance Society, Detroit, Mich.
Benevolent Life Insurance Co., Inc., Shreveport, La.
Booker T. Washington Insurance Co., Birmingham, Ala.
Bradford's Industrial Insurance Co., Birmingham, Ala.

Central Life Insurance Co. of Florida, Tampa, Fla.
Chicago Metropolitan Mutual Assurance Co., Chicago, Ill.
Christian Benevolent Burial Association, Inc., Mobile, Ala.
Crusader Life Insurance Co., Kansas City, Kans.
Detroit Metropolitan Mutual Assurance Co., Detroit, Mich.
Domestic Life Insurance Co., Louisville, Ky.
Douglass Life Insurance Co., New Orleans, La.
Federal Life Insurance Co., Washington, D.C.
Fireside Mutual Insurance Co., Columbus, Ohio.
Gertrude Geddes Willis Life Insurance Co., New Orleans, La.
Golden Circle Life Insurance Co., Brownsville, Tenn.
Golden State Mutual Life Insurance Co., Los Angeles, Calif.
Good Citizens Life Insurance Co., New Orleans, La.
Great Lakes Mutual Life Insurance Co., Detroit, Mich.
Guaranty Life Insurance Co., Savanah, Ga.
Keystone Life Insurance Co., New Orleans, La.
Lincoln Industrial Insurance Co., Birmingham, Ala.
Louisiana Life Insurance Co., New Orleans, La.
Mammoth Life & Accident Insurance Co., Louisville, Ky.
National Service Industrial Life Insurance Co., New Orleans, La.
North Carolina Mutual Life Insurance Co., Durham, N.C.
Peoples' Insurance Co., Inc., Mobile, Ala.
Peoples' Life Insurance Co. of Louisiana, New Orleans, La.
Pilgrim Health & Life Insurance Co., Augusta, Ga.
Pilot Mutual Insurance Society, Inc., Cleveland, Ohio.
Progressive Industrial Insurance Co., New Orleans, La.
Protective Industrial Insurance Co. of Alabama, Birmingham, Ala.
Provident Home Industrial Mutual Life Insurance Co., Philadelphia, Pa.
Pyramid Life & Accident Insurance Co., New Orleans, La.
Richmond Beneficial Insurance Co., Richmond, Va.
Security Life Insurance Co., Jackson, Miss.
Southern Aid Life Insurance Co., Inc., Richmond, Va.
Southern Life Insurance Co., Baltimore, Md.
Standard Life Insurance Co. of Louisiana, New Orleans, La.
Supreme Industrial Life Insurance Co., New Orleans, La.
Supreme Liberty Life Insurance Co., Chicago, Ill.
Union Mutual Life, Health & Accident Insurance Co., Philadelphia, Pa.
Union Protective Assurance Co., Memphis, Tenn.
Union Mutual Life Insurance Co., New York, N.Y.
Unity Burial & Life Insurance Co., Mobile, Ala.
Unity Mutual Life Insurance Co., Chicago, Ill.
Universal Life Insurance Co., Memphis, Tenn.
Victory Mutual Life Insurance Co., Richmond, Va.
Winston Mutual Life Insurance Co., Winston-Salem, N.C.
Wright Mutual Insurance Co., Detroit, Mich.

The CHAIRMAN. Senator Kerr.

Senator KERR. No questions.

The CHAIRMAN. Are there any other questions? Senator Frear?

Senator FREAR. No questions.

The CHAIRMAN. Senator Carlson? Senator Talmadge?

Senator BUTLER. Mr. Chairman, if we have finished with this witness, I would like permission to insert in the record a statement that I prepared in connection with tax-exempt interest under the bill H.R. 4245.

(The statement of Senator Butler follows:)

During the hearings on H.R. 4245 on March 3, Mr. David A. Lindsay, assistant to the Secretary of the Treasury, explained to the committee the Treasury Department's position relating to the treatment of tax-exempt interest under provisions of the bill.

In response to specific questions I posed, Mr. Lindsay testified (and I quote), "We (the Treasury) exclude tax-exempt interest in both phases of the bill, but we do make an adjustment to the deduction to avoid a double benefit or double deduction." In other words, Mr. Lindsay suggested that companies receiving an exemption for "tax free' interest should not receive the full "reserve deduction." As the percentage of "tax free" interest increases, this other deduction normally permitted taxpayers in full, would be reduced.

On the basis of this reply, I asked Mr. Lindsay whether certain decisions of the Supreme Court cast doubt on the constitutionality of those provisions of H.R. 4245 as recommended by the Treasury which, in effect, partially tax interest from tax-exempt securities.

In response to this question, Mr. Lindsay testified as follows: "I feel that we should determine with the best advice we can, as to whether or not we *today* think such a provision is unconstitutional and if we believe it is not, and if we believe the provision is right we ought to include it in the bill." (Emphasis added.)

I wish to indicate, by an appropriate example, the inequitable manner in which tax-exempt income is treated under provisions of H.R. 4245, then to call the committee's attention to the specific Supreme Court decisions to which I referred in the testimony of March 3.

First, as an example of the treatment of tax-exempt income under provisions of H.R. 4245, we take two companies, A and B, identical in all respects except that company A has an additional increment of income from tax-exempt securities in the amount of $50,000. Note that under both phase 1 and phase 2 this additional tax-exempt income has the direct effect of increasing the tax base of company A.

*Phase I*

| | Company A | Company B |
|---|---|---|
| Investment income | $1,000,000 | $950,000 |
| Tax-exempt income | 50,000 | |
| Gross taxable income | 950,000 | 950,000 |
| Deduction for investment yield on adjusted life insurance reserves | 700,000 | 700,000 |
| Less reduction to avoid double deduction | 35,000 | |
| Net deduction | 665,000 | 700,000 |
| Gross taxable income | 950,000 | 950,000 |
| Net deduction | 665,000 | 700,000 |
| Net taxable investment income | 285,000 | 250,000 |

*Phase II*

| | Company A | Company B |
|---|---|---|
| Net gain from operations after dividends to policyowners | $2,050,000 | $2,000,000 |
| Deduct tax-exempt income | 50,000 | |
| Remainder | 2,000,000 | 2,000,000 |
| Add back to prevent double deduction | 35,000 | |
| Taxable net gain from operations | 2,035,000 | 2,000,000 |
| Deduct net taxable investment income | 285,000 | 250,000 |
| Excess | 1,750,000 | 1,750,000 |
| Take half of excess | 875,000 | 875,000 |
| Add taxable investment income | 285,000 | 250,000 |
| Net taxable income | 1,160,000 | 1,125,000 |

The Supreme Court on at least two occasions has specifically passed on the constitutionality of life insurance company taxing formulas as they relate to tax exempt interest. In *National Life Insurance Company* v. *United States* (277 U.S. 508), the facts as stated in this opinion are as follows:

"In 1921, departing from previous plans, Congress laid a tax on life insurance companies based upon the sum of all interests and dividends and rents received, less certain specified deductions—(1) interest derived from tax exempt securities, if any; (2) a sum equal to 4 percent of the company's legal reserve diminished by the amount of the interest described in paragraph (1); (3) other miscellaneous items—seven—not presently important.

"Petitioner maintains that acting under this plan, the collector illegally required it to pay taxes, for the year 1921, on Federal, State and municipal bonds; and it seeks to recover the amount so exacted. The Court of Claims gave judgment for the United States."

Mr. Justice McReynolds, in delivering the majority opinion of the Court, stated:

"The portion of petitioner's income from the three specified sources which Congress has power to tax—is taxable income—was the sum of these items less the interest derived from tax exempt securities. Because of the receipt of interest from such securities, and to its full extent, pursuing the plan of the statute, the collector diminished the 4 percent deduction allowable to those holding no such securities. *Thus, he required petitioner to pay more upon its taxable income than could have been demanded had this been derived solely from taxable securities. If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free.* No device or form of words can deprive him of the exemption for which he has lawfully contracted." [Emphasis added.]

Note specifically that as in the National Life Insurance Company case the Treasury Department advocates that a so-called deduction allowed to a general class of taxpayers be diminished solely because of the receipt of interest from tax exempt securities.

In *Missouri* v. *Gehner* (231 U.S. 313 (1930)), the Supreme Court construed a Missouri statute relating to the taxation of life insurance companies. The Missouri Supreme Court had upheld a statute which required that the legal reserve deduction afforded insurance companies under the statute must be reduced by the proportion of the value of U.S. tax exempt bonds the company might hold as compared to the total assets of the company.

In reversing the Missouri Court, the Supreme Court held:

"The section discloses a purpose as a general rule to omit from taxation sufficient assets of the insurance companies to cover their legal reserve and unpaid policy claims. It would be competent for the State to permit a less reduction or none at all. But where as in this case the ownership of United States bonds is made the basis of denying the full exemption which is accorded to those who own no such bonds this amounts to an infringement of the guaranteed freedom from taxation. It is clear that the value of appellant's Government bonds was not disregarded in making up the estimate of taxable net values. This is in violation of the established rule."

Mr. Chairman, I cannot conclude this statement without pointing out what I consider to be dangerous thinking upon the part of the Treasury. The question involved is basic. It goes to the heart of the Federal-State relationship under the Constitution. I regret that the Treasury has asked us in effect to ignore the two Supreme Court decisions above cited in the apparent hope that a so-called more progressive court may reverse them.

(See also p. 700.)

The CHAIRMAN. Senator Hartke, do you have any questions?

Thank you.

Is Mr. McCreless in the audience?

Mr. McCreless, I understand you are scheduled to testify on Thursday but would like to make your statement today if time permits.

Mr. MCCRELESS. I would be very happy to make it today.

The CHAIRMAN. We shall be pleased to accommodate you.

This is Mr. S. E. McCreless, of the American Hospital & Life Insurance Co. of San Antonio, Tex.

Senator KERR. Where?

Mr. MCCRELESS. San Antonio.

Senator KERR. What State is that?

[Laughter.]

Mr. MCCRELESS. Senator Kerr, that is very close to your State, sir.

Senator KERR. I understand it is the second largest State in the Union.

Mr. McCreless. It is, sir. Senator, it is the largest State in the Union without a glacier in it.

Senator Kerr. It is the largest tributary in Oklahoma, I mean, it is the largest boundary of Oklahoma.

Mr. McCreless. That is right, sir.

The Chairman. You may proceed, sir.

## STATEMENT OF S. E. McCRELESS, PRESIDENT, AMERICAN HOSPITAL & LIFE INSURANCE CO. OF SAN ANTONIO, TEX.; ACCOMPANIED BY GENE P. ARCHER, VICE PRESIDENT AND ACTUARY

Mr. McCreless. Mr. Chairman and members of the committee, my name is S. E. McCreless, president of the American Hospital & Life Insurance Co. of San Antonio, Tex. With me is Mr. Gene P. Archer, vice president and actuary of our company, and I hope you will allow him to help me in answering any questions.

The American Hospital & Life Insurance Co. is a stock company, issuing nonparticipating ordinary and the usual forms of group life and group accident and health insurance and individual accident and health and hospital insurance. We are in our 24th year of business, and as of December 31, 1958, we had insurance in force amounting to $155 million, with assets amounting to $12 million. We would be classified, Mr. Chairman, as a small life insurance company.

I have examined very carefully the proposed legislation for taxing life insurance companies on which you are holding this hearing today. I have examined it from the standpoint of my own company and from the standpoint of my knowledge of life insurance companies in general, a knowledge which I have gained from a life time devoted to the insurance business.

If we are to abandon the concept of investment income as our tax basis, as it appears we must, then I am in accord with the philosophy of taxing insurance companies as is reflected in the proposed legislation.

However, there is one point which I would like to bring to the attention of the committee which is of very considerable importance to virtually all of the small life insurance companies in this country. The point which I have in mind is that the loss carryover provisions which appear in the proposed legislation be written so that the losses of the 3 years prior to 1958 can be brought forward as an offset against possible income in 1958 and later years.

The reason I make this request stems from the peculiar history of small life insurance companies. This history shows that their earnings can fluctuate quite widely from year to year, and that national disasters, such as the flu epidemic of recent years, tend to hit them harder than larger companies whose insurance writing base is much broader than ours. In the case of my own company, and in the case of the bulk of the small life insurance companies in this country, substantial losses were suffered in one or more of the years 1955 through 1957. My request that the new tax law permit the losses of these 3 years to be brought forward as an offset against possible profits in 1958 and later years fits quite naturally and normally into the proposed tax legislation which has already embraced the principle of loss carryovers and loss carrybacks. I am simply asking that the leveling out period provided by the principle of loss carryovers and carrybacks include the bringing forward of losses from these three recent years.

This request which I have made is simply a reflection of the principle of leveling out co. orate earnings, which principle has been in our tax law for ordinary corporations for many, many years. You are all familiar with the proposition that the purpose of loss carryovers and loss carrybacks is to give a corporation an 8-year period during which all its losses and all its profits shall be taken into consideration. All I am asking now is that the leveling out period embrace the 3 years prior to 1958, not for the purpose of carrying losses back to these years and getting a tax refund, but only for the purpose of bringing these losses forward to 1958 and later years.

There is, of course, no assurance that the right to bring the losses of these 3 years forward will actually mean that companies which have suffered as I have indicated can make use of the losses. However, it does mean that they will have a fair chance of making use of these losses and it is that fair chance that I ask this committee to adopt as a provision of the proposed legislation.

It is my understanding that the proposal which I am now making can be put into the law simply by changing the date referred to in section 812(b)(1) from December 31, 1957 to December 31, 1954.

I do not feel that the amendment which I have requested of this committee needs much elaboration. It is a simple request and the reason for it is obvious. As I have pointed out, the requested amendment is basically nothing more than an extension to insurance companies of the general philosophy of leveling earnings, a privilege which has always been enjoyed by ordinary corporations. Insurance companies are ready to do their part in carrying the tax burden but we do feel that we should be given this same leveling treatment which the Congress in its wisdom has heretofore accorded to all other corporations.

In closing I would like to state that all I am really asking is that the principle of leveling should encompass the 3 past years, to the end that Congress will not ask any insurance company to come up to the beginning of this brandnew scheme of taxation at a disadvantage. I am not asking for an advantage for small companies, I am simply asking that we be permitted to come up even with the board. The losses which we have suffered in the past 3 years we had expected to recover before new methods of taxing were adopted. Therefore, in all fairness I believe we should be permitted at least to bring these losses forward in the hope that we may have sufficient profits in future years to recover the losses we have suffered before these new taxes are collected from us.

That is our statement, Mr. Chairman.

Senator KERR (presiding). Thank you, Mr. McCreless.

Are there any questions?

(No response.)

Senator KERR. Thank you.

We are honored by the presence of Representative Hastings Keith. I see by the badge on his coat that they have done to him what they have done to me, put an "O'" before his name, and I doubt that——

Mr. KEITH. I come from Boston.

Senator KERR. A Keith by any other name wouldn't be any more Irish, but then it wouldn't hurt you.

I believe the distinguished Senator from Delaware has a remark to make, Congressman. Sit right down.

Senator FREAR. Thank you, Mr. Chairman.

It is a pleasure, I think, for a member of the committee to have the opportunity at times to personally introduce and present a witness not only to the committee, but also to those who have gathered to hear the testimony.

I have known the father of this witness for a number of years. I know many good and fine things about him. He bears well the reputation that he has in New England, and it has spread farther than New England.

I think all that I have ever heard about him, all that I have ever seen of him, is of the finest and of the best.

I might add just one thing, however. He is a member of the Republican Party. [Laughter.]

We can identify that very well, Congressman Keith, by your "O'Keith" today, and the trunk that you display with the green ribbons. We have attempted, you know, thus far here, to try to differentiate between the good and the bad, but we never do it too obviously.

Senator WILLIAMS. Let the record show that the Senator from Oklahoma has already identified his badge as being the same. [Laughter.]

Senator KERR. Congressman, the Senator had said something about you which would be terrible if it weren't true. [Laughter.]

Mr. KEITH. I was going to send my father the remarks that Senator Frear made, but in view of the amendment by his colleague to your left, I perhaps had better look more carefully at them than would otherwise have been the case.

Senator KERR. I must say to you that it wouldn't be without precedence for a witness to correct his testimony before it is finalized. [Laughter.]

## STATEMENT OF HON. HASTINGS KEITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. KEITH. This is a very, very unique position in which I find myself. I have yet to appear before a committee of the House.

Senator FREAR. You are starting pretty well.

Mr. KEITH. I have been very faithful in my attendance at the committee hearings on Interstate and Foreign Commerce, of which I am a new member, and I have been as faithful as time would permit in attendance at the sessions. But I have been, because of a longing for a business which I have left behind me, very much concerned with the matter which your committee is considering today; namely, the welfare of the life insurance industry.

I carried a rate book for a mutual company, with always a stock company rate book in the other pocket in case I needed it, for 20 years, and life insurance is not an easy product to sell. It is one that the public needs, perhaps, more than they realize, and oftentimes, perhaps, more than the Congress realizes.

So I am sorry to see this difference of opinion between stock and mutual companies, and the absence in some cases of an institutional point of view.

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It seems to me at times they forget the policyholder and the buying public, and so today I am here as a Congressman concerned about the trend within this industry. This trend is aided and abetted by our administration's policy of encouraging substantial taxes which must sooner or later be paid for by the policyholder. Taxes will make the product much more expensive and therefore much less attractive. It will thereby cause us to turn to more social security. And social security, having to be paid for by taxes, must be added to the cost of the product and passed on to the consumer and will further add to the inflationary tendency in our economy today.

So it is this concern, as a new Congressman, that provokes my coming here today.

I have prepared for you some copies of my remarks. I am afraid because of the informal nature of the introduction that I got away from the prepared script, and I, however, would like to read it, not so much for the benefit of the committee, perhaps, but for the benefit of my colleagues to the rear.

I might say by way of prefacing it, to invite their attention to my remarks, that I am a Chartered Life Underwriter, which is to the life insurance fraternity what the CPA is to the accountant, and we have as our goal in our relationships with the insurance buying public the effort to see things through the buyer's eye.

Mr. Chairman and members of the committee, I am grateful for this opportunity to be heard. I appear as the newly elected representative of Massachusetts' Ninth Congressional District, and as one who in private life has spent 20 years in the life insurance industry. It is my hope that from my experience in the field I may be able to contribute something toward the solution of the problem before your committee today—the taxation of life insurance companies.

I recognize that we have already determined by policy and by law that life insurance companies should be taxed, and I believe that the House Ways and Means Committee has done a good job in studying the problem, which is admittedly a complicated one. It seems to me, however, that in dealing with the problem we must not ignore the long-range effects of the legislation you have before you.

The first of these effects is that the increased tax burden will inevitably be passed on to the policyholder in a more expensive life insurance contract. This, you may say, is too bad, but it has happened in many other industries to many other products. And why should life insurance be different?

The answer is that here you have an industry whose product is of a sort which encourages an individual to solve his own problems so that he is less of a burden to the Federal Government. Here you are dealing with the desire and the ability of the average American to take care of his wife and children in the event of his death, and of himself in his old age. It seems to me that, far from being penalized in his attempt, he should be encouraged.

But it is not the policyholder that we need worry so much about—it is the prospective policyholder—the man who is looking for security and trying to plan intelligently for his own future. If we make life insurance more expensive for him and therefore less attractive, he will inevitably turn more and more to the Federal Government for his needs. He will demand further expansion of the social security system—and that will mean greater and greater taxes, and a consequent spur to inflation. And aside from the purely economic aspects of the situation, our average American will become more and more oriented toward Government paternalism, and will expect the Government in many other fields to do his planning and providing for him.

Now the insurance companies may feel, and the House Committee was led to believe by Mr. Scribner from the Treasury, that they have done a good job in furnishing protection to the public. In my opinion, they have not. I believe that the fact that they had not done a better job was partly responsible for the institution of the social security system, and for its further expansion since it was initiated. I am not here as an apologist for the industry.

I went into the business back in 1938, when I graduated from college, during the depths of the depression. At that time, 5.7 percent of the disposable income of the average family went to purchase life insurance. Almost 20 years later, in 1957, the percentage had dropped to 3.9 percent, in spite of the further industrialization of our society in those 20 years and our increased reliance upon a monetary economy rather than an agricultural one. The average life insurance policy is still for only $3,400. Therefore, I do not agree with those who would have us believe that the insurance companies have done the best job they could.

It seems to me that the Treasury Department has conceived of the companies as custodians of their policyholders' savings, and that the companies themselves have agreed with that understanding of their role. I believe that is a mistaken view. I think that the companies have a larger and more important duty, that their really important job is to convince the people that they should save through life insurance, that they should plan for their own future and try to take care of themselves. The companies have a large responsibility to inspire thrift and foresight, to sell the public on self-protection, to boost the idea of do-it-yourself security.

I might interpose here that we have seen a great growth in small life insurance companies throughout the country in areas where the larger ones haven't been able or haven't chosen to go, and these small companies have done exceedingly well, because of the failure of the larger ones to fill those gaps. And I remember it was the goal of the Equitable, which was the company with which I was most intimately associated, that in every phone book throughout the country there should be an Equitable agent listed as such. Those days were never realized, and there is an opportunity, and we have seen it filled by these small companies coming in and offering competition to the larger ones.

Whether or not the industry has correctly recognized its role and fulfilled it, the public interest will not be served by burdening it with excessive taxes—taxes that will, in effect, raise the cost of insurance to the public and will thwart the effectiveness of the industry in the future.

Another effect which we should consider is the long-range inflationary one. The increased social-security program that would result from the stagnation of the life-insurance industry would contribute directly to inflation because of the method of financing social security.

And a third practical effect of an undue tax burden on the companies is the loss of capital that would result. We must not forget that the investments of the life insurance companies provide capital for the long-range growth and development of this country.

And I might say in that respect while I was chairman of the committee on mercantile affairs in the Massachusetts Senate we had a proposal that would have disposed of the Backbay yards for a very reasonable sum to a very wealthy promoter who wanted to establish there a great commercial and residential center. He asked tax concessions. It was determined to be unconstitutional. He couldn't build there, and so it was sold to Prudential, and the Prudential has started even this week construction of a gigantic project which will perhaps save Boston's future. It will provide $50 million of taxable property as contrasted with the Government aid that was asked through tax subsidies to the earlier promoter.

So the institution of life insurance, as I am sure you gentlemen realize, does provide the capital that is needed for the long-range growth and development in this country, capital which is needed in ever-increasing amounts and for longer periods of time. The insurance companies buy the Government's bonds. They furnish the prime source of capital for the homeowner and for urban development. They finance railroads and airlines, hotels and industrial establishlishments for the entire economy. The whole country benefits from this source of capital, without which the economy would be forced to further rely on Government subsidy and support.

The insurance industry is just in its infancy, and it has much to contribute to our economic growth. We have an opportunity to encourage its development or to impede and weaken it. I hope that we will recognize the issue, and I urge you to consider sympathetically the amendments proposed to your committee on behalf of the companies, whose future growth is so intimately related to the health of our economy and our institutions.

Thank you very much.

Senator KERR. Thank you, Congressman "O'Keith."

Are there any questions?

(No response.)

Senator KERR. There being none, we will recess until 10 o'clock in the morning.

Mr. KEITH. Thank you.

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

AMERICAN LIFE CONVENTION,
*Chicago, Ill.*

LIFE INSURANCE ASSOCIATION OF AMERICA,
*New York, N.Y., March 18, 1959.*

Re H.R. 4245.
Hon. HARRY FLOOD BYRD,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: We are attaching to this letter a number of what might be called suggested technical amendments to the above bill.

As you will see, some of these suggested amendments are purely formal. Others are substantive in nature, but involve points which we believe may have been overlooked to date. Still others concern points which probably have been considered at some stage in the development of this bill, but which we think clearly warrant reconsideration. With one or two exceptions, we doubt that these points will be mentioned in the testimony to be presented to your committee, since the witnesses will be preoccupied with more basic issues. Nevertheless, these are significant points which we believe merit consideration by the committee.

We are therefore taking this means of bringing these matters to the committee's attention, and we respectfully request that this letter and the attachment be incorporated in the printed hearing record.

Sincerely yours,

AMERICAN LIFE CONVENTION,
CLARIS ADAMS,
*Executive Vice President and General Counsel.*
LIFE INSURANCE ASSOCIATION OF AMERICA,
EUGENE M. THORÉ,
*Vice President and General Counsel.*

(See also pp. 124, 524, and 624.)

SUGGESTED TECHNICAL AMENDMENTS TO H.R. 4245

1. *Suggested amendment.*—Page 4, strike out lines 10–18 and insert: "(4) DEFICIENCY RESERVES EXCLUDED.—The term 'life insurance reserves' does not include deficiency reserves. For purposes of this paragraph and subsection (c), the 'deficiency reserve' on any policy or contract is that amount, if any, by which—

"(A) the present value of the future net premiums for the policy or contract, exceeds

"(B) the present value of the future actual premiums and considerations charged for such policy or contract."

*Reason.*—The definition of "deficiency reserves" now in the bill is incorrect in defining deficiency reserves in terms of aggregate premiums on life insurance and annuity contracts. The House report describes deficiency reserves somewhat more accurately. The suggested language would make the bill text consistent with the House report and correctly defines "deficiency reserves" in terms of the aggregate of reserves on individual contracts.

2. *Suggested amendment.*—Page 10, strike lines 12 and 13, and insert: "occupied in whole or in part by a life insurance company for insurance purposes other than investment activities shall be limited to an".

*Reason.*—The bill should make it clear beyond any doubt that a company is entitled to deduct depreciation, and real estate taxes and expenses, on company-owned space occupied by its investment department. This is of course money spent to produce investment income, as distinguished from other functions of the company. If the company were to rent space for its investment department, these items could be deducted. Accordingly, these items should be just as clearly deductible where the investment department is operated in a part of a company-owned building.

3. *Suggested amendment.*—Page 11, following line 9, insert:

"(8) BAD DEBTS.—The deduction for bad debts allowed by section 166, to the extent that such bad debts arise from or in connection with any instrument or agreement described in subsection (b)(1)(B)."

Page 11, line 10, strike "(8)", and insert "(9)".

Page 12, line 11, strike "(9)", and insert "(10)".

*Reason.*—In this bill, as contrasted with the Mills law, capital gains and losses are taken into consideration. Consequently losses on bonds, debentures, etc., are recognized as capital losses. Losses on mortgages, however, are considered to be bad debts rather than capital losses. It would seem clear that such mortgage losses should be allowed as a deduction, and the above amendment is designed to accomplish that purpose.

4. *Suggested amendment.*—Page 16, strike lines 4–11, and insert: "the amount attributable to any asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition."

*Reason.*—We believe that real property and stock should be valued for the purpose of this provision on the adjusted basis rather than on the basis of fair market value. This would make it consistent with other provisions of the bill. The suggested change might not make any great difference in revenue results, but it would eliminate the tremendous difficulty in the annual determination of a "fair market value" acceptable both to the Internal Revenue Service and to the company.

5. *Suggested amendment.*—Page 17, strike lines 13–24; and page 18, strike lines 1–11, and insert:

"(2) PENSION PLAN RESERVES DEFINED.—For purposes of this part, the term 'pension plan reserves' means that portion of the life insurance reserves which is allocable to contracts—

"(A) entered into with trusts which (as of the time the contracts were entered into) were deemed to be (i) trusts described in section 401(a) and exempt from tax under section 501(a), or (ii) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

"(B) entered into with employers under plans which (as of the time the contracts were entered into) (i) were deemed to be plans meeting the requirements of section 401(a) (3), (4), (5), and (6), or the requirements of section 165(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1939; or (ii) were plans for which under the provisions of prior revenue laws the employer contributions were deductible;

"(C) entered into with employers exempt from tax under section 501 (c) or (d) or section 115(a), or exempt from tax under the corresponding provisions of prior revenue laws;

"(D) provided for employees or agents of the life insurance company under a plan which, for the taxable year, meets the requirements of section 401(a) (3), (4), (5), and (6);

"(E) entered into under approved superannuation funds or plans as defined by section 127, subsection (1), paragraph (c), of the Income Tax Act of Canada."

*Reason.*—The above language is designed to change the paragraph as it now appears in the bill in four respects: (1) Subparagraph (B) is amended to include specifically contracts with employers under plans where the employer contributions were deductible under revenue laws prior to the 1939 code. It would seem clear that subparagraph (B) should have such scope, the same as subparagraph (A) already does. (2) Subparagraph (C) brings in contracts entered into with tax-exempt employers. The reason is that, since Congress has concluded to exempt such employers from all taxation, they should not be taxed indirectly through taxation of the insurance company. (3) Subparagraph (D) adds the words "or agents" to the provision covering contracts for employees of the life insurance company. The purpose is to avoid any controversy over the question of whether the term "employees" includes agents. (4) Subparagraph (E) brings in Canadian plans which fall under the provisions of Canadian tax law most nearly approximating sections 401–404 of the code. The reason is that Canadian banks, trust companies, and insurance companies are not taxed on such plans, and American companies should be enabled to meet this competition with respect to their Canadian business.

6. *Suggested amendment.*—Page 19, strike line 15 and insert "contracts or obligations (including contracts or obligations supplementary thereto)".

*Reason.*—The language presently in the bill is ambiguous. It might possibly be construed as not including interest on obligations arising from insurance contracts where the contract as a whole involves life, health, or accident contingencies, although the particular obligation giving rise to the interest does not. Clearly, the intent of the provision is to make deductible interest on all obligations which do not involve such contingencies, regardless of whether another part of the contract may do so. The above amendment will make express this intent.

7. *Suggested amendment.*—Page 22, lines 3–6, change the sentence (or word the report on the bill) so as to make it clear that return premiums includes premium refunds made on cancellation of policies or change to lower premium plans.

*Reason.*—Certain refunds of premiums are as a matter of practice made on cancellation of policies or change to lower premium plans. In a sense these are contractual, but the right to a return of these premiums is not spelled out in the policy. For that reason it could be suggested that they are paid in "the discretion of the management." At the same time, it is clear that they should be treated as return premiums, and not as policyholder dividends. This ambiguity should be corrected either in the bill or in the report on the bill.

8. *Suggested amendment.*—Section 809(d) should be amended to allow a deduction for payments to stockholders in retirement of stock under a mutualization plan entered into prior to enactment of the bill.

*Reason.*—A statement in support of such an amendment was made to the committee on March 4, 1959, by Paul E. Martin, administrative vice president, the Ohio National Life Insurance Co., Cincinnati, Ohio. Insofar as that statement relates to this point, we support its objective.

9. *Suggested amendment.*—Page 43, strike lines 11–15, and insert:

"(ii) the sum of the excess described in clause (i), plus the amounts (determined as of the beginning of the year of the distribution) in the shareholders surplus account and in the policyholders' surplus account."

*Reason.*—The clause as it appears in the bill is ambiguous in that it is difficult to determine whether existing surplus is to be determined as of December 31, 1958, or as of the beginning of the year of distribution. The House report (p. 40) makes it clear that surplus as of December 31, 1958, is meant. It would seem, however, that the bill itself should be clarified.

10. *Suggested amendment.*—The sentence on page 45, lines 11–15, relating to the tax on capital gain on property having a substituted basis, should be amended.

*Reason.*—Section 817(b) provides in effect for the nonrecognition of gain on the sale or other disposition of property acquired before December 31, 1958, up to the fair market value of the property on that date. An exception to this provision is stated as follows: "In the case of property having a substituted basis (within the meaning of sec. 1016(b)), the preceding sentence shall apply, but only if during holding periods concerned the property or properties were held only by life insurance companies."

At the outset it is unclear what is meant by "holding periods." Some inference may be drawn that the exception applies in some cases to property acquired by the company prior to 1959, although this does not appear to be intended. It should be made clear in any event that the exception is not to apply to any property which has a basis determined by the basis of property on or before December 31, 1958.

As to property acquired since December 31, 1958, the exception should not apply to any property which has a basic determined by the basis of property held by the company prior to 1959. This is the case where property acquired prior to that date is exchanged for like property. As to property which is acquired by a life insurance company and takes the transferor's basis, as in certain corporate reorganizations, different rules would probably apply.

11. *Suggested amendment.*—Page 48, line 2, after the word "mortality," insert "and morbidity."

*Reason.*—This provision authorizes the conversion of reserves for noncancelable or guaranteed renewable accident and health insurance (as well as the reserves for life insurance) from a preliminary term basis to a net level premium basis. The word "mortality," however, relates only to life insurance. Consequently, to make the provision accurate in all respects, the words "and morbidity" should be added.

12. *Suggested amendment.*—Section 818(c), page 48, lines 16 to 21, relating to revaluation of reserves computed on a preliminary term basis, should be amended to permit the taxpayer, if it desires, to use either the exact basis or the approximate basis for the taxable year beginning in 1958, without being required to adhere to such basis thereafter; and to provide further that any such election for a taxable year beginning after December 31, 1958, shall be adhered to in subsequent taxable years unless a change is approved by the Secretary.

*Reason.*—As the bill now reads, any election between the two revaluation bases made for the taxable year 1958 (or thereafter) would be binding on the taxpayer in future taxable years unless the Secretary approves a change. Many companies would find it impossible to make an exact revaluation prior to the return date for the taxable year 1958, and therefore could not make an informed choice. To avoid this difficulty, the taxpayer should be allowed, if it desires, to use either revaluation basis for the taxable year 1958, and then make a binding election in taxable year 1959 or thereafter.

13. *Suggested amendment.*—The Canadian life insurance companies doing business in the United States have suggested three amendments to section 819(c), relating to distributions to shareholders in the case of foreign life insurance companies. A copy of these proposed amendments and a memorandum supporting them is attached hereto. We believe that these proposals are reasonable and we urge their favorable consideration by the committee.

MEMORANDUM

From: The Canadian life insurance companies doing business in the United States.
Re: Section 819 of H.R. 4245. A bill relating to the taxation of the income of life insurance companies.

The rule prescribed in section 819(c) to determine the proportion of a distribution to shareholders which is to be allocated against the U.S. business aims at making the division in the ratio that the surplus on U.S. business bears to the total company surplus. The use of the ratio of these respective surpluses for this particular allocation seems to follow a sound principle. We recognize that the application of the principle requires some definition of that amount to be regarded as the surplus on the U.S. business and that the choice made in the bill is properly consistent with the rule prescribed for foreign companies in section 819(b) (2) (A). For these reasons we feel that the rule set out in the bill should be retained as a permitted method of allocating any distribution to shareholders.

It does, however, require the company to revalue its total assets and insurance liabilities on the basis required for purposes of the annual statement on the form approved by the National Association of Insurance Commissioners. This presents serious problems in practice, chief among these being the matter of valuing the total assets of the company on the basis prescribed in the bill, a situation which was outlined in our conference with Treasury and other officials in Washington, D.C., on February 2, 1959.

To overcome this practical difficulty, it is suggested that a company should be permitted to allocate any distribution to shareholders either by the method provided in the bill or in the ratio that its U.S. total insurance liabilities bears to the company's total insurance liabilities. The suggested new alternative would, we believe, generally result in a larger allocation against the U.S. business than the one provided in the bill. In spite of the fact that there could be some tax disadvantage in doing so, the alternative method might nevertheless be elected by a company to avoid the onerous task of adjusting all its foreign assets and liabilities to the U.S. basis. Moreover, neither of the two suggested ratios can under any circumstances give an unreasonably low allocation against the U.S. business and for that reason it is felt there would be no objection to permitting a company to elect at any time which of the two ratios is to be used.

The suggested change is covered in paragraph (1) of the attached draft of an amended section 819(c) which is submitted for your consideration.

Paragraphs (2) and (3) of this draft contain suggestions for additions which may help to clarify questions that may arise in the application to foreign life insurance companies of section 815(e), "Special Rules for Certain Mutualizations."

In applying section 815(e) (1) (A), it is presumably not intended that a foreign company should have the advantage of reducing the U.S. portion of a mutualization payment by the full amount of its paid-in capital and paid-in surplus. Paragraph (2) is included in the draft to provide that only a proportionate part of paid-in capital and paid-in surplus will be allowed for this purpose.

Paragraph (3) of the draft is suggested to clarify how the allocation ratio prescribed in 815(e) (2) will be determined for a foreign company. The amount fixed by clause (i) (assets less total liabilities) is presumably to be determined in respect of the company's U.S. business only, and this has been indicated in the draft.

However, the rule prescribed in section 819(b) seems to indicate that this excess of assets held over the liabilities on U.S. business was not in all circumstances regarded as an acceptable measure of surplus in determining the tax to be paid by a foreign company on investment income or operating gain. To the extent that it is inappropriate for that purpose it seems that it may be equally so as a measure of surplus at December 31, 1958, to be used as a basis for the allocation required under section 815(e) (2).

A foreign company will in effect be required to pay tax as though the surplus on its U.S. business at December 31, 1958, was either the amount held in the United States or the minimum prescribed by section 819(b) (2) (A), whichever is the greater. It seems logical, therefore, that the greater of these amounts should be used in applying section 815(e) (2).

A suggested rule to this effect is included in paragraph (3) of the attached draft.

ILLUSTRATIVE REVISION OF SECTION 819(c) OF H.R. 4245

(Attached to memorandum submitted by Canadian life insurance companies doing business in the United States)

Section 819: Foreign life insurance companies—

(a) No change.

(b) No change.

(c) DISTRIBUTION TO SHAREHOLDERS.—

(1) In applying sections 802(b)(3) and 815 for purposes of subsection (a), the amount of the distributions to shareholders shall be determined by multiplying the total amount of the distributions to shareholders (within the meaning of section 815) of the foreign life insurance company by the percentage specified in subparagraph (A) below or specified in subparagraph (B) below, whichever percentage the company may elect—

(A) the percentage that the minimum figure for the taxable year (determined under subsection (b)(2)(A)) is of the excess of the assets of the company over the total insurance liabilities;

(B) the percentage that the total insurance liabilities on U.S. business for the taxable year is of the company's total insurance liabilities.

(2) In applying section 815(e)(1)(A), the paid-in capital and paid-in surplus shall be determined by multiplying the paid-in capital and paid-in surplus of the foreign life insurance company by the percentage determined as provided in paragraph (1).

(3) In applying section 815(e)(2), the amount defined in subparagraph (a)(1) shall for a foreign life insurance company be—

the excess (determined as of December 31, 1958) of the assets held in the United States over the total liabilities on U.S. business, or

the minimum figure determined as of December 31, 1958, under section 819(b)(2)(A),

whichever amount is the greater, and this amount shall be the amount referred to in section 815(e)(2)(A)(ii) as "the excess described in clause (i)" and in section 815(e)(2)(B) as "the excess described in subparagraph (A)(i)."

(Whereupon, at 4:15 p.m., the committee recessed, to reconvene at 10:20 a.m., Wednesday, March 18, 1959.)

# TAX FORMULA FOR LIFE INSURANCE COMPANIES

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**WEDNESDAY, MARCH 18, 1959**

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

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

Present: Senators Byrd, Kerr, Frear, Gore, Talmadge, Hartke, Williams, Carlson, and Cotton.

Also present: Elizabeth B. Springer, chief clerk; L. N. Woodworth, economist, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The Senator from Georgia, Senator Talmadge, will present the first witness.

Senator TALMADGE. Mr. Chairman, Senator Smathers, from Florida, had hoped that he would be here and wanted to present the next witness this morning, but unfortunately was detained on official business and could not be here.

I have known the next witness a long period of time. We shared adjoining offices in the William-Oliver Building in Atlanta, Ga., before his duties called him to the State of Florida.

Mr. Verlander is a native son and a man of great integrity, and it is a great pleasure to present him to this committee.

The CHAIRMAN. Mr. Verlander.

Mr. VERLANDER. Thank you, Mr. Chairman.

## STATEMENT OF W. A. VERLANDER, EXECUTIVE VICE PRESIDENT AND TREASURER, AMERICAN HERITAGE LIFE INSURANCE CO., JACKSONVILLE, FLA.

Mr. VERLANDER. Mr. Chairman and members of the committee, my name is W. A. Verlander, executive vice president and treasurer of the American Heritage Life Insurance Co. of Jacksonville, Fla. It is a new, small stock company, chartered in 1956.

My company favors the enactment of H.R. 4245 with a few minor changes. Being a new, small company, it is necessary that we have a chance to get established in business. I will speak only of the changes that I feel pertain particularly to new, small companies.

Representing a new, small company, I heartily support the proposal of the American Life Convention with regard to liberalizing the small-business deduction.

The principal change which we feel should be made in the proposed law is a more equitable treatment of operating losses for newly organized companies. It is a well-established fact that the first 9 years of a new life insurance company's operations are the most perilous. During this period, the initial expenses incurred in "putting policies on the books" are greater than the premiums received. A study of new life insurance companies' reports has shown that 8 or more years of operations are normally required before a gain from operations can be expected.

Section 812(b) provides, in line with existing tax policy, for an operations loss carryback to each of the 3 taxable years preceding the loss year, and an operations loss carryover to each of the 5 taxable years following the loss year.

A new company cannot carryback its early year losses. In order to prevent discrimination between long-established companies and the struggling new companies in a highly competitive industry, it is imperative that the new companies be allowed additional years of loss carryover.

Section 812(b) also provides that the loss from operations for any taxable year ending prior to January 1, 1958, shall not be eligible for carryback and carryover provisions. Since the proposed bill represents an entirely new concept of income taxation on life insurance companies, a new company such as American Heritage should be allowed to avail itself of the carryback and carryover provisions for any of its first 8 years of operations.

To more clearly highlight this problem, I will use my company as a specific example. It was chartered September 14, 1956, and by December 31 we showed a loss from operations of $42,272.92. For 1957, our second year of operation, our statement reflected a loss from operations of $217,361.82. Under the provisions of H.R. 4245 as now presently drawn, we would have to pay Federal income taxes on this $260,000 as it is earned back. We feel this is basically unfair. This $260,000 was originally paid-in capital and represents a loss in normal insurance operations. We respectfully urge and beg this committee to allow us to recover paid-in capital without having the additional burden of paying Federal income tax on it. H.R. 4245 places us in the very unfortunate position of losing $260,000 and then being forced to make back approximately one-half million dollars, and pay taxes on that amount in order to get back to our original starting point.

This would create, in my opinion, a hardship unintended by the authors of H.R. 4245. Further, it is my opinion from having heard witnesses who have preceded me and conversing with other insurance officials, that there is no opposition to this proposal.

I am attaching as addendum A a proposed amendment which would rectify this situation.

Mr. Chairman, I won't read that unless you later ask me to.

The CHAIRMAN. That will be inserted in the record.

Mr. VERLANDER. Thank you.

(Addendum A referred to follows:)

ADDENDUM A

Section 812(b)(3):

OPERATIONS LOSS CARRYBACKS AND CARRYOVERS AS APPLICABLE TO NEW LIFE INSURANCE COMPANIES.—For purposes of this part, a new life insurance company shall mean a life insurance company as defined under section 801(a) which was licensed to write life insurance within 9 taxable years prior to the year for which it files its return:

> "For new life insurance companies, the loss from operations for any taxable year (hereinafter in this section referred to as the 'loss year') shall be an operations loss carryover to each of the 8 taxable years following the loss year. Paragraph 812(b)(1) setting forth any taxable year ending after December 31, 1957, is specifically not applicable to new life insurance companies.

Mr. VERLANDER. There is one more relief amendment I would like to recommend for your consideration for new life insurance companies.

Many States require by statute large minimum amounts of capital and surplus. These statutory requirements are for the purpose of preventing undercapitalized companies from coming into existence without adequate policyholder protection. The greater the capital and surplus, the more protection is afforded the insured public. Without adequate capitalization, the proper steady growth of a new company is seriously hampered. If proper relief is not afforded the new small companies, such as American Heritage, their ability to compete and survive in this industry could be seriously impaired. The 1942 law as well as the so-called stopgap law recognizes this situation and makes provision for new companies during the first 9 years of their operations.

New companies' reserves obviously are only a very small percentage of their assets. Also, they require an extra safety factor because of a relatively small spread of lives insured.

A specific deduction of 87.5 percent of the net investment income should be allowed new life insurance companies in lieu of the deduction for investment yield on adjusted life insurance reserves provided in section 805(b)(1).

Attached hereto as addendum B is a proposed amendment which would accomplish this.

I would like to also have this placed in the record at this point.

The CHAIRMAN. It will be inserted in the record at this point.

(Addendum B referred to follows:)

ADDENDUM B

Section 805(b)(8):

RELIEF PROVISION FOR SPECIFIC DEDUCTION FROM NET INVESTMENT INCOME FOR NEW LIFE INSURANCE COMPANIES.—For purposes of this part, a new life insurance company shall mean a life insurance company as defined under section 801(a) which was licensed to write life insurance within 9 taxable years prior to the year for which it files its return.

> "For new life insurance companies, if the deduction for investment yield on adjusted life insurance reserves determined in accordance with section 805(b)(1) does not exceed 87½ percent of the net investment income of the company, a specific deduction of 87½ percent of the net investment income of the company shall be allowed in lieu of that determined under section 805(b)(1)."

Mr. VERLANDER. It is often said that a small life insurance company is one whose assets are a hundred million dollars or less. I am speaking of the very, very small new life insurance companies whose assets range from $200,000 to $10 million.

H.R. 4245 can give life to small companies or it can take it away. In the early days of their existence they need help. It is my considered opinion the proposals I have presented will enable small companies to survive and preserve competition in the life insurance industry.

While these proposed changes may appear to be minor ones, they are certainly major ones to each individual new small company.

I want to thank you very much for permitting me to express these views.

The CHAIRMAN. Thank you very much, Mr. Verlander. I assure you the amendments will be considered in executive session.

Have you an estimate of any revenue loss, which may result, from these amendments?

Mr. VERLANDER. Yes, sir; if you take all the new small companies and add their assets, I would say it would total probably less than one medium small company. The total assets of all the new companies in my opinion would be somewhere around $100 million to $125 million.

I would think that the loss carryforward provision, if allowed, would probably total $3 million to $4 million in taxes. Not per year, but forever, because that would be all the loss carryforward we would have available to us. So I would think for the entire situation we are talking about $3 million.

The CHAIRMAN. The loss would only be for one time?

Mr. VERLANDER. One time, yes, sir. It is not per year loss revenue.

The CHAIRMAN. Are there any questions?

Senator CARLSON. Mr. Chairman, just this one thought:

If the loss on this additional year's of loss carryover would be $3 or $4 million——

Mr. VERLANDER. Yes, sir.

Senator CARLSON. Have you estimated any loss of revenue based on this 87.5 percent of the net investment income if it should be allowed? What happens then?

Mr. VERLANDER. No, sir; I don't have the total figures.

Using, say, $100 million as the total assets of the small companies, and say they are making 3.5 percent on their money, that would be $3.5 million. If you forgave the full 87.5 percent, we would be paying 30 percent of 12.5 percent, or 3.75 percent. The total reduction would be somewhere around $1 million in tax.

The law as it is now provides some deduction, so it would be less than a million dollars, in my opinion.

Senator CARLSON. Mr. Chairman, I am very sympathetic to the problems of Mr. Verlander and his company, and many others similarly situated, so I sincerely hope we can do something, keeping in mind the Treasury as well as competition with other companies.

Mr. VERLANDER. Thank you, sir.

The CHAIRMAN. Very careful consideration will be given.

Are there any other questions?

Senator TALMADGE. Mr. Verlander, are you a certified public accountant?

Mr. VERLANDER. Yes, sir.

Senator TALMADGE. Are you also an insurance actuary?

Mr. VERLANDER. I was with a firm of insurance management consultants, but I personally am not an actuary.

Senator TALMADGE. Prior to the time you became executive vice president and treasurer of the American Heritage Life Insurance Co., did you examine the books and do actuarial work for a good many insurance companies?

Mr. VERLANDER. Yes, sir; we represented probably 30 or 40 companies; most of them were small new companies; some of them were older companies.

I also for about 11 years acted as senior examiner for one of the Southern State's insurance departments.

Senator TALMADGE. Based on your knowledge and experience in these 30-odd companies, how long does it normally take a new company to begin operations in the black?

Mr. VERLANDER. Normally it will take 8 to 10 years, depending, of course, on the capital and surplus of the new company.

During the first few years of a new company's existence, the only hope for income is investment income, because all of your insurance operations cover new business, and your outgo is greater than your income.

A company organized with $200,000 of capital and surplus naturally has a much longer road and a tougher road getting around the corner than one with a million dollars of capital and surplus.

Senator TALMADGE. Will you explain to this committee why it takes a new insurance company 8 to 10 years before it gets in the black?

Mr. VERLANDER. Yes, sir.

During the first year of a new company's operation, or the first few years, the greater portion of your premium income is from first-year business, and the first-year premium of $1 is exceeded by probably 30 to 40 cents, and in some cases up to 60 cents of outgo for every dollar coming in. The reason for that is your high first-year commissions, your acquisition costs, including the medical examinations, credit reports, small reserve increase in the first year.

Your second-year premium on renewal business is the same as your first-year premium, but your expenses are not as great, and until you reach a point where there is a preponderance of your premium coming in from renewal premiums, as opposed to first-year premiums, you are faced with an almost certain loss.

Senator TALMADGE. And during those 8 or 10 years of losses, is there in depletion of capital?

Mr. VERLANDER. Yes, sir. For a new company that is exactly what it is. It is a pay out of paid-in capital from stockholders. That is the bulk of our request here. We feel that if we take stockholders' money and pay it out for normal operations, that in all fairness we should be allowed to recover those dollars before we start paying Federal income tax.

Senator TALMADGE. The normal corporate tax, I believe, has a carryforward provision of 5 years and carryback provision of three years; is that correct?

Mr. VERLANDER. That is correct.

Senator TALMADGE. That is a total of 8 years in which to average the taxes.

Mr. VERLANDER. Eight years in which he can level out his taxes; yes, sir.

Senator TALMADGE. The reasoning for that presumably is because an ordinary business has a profit and loss statement on an annual basis; is that correct?

Mr. VERLANDER. Yes, sir.

Senator TALMADGE. But in an insurance business, you do not have that situation.

Mr. VERLANDER. In an insurance business for a small new company writing ordinary lines, it would be most unusual and most difficult to have a profit the first year; yes, sir.

Senator TALMADGE. What you are requesting, then, is for the insurance industry the same thing that other businesses now have, is that correct?

Mr. VERLANDER. Yes, sir. We are asking that, and we are also asking that any losses that we have incurred in our first years prior to the enactment of this law be carried forward under this law.

Senator TALMADGE. Why is that request made?

Mr. VERLANDER. Well, at the time we got into the life insurance business we had one set of rules. We determined how much original capital and surplus we would need under these rules to eventually turn the corner and start making a profit.

Well, now, with the ball game one-quarter over, the rules have been changed. New companies in their original budgetary planning of needing X dollars, are all faced with the situation now that they need 2 X dollars. Either the Treasury Department and this committee allow us to bring those losses forward and get back to our original point or most of us will be faced with the proposition of going back to our stockholders and saying, "We are sorry, the rules have been changed. Instead of needing what we thought we originally needed, we need twice one and a half times that amount."

Senator TALMADGE. I have no further questions, Mr. Chairman.

The CHAIRMAN. Are there any other questions?

(No response.)

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

Mr. VERLANDER. Thank you, sir.

The CHAIRMAN. The next witness is Mr. William F. Poorman of the Central Life Assurance Co.

## STATEMENT OF WILLIAM F. POORMAN, PRESIDENT, CENTRAL LIFE ASSURANCE CO., DES MOINES, IOWA

Mr. POORMAN. Mr. Chairman and members of the committee, I am William F. Poorman, president of the Central Life Assurance Co. of Des Moines, Iowa.

The Central Life is a relatively small mutual life insurance company licensed to do business in 22 States and the District of Columbia.

I have with me Mr. Norman T. Fuhlrodt, executive vice president of the Central Life, to help me answer any questions which you may wish to ask.

I support the three phase structure of H.R. 4245, but with a 5-year average earned rate in phase 1, as has been recommended by other witnesses. My comments, however, are on another aspect of the bill, section 809(g), which denies a full deduction of policyholders dividends under phase 2.

Central Life competes in the sale of life insurance with both stock and mutual companies. The company does its best to provide insurance to policyholders at a net cost competitive with that of other mutual companies as well as the nonparticipating life insurance of stock companies.

For many years Central Life has adhered to a policy of maintaining a competitive net cost in the belief that the interests of its policyholders are best served by such a policy. As a small mutual company this means that Central Life has not been able to finance rapid expansion. As a result, the growth of the company has been less rapid than that of many other life insurance companies.

To assure the continued solvency of the company, we feel that an adequate surplus is of first importance. Second in importance is the maintenance of a competitive dividend scale that we may attract the right kind of agents and policyholders. Only after these conditions are met do we feel that we can use funds for the development and expansion of the company. Any tax on our policyholder dividends will obviously reduce this balance and will further retard the growth of the company.

Under H.R. 4245, the taxable investment income of Central Life for the year 1958 was approximately $1,665,000.

The gain from operations if we were allowed to deduct all our dividends to policyholders was $1,154,000.

Accordingly, Central's tax base under phase 1 would be $511,000 in excess of its actual gains from operation. It would be overtaxed by 52 percent of this excess or by $266,000. This inequitable treatment results from the fact that section 809(*g*) disallows as a deduction $511,000 of dividends paid to policyholders. In the final analysis the bill as now written taxes this amount of the dividend by 25 percent.

In the case of my company this tax on dividends to policyholders amounts to an average of over 50 cents for each $1,000 of life insurance on our books. It is obvious that a company whose premiums or net costs are consistently 50 cents higher than its competitors will have difficulty in keeping its competitive position with the stock companies in the field.

Most other mutual companies are similarly affected. I am sure this would be used against mutual companies most effectively in competition.

Why should a prospect pay $5 more per thousand in a mutual company than in a stock company when he is told that a substantial part of this excess premium will be paid to the Government in taxes and so could not be returned in so-called dividends?

A mutual company in effect says to its policyholders: "Instead of trying to estimate very closely the actual interest we will earn on your premiums, your share of mortality losses and the actual expenses, including taxes, we will calculate the premium conservatively but we promise to make a price adjustment from year to year when we actually know what our experience has been." Thus these so-called dividends are a price adjustment which in effect reduces the premium charged.

If allowance is not made for this, the great safety factor in participating life insurance represented by the conservative estimates used in calculating participating premiums may be destroyed. Under phase 2 as now written there will be every incentive for mutual companies to reduce participating premiums to about the level of nonparticipating premiums which will leave very little to be returned as so-called dividends, as well as to accelerate the trend from the higher premium permanent plans of insurance to those plans with low reserves, and term insurance.

The continuation of this trend with the consequent minimization of the savings aspect of life insurance can have significant and undesirable effects upon the economy.

Another illustration of the problems and inequities that will be developed by H.R. 4245 is that in a company where the taxable investment income is greater than the gain from operations without the limitations of section 809(g), any expansion of business must be made with 100-cent dollars as will be the case in most mutual companies instead of the 48-cent dollars in many stock companies.

The longer term effect of H.R. 4245 will be to cause, or rather force, companies to expand and develop term insurance rather than the permanent plans of insurance which have so well served both the insuring public and our economy in the past. Dividend adjustments on higher premium plans of insurance that may be required as a result of this bill may result in the termination of a substantial number of the higher premium policies since the benefits will not be competitive with other means of saving except insofar as the policyholders may be impaired risks. Thus the companies will be left with impaired risks and the situation generally worsened.

In summary, H.R. 4245 as now written will have the following unfavorable and inequitable results:

(1) It will limit the growth of smaller mutual life insurance companies and handicap their ability to offer competitive net cost permanent life insurance to their policyholders.

(2) It will accelerate the trend to term and minimum reserve types of insurance with consequent unfavorable effects upon the economy.

(3) It will result in less conservative assumptions in the calculation of premiums, resulting in a possible impairment of the issuing company's financial condition.

(4) It will place mutual companies at a competitive disadvantage in financing the expansion of their businesses.

Yesterday one of the witnesses suggested that this problem of negatives could be resolved by permitting negatives——

Senator KERR. Would you go a little slower?

Mr. POORMAN. I am sorry, sir. Yesterday one of the witnesses suggested that this problem of negatives could be resolved by permitting negatives that are not allowed in one year to be carried forward and carried back to other years and applied against phase 2 taxable income.

This would be quite inadequate so far as my company is concerned and I believe we are a typical mutual company. Certain stock companies would be the principal beneficiaries of such an arrangement, whereas it is the mutual companies that primarily suffer from this discriminatory disallowance of dividends.

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

Are there any questions?

Senator KERR. I have a question or two, Mr. Chairman.

Is it your position, Mr. Poorman, that the money returned to your policyholders as dividends is in reality a return of an excess premium charged.

Mr. POORMAN. Yes, sir.

Senator KERR. Well, does it not include moneys earned by your company on assets which have been built up or are being built up out of funds coming either from these same premiums or from funds set aside from previous premiums as a reserve against your commitments?

Mr. POORMAN. The interest on the funds set aside, arising from the premiums, or the reserves accumulated from those premiums were assumed.

In other words, the premiums are calculated conservatively, so that there is an expectancy that there will be an adjustment of these premiums by dividends.

Senator KERR. Well, now, you have built up quite a portfolio of assets.

Mr. POORMAN. Yes, sir.

Senator KERR. Is there anything in the experience of the life insurance business that you feel makes that a necessity against unusual circumstances or an unusual series of events which on the basis of history you feel are probable or likely to happen in the future which would adversely affect those reserves and therefore make them necessary?

Mr. POORMAN. In the late twenties and early thirties, sir, our surplus was practically depleted.

Following that, we adopted a policy of accumulating what we felt was an adequate surplus for the unexpected.

Senator KERR. Do you think there is anything peculiar about the life insurance business that makes such a policy necessary in it as in contrast to other financial institutions organized more completely for the benefit of the people that organize them and put the money in them.

Mr. POORMAN. I would feel, sir, that it is more important for a life insurance company to be unquestionably sound than even other lines of business.

Of course, this is highly desirable in any line of business.

But the suffering that is occasioned by the failure of a life insurance company, sir, is terrific.

Senator KERR. Why do you feel that all of the investment earnings or savings out of premium which you return to your policyholders, why do you feel in their entirety they should be exempt from tax?

Mr. POORMAN. The reason, is that the premiums are accumulated conservatively, and we in effect say to our policyholders we will adjust for this extra premium from year to year.

If there is any excess, it would be the interest earned on the excess premium which we hold for 1 year, over we will say the true premium or nonpar premium under which we would contemplate little if any profits, that could be considered to be an extra interest income to the policyholder.

In our case the extra premium is about $5 a thousand.

Senator KERR. Now there was an officer here of one mutual company and he was a very fine gentleman and he had a very good company and was a very able witness. He took the position that if the law were to grant a further deduction than is contained in this bill for dividends to policyholders, as you seem to advocate, it would permit the mutual companies to do what he said would dividend the smaller mutuals out of the market.

Are you one of the smaller or one of the larger or medium size? What is your relative rank?

Mr. POORMAN. Small and large, sir, are quite relative terms.

Senator KERR. Yes.

Mr. POORMAN. We think of ourselves as being one of the relatively smaller mutual companies.

Senator KERR. One of the soundest but one of the smaller.

Mr. POORMAN. Yes, sir. We claim we are one of the best.

Senator KERR. What is there about this thing that causes you, as the operating head—that is what you are, are you not?

Mr. POORMAN. Yes, sir.

Senator KERR. Of one relatively smaller mutual to have such a firm conviction on this thing in one way, apparently without fear of being dividended out of the market?

Mr. POORMAN. Sir, our past experience suggests that that is not——

Senator KERR. I did not hear that.

Mr. POORMAN. Our past experience has suggested this is not a hazard. In other words, we have competed with those companies for many years; we have been competitive with them.

So that certainly this bill would not change our position. It would increase the price which we would have to charge policyholders for insurance. In other words, I do not agree with the previous witness, sir, and, as a matter of fact, I have contacted the six other mutual life insurance companies in Des Moines——

Senator KERR. You have done what with them?

Mr. POORMAN. I have contacted them, the six other mutual companies in Des Moines, and they do not have this fear, either.

Senator KERR. Are you reported about in this week's Best's?

Mr. POORMAN. Central Life, yes, sir.

Senator KERR. Are you in this very mysterious operation of insured pension funds?

Mr. POORMAN. No, sir.

Senator KERR. You are not in that?

Mr. POORMAN. No, sir.

Senator KERR. Is it because you are not big enough, or because you are in my fix and do not understand it and better not get into it?

Mr. POORMAN. We have looked into it, sir, and we have not felt that we could be effective in the field. It is highly competitive, and we did not think that that was a place for us to be.

Senator KERR. Well now, if you know enough to stay out of it, maybe you would know enough to explain it to me. [Laughter.]

You can decline to answer that question on any of the bases generally in use by witnesses to achieve that purpose, if you like. [Laughter.]

Mr. POORMAN. I will try to explain it as I understand it. We looked into the field very briefly some years back when this matter of pensions became quite popular.

It appeared to us that the competition in the field was very rough. It took a skilled staff to operate the business. It also appeared to us that as compared with trust companies, we would be at a disadvantage. In other words, we did not see how we could go into the field.

Senator KERR. Why? Tell me why?

Mr. POORMAN. Because, sir, with the Federal taxes we would have to pay, we could not show the return. For example, last year taxes took in the area of a half of 1 percent of our earnings.

Senator KERR. What are your interest earnings?

Mr. POORMAN. They were 4.01 percent last year, sir.

Senator KERR. They were 4.01?

Mr. POORMAN. Yes, sir.

Senator KERR. And taxes took—in other words, then, taxes took 12½ percent of it.

Mr. POORMAN. Under H.R. 2445 our earnings would be 3.47.

Senator KERR. That is a little more than 12½ percent of the gross.

Mr. POORMAN. Yes, sir.

Senator KERR. Is that correct?

Mr. POORMAN. Of the net, sir; 4.01 percent was our net.

Senator KERR. The 4.01 percent was your net?

Mr. POORMAN. Yes, sir; that is before taxes.

Senator KERR. What is the difference between net interest return and gross interest return?

Mr. POORMAN. Well, from the gross——

Senator KERR. Do you not take into account in the term "interest return" all the interest return that you get?

Mr. POORMAN. Yes, sir; but we then deduct our investment expenses from that. So that is the net after investment expenses but before Federal taxes.

Senator KERR. You felt like that would put you at such a disadvantage as contrasted to the trust companies that you would not want to go into that field?

Mr. POORMAN. That is the way it appeared to us, sir. And we have not studied it recently.

Senator KERR. If a trust company has a trusteed program, what do they call it?

Mr. POORMAN. Well, they are a trustee of pension funds.

Senator KERR. You call it an insured pension plan, do you not?

Mr. POORMAN. If we issued it.

Senator KERR. What do they call it?

Mr. POORMAN. A trusteed plan. I am over in a field that I am just vaguely familiar with, not completely, sir.

Senator KERR. Well, if the trust company has $100,000 and invests it and gets $4,000 interest, they can add that to the trusteed account without any tax on it, is that right?

Mr. POORMAN. That is right, if it is qualified properly.

Senator KERR. Qualified under the law. If you had that $100,000 and you got 4 percent interest on it, under present law you would have to pay taxes on the 4 percent.

Mr. POORMAN. I would imagine, sir; there would be a deduction, but we would have to pay a tax on a portion of the——

Senator KERR. That is right. You would have to pay a tax on the same part of that as you would on the interest you got for any other funds you had.

Mr. POORMAN. That is right, sir. That would be my understanding.

Senator KERR. So that actually this business about the tax that is being taken off of earnings on these insured pension plans in the first place is the tax taken off of the funds available to the beneficiaries and not a tax taken out of the pocket of the insurance company; is that correct?

Mr. POORMAN. I feel quite sure it would not be taken out of the pocket of the insurance company.

Senator KERR. You mean on account of their adroitness, not because the hand is quicker than the eye or anything like that.

Mr. POORMAN. Well, of course I view that either the owners of the company pay the tax or the customers. Now, a company as such-——

Senator KERR. The question I asked you was addressed to this proposition as to who is being taxed: as to who is being taxed. Since it is the earnings on a trust fund account, is it a fact that the tax taken in actuality comes out of the pockets of the beneficiaries of the trust rather than out of the pockets of the insurance companies?

Mr. POORMAN. It would be so if we were issuing such a plan, sir.

Senator KERR. Are you familiar enough with the plans issued—for instance, the Connecticut General, I think that is a stock company, had a very smart man yesterday except he did not know how little I knew, and he was not smart enough to enlighten me, and it was no fault of his, but you do not know how he handles his business, do you?

Mr. POORMAN. No, sir.

Senator KERR. Do you know what the general practice is?

Mr. POORMAN. I am only familiar with the typical bidding form where there is a provision for allowance for Federal taxes in the forms that I have seen.

Senator KERR. Does that bidding form not disclose that the insurance company which is the custodian of this insured pension plan returns to the employer for his own account or for the account of his employees the return earned on the assets in the hands of the insurance company other than very minor expense charges?

Mr. POORMAN. As I recall, sir, the last one I saw had a provision for both expenses and taxes.

Senator KERR. Yes; but that they return the balance of it.

Mr. POORMAN. Oh, yes, sir.

Senator KERR. If the Government takes it away from them in the form of taxes, they cannot return that.

What I am trying to get in my own mind and into this record is an accurate, detailed account of what happens to the earnings on that fund if it is in the hands of a trust company, and what happens to those earnings if they are in the hands of an insurance company.

Mr. POORMAN. I would not be the best source of information on that, Senator.

Senator KERR. Well, you have done pretty good.

Mr. POORMAN. I would be a poor source of information.

Senator KERR. You told me if it was in the hands of the trust company, whatever the fund earns is free of tax and goes into the fund for the benefit of the people for whom it is set up; is that correct?

Mr. POORMAN. That is the way I understand it.

Senator KERR. That is the way I understand it, and if it is in the hands of an insurance company, the full amount cannot go into the fund, back to the employer or to the employee, for the very simple reason that a part of it is taken in the form of taxes.

Mr. POORMAN. That is right, sir.

Senator KERR. But that generally that which is not taken in the form of taxes does go back into the account for the benefit of the employees or to the credit of the employer.

Mr. POORMAN. That is the way I understand it.

Senator KERR. Thank you very much.

The CHAIRMAN. Are there any further questions?

(No response.)

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

Mr. POORMAN. Thank you.

The CHAIRMAN. Ray E. Lee, of the Austin Life Insurance Co.

## STATEMENT OF RAY E. LEE, VICE PRESIDENT, AUSTIN LIFE INSURANCE CO., AUSTIN, TEX.

Mr. LEE. Mr. Chairman, and members of the committee, my name is Ray E. Lee. I am vice president and a director of the Austin Life Insurance Co., with our home office in Austin, Tex. Our company was chartered and began business in 1946. By industry standards, we are quite a small company, but we are striving to grow up. Our founders set out to build a business enterprise that would endure, not only for their lifetimes, but for generations to come. I am speaking for the company. My statement will deal with two points.

We have studied H.R. 4245 as carefully as we could in the short time the text of the bill has been available. We have consulted our actuaries and lawyers; we have counseled with men who have been at the insurance business much longer and on a much larger scale than we have. I attended the hearings here 2 weeks ago and yesterday, and took careful note of the proposals made by eminent witnesses. On the basis of our present knowledge, we consider that a consequence of enacting H.R. 4245 will be severe discrimination in favor of mutual life insurance companies and against stock life insurance companies.

This discrimination is fundamental to the concept for phase 2 of the bill. It turns on a very simple point. This is the way I see it:

The management of a stock company has a duty to conduct the business to earn an ultimate profit for stockholders. It has no choice but to maximize earnings power.

On the other hand, the management of a mutual company has a duty to reduce the cost to policyholders. It has no choice but to reduce the company's earning power, theoretically to an average of zero over relatively few years.

Subpart C of this bill taxes both types of companies by a common method. When this is done, it is inevitable that the tax burden will fall heaviest on stock companies whose management does the best job, and least on mutual companies whose management does the best job.

In other words, if a mutual company does its job perfectly, the company's gain from operation will be zero and the tax under phase 2 will be zero. And it is equally true, if a stock company does its job perfectly, the company will have gains from operations and will have to pay a tax under phase 2. The result will vary only so far as the job is imperfectly done on either side. A tax based on gain from operation is a discrimination of importance. Such a tax will hinder free enterprisers, and will aid those who do not practice private ownership.

We recommend that the committee:

(1) Eliminate phase 2 entirely from the bill;

(2) Retain phase 1 of the bill, with some modification to solve problems identified to the committee in this hearing; and

(3) Retain and improve phase 3 of the bill, so that an appropriate corporate tax is levied upon any sum over and above the amount taxed in phase 1, which is distributed to stockholders in the form of cash dividends, the tax to be imposed with respect to the year in which the distribution is made. By way of improving phase 3, we urge that company surplus accumulated prior to the effective date of the new tax measure, be readily available to the stockholders. It has already passed through the tax screen. When any part of the existing surplus is not required by the company, there should be no tax obstacle to its release.

As I said, we request that phase 2 be eliminated from the bill. But, if it is decided that phase 2 must be retained, certain amendments should be made to reduce the discrimination against stock companies. We are unable to see that these amendments will do away with discrimination. But they will reduce the margin of discrimination.

The committee has already heard testimony about aiding small companies by exempting the first $25,000 investment income from taxation, or 25 percent of the first $100,000, instead of 5 percent of $500,000 as now proposed.

You have heard about the need for a period longer than 5 years for loss carryover.

You have heard proposals for fully exempting from income tax the interest yield on tax-exempt securities.

You have heard about the need for increasing the 10-percent margin of deduction for increases in nonparticipating reserves. I believe the best estimate is that the margin should lie between 9 and 15 percent, and possibly at the median or midpoint of 12 percent.

Our company supports these proposals if phase 2 is to be retained in the bill.

In addition to these, our company has a singular problem about deficiency reserves. There may be some other company with a similar problem, but at this time I do not know it. This problem relates to the definition in section 801, subsection (b), paragraph (4), which is headed "Deficiency Reserves Excluded."

Our company has a deficiency reserve. It was established under contract in 1954 and added to in 1955. No further additions will be required. This reserve meets the requirement of Texas law, but does not seem to meet the definition in the bill which would entitle us to an exclusion. Let me tell you how this reserve came about.

In 1954, Austin Life assumed liability for nearly $15 million mutual assessment insurance issued by a Texas company. In 1955, we assumed liability for another $8 million mutual assessment insurance issued by another Texas company. As a consideration for issuing legal reserve term contracts to the holders of the mutual assessment policies, Austin Life received the balance of the mortuary fund of each company, after optional settlements prescribed by Texas law has been paid. The sum by Austin Life as consideration was on the order of $8 million.

When the legal reserve term contracts were issued to each policyholder to replace the mutual assessment contracts, each insured was permitted to continue paying the same amount of premium which had been due on his mutual assessment policy; and in order to provide for the resulting deficiency in premium, Austin Life set up as a reserve an amount equal to the then present value of a temporary life annuity which would provide for annual payment of the part of the premium the policyholder would not pay.

This disposition of the mortuary fund is one of the two alternatives provided in the Texas insurance code, and is the method selected by the contracting parties.

The money received by Austin Life had been accumulated by the two mutual assessment companies between 1921 and 1955. Federal income tax had been paid by both these companies with respect to their mortuary funds. Thus the funds came to Austin Life through this tax screen. It was invested, and since 1954 Austin Life has paid income tax as prescribed by the Congress with respect to the investment yield on these investments.

Now, in the operation of this premium paying plan, a substantial amount of the reserve for premium deficiency is released each year, something on the order of $250,000. In the past, Austin Life has reported the sums to the Texas Insurance Commission as premium income; but it has not paid the State premium tax on the sums, and the Commission has accepted our company reports for 1954, 1955, 1956, and 1957 reflecting this practice. Our company was examined by the State authority in 1956, and this deduction from State tax liability was then allowed. We mention this to show that the regulatory authority for Texas for life insurance recognizes that the company is not receiving new income with respect to this part of the premiums required.

We believe that we truly have a deficiency reserve; and that the funds released in 1958 and thereafter should not be taxed a second time, because they have been taxed in the past. We fear that the present definition of a deficiency reserve in the bill does not clearly cover our case. We request that the provision cited be amended to make clear that the type of deficiency reserve Austin Life has is to be excluded. A draft proposal for this purpose is attached to this paper.

(The draft proposal referred to follows:)

### Draft Amendment to Section 801 (b) (4)

(4) Deficiency and other reserves excluded.—The term "life insurance reserve" does not include deficiency reserves and reserves on reinsured mutual assessment life insurance. For purposes of this paragraph and subsection (c), the term "deficiency reserves" means the total present value of the amounts by which—

(A) the net premiums required by life insurance and annuity contracts, exceeds

(B) the actual premiums and other consideration charged for such contracts;

and the term "reserves on reinsured mutual assessment life insurance" means the total present value of the amounts under closed blocks of assumed mutual assessment life insurance by which—

(A) the gross premiums required according to the reinsurance contracts and assumption certificates exceed

(B) the actual premiums to be paid by the policyholders according to the reinsurance contracts and certificates of assumption.

Mr. LEE. May I refer once more to our first proposal, that phase 2 be eliminated from the bill. If this is done, it appears that our company will pay just about the same amount of taxes, through operation of phase 1 and phase 3, as it would pay if H.R. 4245 were enacted with all 3 phases of taxation. But this change would clearly demonstrate that the Congress has no intention of giving mutual companies a business advantage over private enterprise companies. We are not objecting to paying our fair and reasonable share of taxes. We are objecting to an unfair method of measuring the tax burden our company and other stock companies will bear.

If phase 2 is not eliminated from the bill, we need and ask for some relief with respect to the exclusion of "deficiency reserves."

That is all, sir.

Senator KERR (presiding). You say:

> Our company has a deficiency reserve. It was established under contract in 1954 and added to in 1955.

Is that the same as saying that our stockholders, or some of them, added funds to the company into a surplus account or a policyholders' protection account as an added feature of safety for your policyholders which was required because of the financial condition or certain operations, certain commitments at the time but which, in your judgment, will one say, if not already, be available for redistribution to those stockholders, and the situation still be left in a condition of safety for which you made this added provision at the time?

Mr. LEE. This deficiency reserve relates to that purpose, sir, but it did not come about in that manner.

Senator KERR. How did it come about?

Mr. LEE. It came about by the assumption of our company of liability for insurance contracts previously issued by mutual assessment associations.

Senator KERR. In other words, you acquired their business?

Mr. LEE. We acquired their business, and with that——

Senator KERR. That gave you a commitment with reference to which there were not adequate reserves.

I say, what you received did not provide adequate reserves against commitments?

Mr. LEE. The amounts we received were sufficient to establish a deficiency reserve which was used to pay the balance of the premium required on the new contracts issued to the mutual assessment policyholders. Instead of mutual assessment——

Senator KERR. Do you pay a premium to the policyholders?

Mr. LEE. We pay part of the premium for the policyholder out of this fund received.

Senator KERR. Well, you paid it to establish a portfolio of assets or reserves that would give you ample safety there with reference to that commitment, wasn't that it?

Mr. LEE. Actually, the reserve was established to avoid increasing the premium the policyholders would have to pay. The mutual assessment business had been sold at one price, and when legal reserve business was issued, a higher price was required.

Senator KERR. Well, the higher price was to make the position of the company issuing the policy adequately safe, was it not?

Mr. LEE. It would; it would make the position of the policyholder adequately safe, too.

We judge that the position of the policyholder under the mutual assessment contract was not entirely safe.

Senator KERR. Well, that was because there wasn't an adequate reserve in the hands of the insurer against probable liability represented by the policies, was it not?

Mr. LEE. I think I would agree with that statement; yes, sir.

Senator KERR. If I understand your answer to the question, it is yes, but on the basis that you would rather have it than to have said "Yes."

Mr. LEE. I beg your pardon, sir?

Senator KERR. Well, maybe you have as much trouble understanding me as I do you, that is all.

Mr. LEE. I am sorry. I would like to help you.

Senator KERR. I thought I was trying to be helpful about it and trying to get the matter in such a way as I can understand it, but I haven't succeeded in that, and I don't take any more of your time.

Mr. LEE. I am sorry, sir. I am afraid I didn't hear the last words of your original question, that is the reason I could not reply.

Senator KERR. That is all.

The CHAIRMAN. Are there any further questions?

(No response.)

The CHAIRMAN. Thank you very much.

Mr. LEE. Thank you, sir.

The CHAIRMAN. Mr. W. H. Painter, Sr., United Fidelity Life Insurance Co.

Take a seat, sir.

## STATEMENT OF W. H. PAINTER, EXECUTIVE VICE PRESIDENT, UNITED FIDELITY LIFE INSURANCE CO., DALLAS, TEX.

Mr. PAINTER. Gentlemen, first I want to thank your committee for the courtesy extended to me, along with so many others vitally interested in this bill, to appear before you.

My name is W. H. Painter. I am executive vice president of United Fidelity Life Insurance Co. of Dallas, Tex. Our company was incorporated in 1920, and I was privileged to be one of its original directors.

Within 6 months after its first policy was issued I became a full-time employee, and have been continuously employed by it until the present time.

Ours is not a large company, as measured by many whose representatives have appeared before you, but rather falls into the category of the many small companies that have such a vital interest in this proposed legislation.

Our original purpose and plan, to which we have adhered all these years, was to build a sound, financially strong life insurance company that could stand up and compete with the largest and smallest and offer life insurance protection in which every policy owner would have full confidence.

Our stockholders have accomplished this by leaving a large portion of the earnings in the company, knowing full well that it could only earn them the interest it would bring in the market and that the income from it would be subject to corporate taxes each year, plus another tax when they withdraw it as dividends. They felt that, particularly during the formative years, their policyowners were entitled to that protection.

We, of course, know that in order to perform the many functions demanded of our Government it must levy and collect taxes, and are perfectly willing to pay our fair share, asking only that our competitors in the same line of business be taxed on the same basis, without discrimination.

When H.R. 4245 was reported out of the Ways and Means Committee and almost immediately passed by the House we had so little time that we could only hurriedly read it and wonder what its real impact might be on our industry and our company in particular.

I am frank to say, however, that since I am not an actuary or a tax accountant, I am still very uncertain of the meaning of the many complicated features of the bill.

There are some things in the bill, however, that we do understand all too well. They are those provisions which on their face show discrimination between companies whose only real difference and distinction is in the name.

There are several types of organizations engaged in writing some form of life insurance, but the two organized on the same sound basic principles, generally referred to as old line legal reserve companies, are distinguished from each other only by the one word, "mutual," which one of the types has adopted.

They are both organized under the same general insurance laws of the several States for the purpose of conducting a life insurance business within that State, or other States, or other countries of the world. They go into the market places throughout these whole United States in competition with each other and all others, using rates, size, dividends (so called), and every other possible means to write all the life insurance they can possibly obtain. This is something they are entitled to do under our laws as commercial enterprises, but not with tax advantages over their competitors.

In defining corporations which have adopted the word "mutual" and have decided to operate under that plan, such as mutual life insurance companies and mutual savings banks, the dictionary says their profits are to be returned to their policyholders or depositors. Thus from an unbiased source we learn that they are organized for profit and that these profits are to be distributed to someone—obviously the owners of the corporation.

We are proud of the insurance industry which has grown up in the several States of the Union within the past 50 years in direct competition with the so-called mutual plan.

This new tax bill, as we read, and at least partially understand it, would now, to an extent, stifle this competition. Even though the Congress has approached this subject by predetermining that it wants $500 million and more from a single industry, and even though it may in its wisdom disregard the fact that such a tax may vary as between different industries in our country, we cannot conceive of the passage of a bill that will be discriminatory as between competitors within the same industry.

It appears rather odd, incidentally, too, that the predetermined amount of taxes was based upon the 1942 law, which you gentlemen, the Members of the House, and the insurance industry as well, agree is an unsound law. Suppose the Treasury and the Congress had made the same approach in the early fifties. It would appear that such an approach would be just as logical one year as another, but if taken at that time it would not have provided any tax at all.

It is my feeling, therefore, and it was certainly that of a substantial number of the members of the Ways and Means Committee (as indicated in their supplemental views on pages 87 and 88 of the report of the Committee on Ways and Means of the House of Representatives on February 13, 1959) that the anticipation of $500 million would not be a consideration of this committee in its deliberations on this question of taxation of life insurance companies.

I am sure you gentlemen will agree that we have all had far too little time in which to consider all the ramifications of this proposed legislation, but we are convinced by the explanation of the bill as published by the Ways and Means Committee of the House that there are many discriminatory features in it which could conceivably stifle the expansion of the life insurance business within the several States and concentrate it in a few big companies in a limited number of States.

May I point out a few of these things?

Phase I taxes all of the investment income over and above that included by contract with the policyholder in the calculation of premiums, which is, of course, all of the investment income which could possibly become subject to taxation. But from a limited study of the bill, since it has been made available to us, and without the Treasury Department's interpretation of it, I am not sure that even this is equitably taxed as between the several companies and types of companies.

If a company in its considered judgment determines that it will accumulate its reserves on a 2½-percent basis, and is then permitted to deduct an industrywide average rate which might very likely be nearer 3 percent, it will then have 0.5 percent on all its reserves as free earnings which will never enter the tax picture at all because it has been freely predicted that the so-called policyholders dividends will relieve it of any tax whatsoever in phase II.

We are glad to see that an amendment correcting this situation has been proposed, thus placing all companies on the same basis.

Phase II takes up earnings from other sources, all other sources, but under the law as written few of the larger, well-managed mutuals will ever pay a dime of tax thereunder.

In a further move to increase the discrimination against stock companies, they have even introduced an amendment to this bill which would have the effect of permitting them to charge so-called policyholders dividends against investment income in phase I and thus relieving them from a portion, and in extreme cases possibly all, of the basic tax on excess investment earnings which could not conceivably be any part of the redundant premium.

Phase III, as now written, cannot possibly be applicable to any but stock companies, and is on its face discriminatory. In fact (and while I am not by the use of the word even remotely suggesting that it was in anyone's mind in drafting the bill) it could almost be called a punitive measure. It purports to set up a so-called policyholders surplus, which most companies already have in adequate amount, and yet while they are creating this new surplus, which is commendable if needed, the stockholders have all their old capital and surplus funds frozen, subject to an additional tax on this new surplus, which reduces this new policyholders surplus by 52 percent and thus thwarts its purpose.

It would appear perfectly logical and reasonable to permit the stockholders to take down their own funds now in the company's old capital and surplus account without penalty to the extent of the gross amount on which they have paid taxes in phase II.

One item in particular in this proposed legislation which is indefinite and uncertain is the method of handling tax free interest. No two companies appear to come up with the same interpretation of this.

In order to protect the credit of our home States we know you will want a specific statement in any legislation that may be passed that under no circumstances will the life insurance companies be required to pay an income tax on this portion of their income, since no one else is required to do so.

Thank you very much.

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

Mr. James P. Swift, Southwestern Life Insurance Co.

## STATEMENT OF JAMES P. SWIFT, VICE PRESIDENT AND GENERAL COUNSEL, SOUTHWESTERN LIFE INSURANCE CO.; ACCOMPANIED BY CHARLES H. CONNOLLY, ASSOCIATE ACTUARY

Mr. SWIFT. Mr. Chairman and members of the committee:

I have with me Mr. Charles Connolly, who is a fellow of the Society of Actuaries.

He is an associate actuary of our company. He is here to provide any technical information that may be needed in connection with my testimony.

My name is James P. Swift, and I am vice president and General Counsel of Southwestern Life Insurance Co., which is a stock company organized in Texas in 1903 and now doing business in seven additional States.

At the close of 1958 it had in force in excess of $1.800 billion of predominantly nonparticipating business, and assets in excess of $450 million.

In round figures and before income tax the net investment income for 1958 was $16.265 million, and the bookkeeping gain from operations was $6.9 million.

On 1957 business it paid $1.050 million in Federal income tax under the Mills-Curtis law.

On 1958 business the income tax would be approximately $1.865 million under the 1942 formula, and $1.960 million under the formula of H.R. 4245.

The life insurance business is disturbed and divided by H.R. 4245. Every kind of life insurance company and association has sought time to testify at these hearings.

Every witness has found fault with the bill and none has defended it without major amendments. My statement will be limited to the single proposition that the bill unfairly discriminates against the many stock companies and in favor of the relatively few large mutuals, and that in that direction lies the possibility of monopoly which is contrary to the public interest.

We subscribe to the assertions, made last November during the Ways and Means Committee hearings, by Mr. Claris Adams, vice president, general counsel and spokesman for the American Life Convention, that—

any significant differential in the tax burden would cripple the stock companies, particularly the smaller ones, and ultimately would drive them into mutualization or force them out of business (1958 Ways and Means hearings, p. 50).

And further, Mr. Adams, speaking of large mutual companies:

I am firmly convinced that a total income approach either in whole or in part, will work to the undue advantage of companies of their particular type and will in fact discriminate against their competitors as some of their own spokesmen have so often and so freely admitted in the past (1958 Ways and Means hearings, p. 67).

We are told that the Congress would never intentionally enact a law which would give the large mutuals a tax advantage over the hundreds of bona fide stock companies which have so well and faithfully served the insurance needs of the people and the economy of their geographic areas of operation.

We are also told that many of these stock companies are convinced that the total income concept of step 2 of the formula will place them at a competitive disadvantage which can sooner or later destroy them, and vest in their large mutual competitors a virtual monopoly in the life insurance field and its related investment functions.

In the light of this apparent conflict between the intention of the Congress on the one hand and the convictions of a large segment of the life insurance companies on the other, it would appear that somewhere there has been a breakdown in the lines of communication between these insurance companies and the Congress.

My purpose here is to demonstrate to this committee that the total income concept of step 2 as it is now written would impose on the stock company segment of our business a tax differential which could sooner or later eliminate us from the private enterprise area of our national economy. For this purpose I have divided the discussion into three points as follows:

Point 1. For all practical purposes, step 2 of the formula imposes a tax on stock companies which is not imposed on mutuals.

Step 2 taxes one-half of the operating gains which are in excess of the investment income tax base under step 1. Inasmuch as the mutuals are allowed to deduct all of their policyholder dividends from these gains, and have unlimited discretion as to how much of the gains they will pay out as dividends, it necessarily follows that the policyholder dividends can eliminate step 2 as a tax base for the large mutuals. This point seems to be universally admitted but as evidence I cite the testimony of Mr. Lindsay at page 36 of the Ward & Paul daily record of these proceedings as follows:

I believe in 1958 there were about $1,400 million of dividends paid to policyholders. About nine-tenths of that amount gets the full benefit of the deduction under this bill, *so that very few mutuals in effect would be paying a tax under phase 2 because those deductions reduce or eliminate phase 2.* [Emphasis mine.]

Stock companies are also allowed some deductions for operating gains but not enough to escape a step 2 tax. These deductions include:

(1) Ten percent of the annual additions to nonparticipating reserves. Beginning at page 19 of the Ward & Paul daily record, Mr. Lindsay explains the purpose of this deduction as follows:

Because of the redundant premiums charged by mutual life insurance companies, they have an additional cushion besides their surplus with which to meet possible adverse operating experience. Stock companies, with their lower initial premiums, do not have this cushion and, consequently, must maintain a larger surplus. In recognition of this situation, the bill provides a deduction of 10 percent of the net increase in reserves on nonparticipating life insurance contracts. This special deduction is limited to the step II or underwriting gain portion of the tax base. It would not be permitted to reduce the net investment income base.

From page 7 of the report of the Committee on Ways and Means it appears that this deduction may also be intended "to reduce the relative impact of policyholder dividend distributions." Whatever its basic purpose may be, it is perfectly obvious that any decrease in the deduction can serve only to increase the discrimination against stock companies.

(2) Two percent of the annual premiums from group, life, accident, and health policies. The purpose of this deduction is stated by Mr. Lindsay as follows:

This allowance is patterned after the reserve requirements of two States for purposes of strengthening the financial safety of companies conducting this kind of business (Ward & Paul daily record, p. 20).

Obviously, this deduction is available to mutual as well as to stock companies.

(3) A possible deduction under the provision allowing the use of net level premium reserves instead of preliminary term reserves. This is apparently a small company consideration and could reduce the tax of some small stock and mutual companies. It does not and will not affect the tax liability of our company.

That step 2, after deductions, is expected to produce revenue is reflected by the testimony of Mr. Lindsay at page 22 of the Ward & Paul daily record as follows:

The chairman asked this question:

As I understand it, step 1 is expected to bring in a revenue of $500 million. Step 2 brings in a revenue of between $45 million and $60 million.

Mr. Lindsay answered:

That is correct.

Attached to this statement and marked "Exhibit A" is a sheet of computations prepared by my associate, Mr. Connolly, to reflect a comparison of the impact of H.R. 4245 on the 1958 operations of our company as a stock company, and also as if it were a mutual operating in the usual mutual pattern. It assumes that proposed amendments will be adopted with respect to the deduction rate and that, in fact, the step 1 tax will apply uniformly to stock and mutual companies. It shows that both twins would be taxed equally under step 1 where each would pay Uncle Sam $1,245,000. But it also shows that the stock company twin would be taxed $589,000 under step 2 while the mutual twin would pay nothing under this step.

In summation of point 1, we submit that step 2 is intended to produce substantial annual revenue; that all or practically all of such revenue is to be exacted from the stock companies with the mutuals home free, and that on comparable operations the stock company with normal operating gains would pay substantially more taxes than its identical twin.

Point 2. The tax differential could force many stock companies out of business.

Every life insurance company, stock or mutual, is basically divided into two departments. One designs and sells policies and the other invests and manages the reserves and other assets of the company. In both fields the mutual and stock companies compete among themselves and against each other under the same ground rules. They offer the same kinds of policies to the same buyers in the same markets under the same agency system. They make the same kinds of investments and loans in the same money markets, and in every respect they are governed by the same or similar State laws.

As said by the Supreme Court in *Penn Mutual* v. *Lederer*, (252 U.S. 523):

> The real difference between the two classes of life companies as now conducted lies in the legal right of electing directors and officers. In the stock company stockholders have that right; in the mutual companies, the policyholders who are members of the corporation.

The successful companies in both categories will normally have investment income and so-called gains from operations at the company level. The testimony of Mr. Guest, vice president of the Massachusetts Mutual Life Insurance Co., at page 221 of the Ward & Paul daily record, contains statistics showing that the net cost to policyholders is practically identical as between stock and mutual companies.

This competition is conducted on a policy by policy, agent by agent, and company by company basis, and is not merely a competition between the mutual companies on the one side and the stock companies on the other. When competition is as finely balanced as this, it is inconceivable to me that a particular company, either stock or mutual, or any class of companies, could long survive against the excess operating expense of the tax differential here demonstrated.

You will remember that in the twin company comparison we showed that the stock twin paid a total of $1,834,000 while the mutual twin paid only $1,245,000. This makes a differential of $589,000 in money, and burdens the stock company with 47 percent more tax than its mutual twin.

I may be wrong, but in terms of my grade school arithmetic it appears to me that the stock company saddled with that kind of handicap is not long for this world.

In summation under point 2, we submit that if the tax differential proposed by this bill is imposed on our company and others similarly situated for any appreciable period of time, it can sooner or later force us out of business.

Point 3. The discrimination is caused by the deduction for policyholder dividends.

On its face the bill purports to treat stock and mutual companies alike. The tax is levied on net investment income and on operating gains of both stocks and mutuals, and the discrimination results from the practical effect of the deduction for dividends to policyholders (sec. 811). In practice the deduction does not apply to hundreds of stock companies which write mostly nonparticipating, guaranteed cost business. But it does apply to the large mutual companies which write mostly participating business. In terms of cause and effect, it is the deduction for dividends to policyholders which effects the discriminatory and destructive tax differential against the many stock companies and in favor of the few large mutuals.

This situation seems to compel a searching examination of the nature of the policyholder dividend. I am not an actuary nor am I qualified by training, experience or otherwise to testify on this complicated subject. However, from my hasty inspection of the court decisions as a lawyer, and from the testimony of other witnesses on the subject already in this record, I am persuaded that policyholder dividends carry no legal immunity from tax and that in their make-up they include some profit and new wealth earned by the mutual company on the investment of its reserve and surplus funds.

I believe the committee would be interested in the discussion of these dividends by the Supreme Court in *Penn Mutual Life Insurance Company* v. *Lederer*, 252 U.S. 523, which has already been mentioned in the record.

Some witnesses have taken the position that the policyholder dividend is strictly a price adjustment involving only the return of unused capital in the form of premiums. Mr. Lindsay has suggested that in the neighborhood of 10 percent is an interest increment. The record does not contain a mathematical demonstration of the truce sources of these dividends as paid by a representative number of mutual companies over a significant period of time.

I am told that in 1954 the joint tax committee of the American Life Convention and Life Insurance Association of America considered a tax formula involving a tax on 25 percent of policyholder dividends, and that there was a substantial agreement among mutual companies that this figure would represent a reasonably accurate average of the earnings increment in the dividends.

Let me make it crystal clear that we do not suggest or desire that the Congress impose any unfair or unreasonable tax on policyholder dividends or any other operation of our mutual company competitors. We have many fine friends among the great mutual companies, and our wish and hope is that the life insurance business, as it is now constituted, may be able to continue to provide the American people with the finest and most efficient life insurance service through a system of fair and equitable competition without tax advantage for either mutual or stock companies.

Certainly the public interest would be well served by the most careful efforts of the best qualified experts to prevent the discriminatory and destructive tax differential from becoming law, whether such prevention be accomplished within or without the framework of the bill.

As the conclusion of this statement I wish I could submit a fair and equitable tax formula that would be acceptable to the Congress, the

Treasury Department, the life insurance companies, and the plain people who must ultimately pay the tax as a part of the cost of their insurance. That I cannot do, and I respectfully suggest that it has not yet been done in these hearings.

Ever since the bill was introduced in the House and first became available to me—just 37 days ago—I have been in almost constant contact with many of the outstanding actuaries, accountants, and tax lawyers in our business, and to this good moment no two of them have yet agreed on how the formula should be written or, for that matter, how the bill in its present form would affect the present and future operations of their own companies or the tax receipts of the Government.

The difficulty inherent in trying to fit an operation so completely unique as the life insurance business into a tax pattern designed to apply to general corporations, and the proposition I have been urging here today, have both been aptly demonstrated by Mr. Shanks, president of the Prudential Life, in his testimony at the House hearings last November when he said:

> If we resort to a total income type of tax, we can do a fair job of equalizing the position of life insurance stockholders and stockholders generally, but we create a possible competitive advantage in favor of the mutual company over the stock company just because of the built-in flexibility afforded by the redundant premium and the policy dividend (p. 217).

As a possible way out of the present unhappy situation we suggest the following procedure:

First. Remove the legislation from the status of a crash program by some temporary method by which the Treasury Department can collect the $500 million it has requested on 1958 business. Five hundred million dollars may or may not be too much on a permanent basis, but at least it is a reasonable price to pay to avoid the possible tragedy of falling from the frying pan into the fire.

Second. Provide the $500 million by either reenacting the Mills-Curtis law with adjustments in the amount of tax and for the specialty companies, or enact H.R. 4245 amended to eliminate step 2, or do nothing and let the 1942 formula apply under the existing law. I want the record to show that I am not suggesting or defending the 1942 formula for any purpose other than the purely temporary one involved in this recommendation, which takes into consideration the fact that it is the existing law on which all companies estimated, or should have estimated, their tax liability on 1958 business.

Third. Give the industry and the Treasury Department until September 1st, or some reasonable and specific date, to come up with an acceptable formula to be enacted into law before the returns are due on 1959 business. As reflected by these hearings, the industry is in a state of disruption and disagreement with respect to this matter. It is conceivable that a reasonable cooling-off period could restore the unity and harmony that has traditionally existed on the tax issues within the business until the rift arose between the mutual and stock companies within the past year.

It is also conceivable that these hearings have demonstrated the necessity of a cooperative effort of both types of companies if we are to preserve for the American people the best life insurance service on both the participating and the guaranteed cost basis.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Swift.

Are there any questions?

Exhibit A will be inserted in the record at this point.

(Exhibit A follows:)

EXHIBIT A

| | Company A (nonparticipating) | Company B (participating) |
|---|---|---|
| 1. Premiums | $47,971,000 | $[illegible]3,971,000 |
| 2. Net investment income | 16,265,000 | 16,265,000 |
| 3. Total income | 64,230,000 | 70,230,000 |
| 4. Claims | 27,814,000 | 27,814,000 |
| 5. Expenses | 9,248,000 | 10,635,000 |
| 6. Reserve increases | 20,100,000 | 20,569,000 |
| 7. Charges against income except dividends and taxes | 57,258,000 | 59,018,000 |
| 8. Dividends to policyholders | | 8,443,000 |
| **TAX COMPUTATION** | | |
| (a) *Investment income* | | |
| 9. Net investment income | 16,265,000 | 16,265,000 |
| 10. Tax-free interest, interest paid, and similar adjustments | 1,301,000 | 1,301,000 |
| 11. Deduction for reserve interest | 12,570,000 | 12,570,000 |
| 12. Step I tax base | 2,394,000 | 2,394,000 |
| 13. Unadjusted gain from operations (line 3 less line 7) | 6,978,000 | 11,188,000 |
| 14. Nonpar deduction | 1,557,000 | |
| 15. Tax free interest, etc | 763,000 | 763,000 |
| 16. Policyholder dividends paid | | 8,443,000 |
| 17. Maximum dividend credit allowed[1] | | 8,031,000 |
| 18. Adjusted gain from operations (line 13 less lines 14, 15, and 17) | 4,658,000 | 2,391,000 |
| 19. Smaller of line 12 or line 18 | 2,394,000 | 2,394,000 |
| 20. 50 percent of excess line 18 over line 19 | 1,132,000 | |
| 21. Step I tax (52 percent of line 19) | 1,245,000 | 1,245,000 |
| 22. Step II tax (52 percent of line 20) | 589,000 | |

[1] Limit is the excess of gains adjusted for tax-free interest, etc., over step I tax base.

This exhibit compares the tax of company A, Southwestern Life with company B, adjusted to be a twin mutual. The figures used for company A are the actual round number figures of Southwestern. The same figures are applied to company B with the following adjustments to conform to normal mutual company operations:

1. Mutual premiums are assumed to be 12½ percent higher.
2. Mutual expenses are assumed to be 15 percent higher. This assumption is based on a comparison of Southwestern's renewal expense ratio per $1,000 of $3.55 with an average of $4.09 for the 14 largest mutuals. (See Best's Life Reports, 1958.)
3. The increase in Mutual reserves is assumed to be 2 percent higher than Southwestern's increase because of the traditionally lower interest rate used by mutuals for reserves.

Mutual dividends were calculated so as to produce an increase in surplus of 7.3 percent of the increase in reserves. This is the average increased in surplus of the 14 largest mutuals. (See Best's Life Reports, 1958.)

Reserve comparisons were based on approximate adjustment methods and in H.R. 4245.

The CHAIRMAN. Any questions?

Senator Kerr.

Senator KERR. I am interested in the life expectancy of this set of twins you have created.

Senator GORE. Identical.

Senator KERR. Yes. Where is the exhibit that sets forth what would happen to them?

Mr. SWIFT. At the back of the statement, Senator Kerr. I hope it is on yours.

Senator KERR. Is that exhibit A?

It is estimated, I believe, that the policyholders under company B would pay $6 million more premiums than the ones under company A.

Mr. SWIFT. Yes, sir.

Senator KERR. But you estimate that they would receive $8.443 million back in dividends.

Mr. SWIFT. Right.

Senator KERR. Where does that differential come from?

Mr. SWIFT. Senator Kerr, I am going to ask the expert on my right, Mr. Connolly, to give you the answer to that question.

Mr. CONNOLLY. Senator Kerr, I interpret that to be a distribution of the earnings of this corporation to the owners of the corporation who are the people who own the policies. The fact that there is a considerable element of earnings in policyholder dividends, I think, is a very important point that the statements on frequent occasions that dividends are simply a price adjustment is not the full facts in the case.

Senator KERR. That is the statement with which you do not agree?

Mr. CONNOLLY. That is right.

Senator KERR. Well, now, you don't mean that company B earned that additional $2.443 million on the $6 million?

Mr. CONNOLLY. No, sir; that is earnings on the whole operations of the corporation.

Senator KERR. Well, now, doesn't company A operate on a basis just as profitable with reference to what its assets are as company B?

Mr. CONNOLLY. Yes, sir.

Senator KERR. Does it then have the $8.443 million to distribute to somebody?

Mr. CONNOLLY. No, sir; it would be the $2.443 million. The $8.443 million, $6 million of it——

Senator KERR. Was in excess premiums.

Mr. CONNOLLY. Redundant premiums.

Senator KERR. Excess premiums.

Mr. CONNOLLY. Yes.

Senator KERR. But it does have the $2.443 million?

Mr. CONNOLLY. Yes, sir.

Senator KERR. What does it do with it?

Mr. CONNOLLY. In our case we paid out to our stockholders $1.350 million. We added the other to surplus.

Senator KERR. In other words, then, on the one hand you take the position that company A should be permitted to transfer how much to surplus?

Mr. CONNOLLY. The dividends to stockholders plus what I would consider stockholders' surplus would total $2.443 million.

Senator KERR. And of that, how much went to stockholders' surplus?

Mr. CONNOLLY. The difference between that and $1.350 million, which would be $1.093 million.

Senator KERR. $1.092 million to surplus, and a million how much to dividends?

Mr. CONNOLLY. $1.350 million.

Senator KERR. Yes. How much tax did company A pay?

Mr. CONNOLLY. This tax figures a total of $1.834 million. This is calculated with the use of actual earned rates rather than the deduction rate as provided by the bill, which causes perhaps $100,000 difference in the tax.

Senator, if I may add a point here in explanation of the $2.443 million. It is my feeling that to a great extent that represents a distribution of investment income which was subject to tax in phase I.

Senator KERR. Do you think that that tax paid by company A should be any less, or that taxes paid by company B should be more?

Mr. CONNOLLY. I feel that probably both things should be true, to bring about equalization.

Senator KERR. But that you think that they should pay the same amount of tax?

Mr. CONNOLLY. Yes, sir.

Senator KERR. In other words, you think that what company A pays to stockholders should be as free of tax as what company B pays to policyholders?

Mr. CONNOLLY. I think that it should be taxed equally; yes, sir.

Senator KERR. Well, now, maybe Mr. Swift would answer that question.

Mr. SWIFT. That isn't exactly my idea, Senator. I think that the tax should be equalized so that it falls with equal impact on both companies.

Senator KERR. Well, now, you said that.

Mr. SWIFT. I think that can be done——

Senator KERR. I asked you the question, Do you think that whatever company A pays to its stockholders should be just as free of tax as whatever company B pays to its policyholders?

Mr. SWIFT. So far as the interest increment or the earnings from investments, I think that is true.

Senator KERR. What about earnings from underwriting and other operations than investment?

Mr. SWIFT. I think the true redundancy in premiums, whatever that is, should be returned to the policyholders as a policyholder dividend free of tax and as a return of capital. But I make the distinction between the return of the redundant premium and an addition to the policyholder dividend of earnings on the invested funds of the company.

Senator KERR. Well, you told me that so far as that item is concerned, you think that whatever the stock company pays to the stockholders should be just as free of tax as whatever the mutual pays to the policyholders, insofar as that item of income is concerned.

Mr. SWIFT. Yes.

Senator KERR. But I asked you what you thought about the treatment of the earnings of either of them with reference to underwriting profit or profit from other operations.

Mr. SWIFT. Well, I think whatever profit a stockholder of a stock company gets out of his company is taxable, it is profit, it is taxable. But I think the redundant premium thing is not a profit. That is a return of capital. I don't know whether I understand you or you understand me.

Senator KERR. Well, you do, you have done a mighty good job of answering just what I have asked you.

As I got your position, it is that you believe that whether a company operates as a stock company or as a mutual company, that with reference to investment income the tax applicable to them should be identical.

Mr. SWIFT. That is right.

Senator KERR. But I haven't understood what your position is with reference to their other gains from operations——

Mr. SWIFT. I think the other gains from operations——

Senator KERR. Whether you call it underwriting profit or specialty profit, or what not.

Mr. SWIFT. Well, I suppose we could call it the redundancy in premium, that is what I am talking about.

Senator KERR. But there are other gains from operations than that, are there not?

Mr. SWIFT. Senator, I think there are, and maybe I didn't make my position on it clear. Maybe I can do it this way:

Whatever gains from operations are made in the competitive field should be taxed alike.

Now, there is not a competitive field in the redundant premium, and to the extent of the redundant premium the mutual should be tax free.

Senator KERR. You mean the redundant premium return should be tax free?

Mr. SWIFT. That is right. And the rest of it should be taxable, or should be equalized. I don't say it should be taxable, Senator. I say that equality should be done there between the stock and the mutual.

Senator GORE. How do you do that?

Mr. SWIFT. Senator Gore, that is a highly complicated question, which has been discussed quite a bit here. It seems to me there has been—we have skirted the edge of that question with a good many witnesses, and I don't have the answer.

I am told that the answer is determinable; that is, that you can take, that one of the large mutuals can take their own figures and they could compute what dividends they paid and what the sources of those dividends were over a period of years.

Senator GORE. Excuse me, Senator Kerr.

Senator KERR. That is all right. Anything that contributes light to this situation is welcomed by me, sir.

I see in this exhibit A that company A had unadjusted gains from operation of $6,078 million; company B had an unadjusted gains from operations of $11,188 million.

Under company A you talk about a nonparticipating deduction. What is that?

Mr. SWIFT. That is that 10 percent that is in the bill now, 10 percent additional nonparticipating reserves.

Senator KERR. I don't see any similar item in the column for company B.

Mr. SWIFT. Senator, I am going to ask Mr. Connolly to take over again on his exhibit here, if you don't mind.

Mr. CONNOLLY. No, sir, that is the differential extended to stock companies because of the fact that we are not collecting redundant premiums.

Senator KERR. Well, does that go to your policyholders or your stockholders?

Mr. CONNOLLY. We look at it as a required surplus item if we are going to stay in business and be healthy. We feel that we must maintain a surplus of at least 10 percent of our reserves because we have only——

Senator KERR. But this is 10 percent of something else besides reserves, is it not?

Mr. CONNOLLY. It is 10 percent of the increase in life insurance reserves. You will note in line 6 our increase in reserves is actually $20 million.

The bill——

Senator KERR. Wait a minute, let me get line 6.

Yes, I see that.

Mr. CONNOLLY. Our increase in reserves are $20 million; 10 percent of that would be $2 million, but a portion of that $20 million increase came on annuity and group reserves which are not granted the 10-percent nonparticipating surplus addition.

Senator KERR. You don't write policies that do not carry premiums sufficient to meet the reserve requirements, do you?

Mr. CONNOLLY. Yes, sir, we do. We have some on the books.

Senator KERR. You do. I mean, this is talking about new ones. Are you doing that now on the new business you write?

Mr. CONNOLLY. Well, in this work here there is no deficiency reserve element which I believe you are referring to.

Senator KERR. I thought you said the reserve increases came about from new business created.

Mr. CONNOLLY. No, these— the $20 million of reserve increase is on operations of all of our business whenever issued. Our reserves went up——

Senator KERR. How much of that additional $20 million reserve is in addition to what is on the books, and how much of it is in reference to new business?

Mr. CONNOLLY. I don't have that figure, Senator, but I would say——

Senator KERR. Would you make an estimate?

Mr. CONNOLLY. I would say a rather small portion of it was put up in new business, perhaps 10 percent.

Senator KERR. It looked to me like this 10 percent deduction here which gives you $1.5 million is a pretty substantial item.

Mr. CONNOLLY. It is a substantial item.

Senator KERR. And free from tax, is it not?

Mr. CONNOLLY. It is a substantial item.

our policy owners, I mean our stockholders, because of phase 3.

Senator KERR. You cannot take the position now that you have to have it as an increased reserve and at the same time distributable to stockholders, can you?

Mr. CONNOLLY. No, sir. I am thinking of the remote possibility of a considerable reduction in business, then the 10 percent works the other way.

Senator KERR. If this committee can figure out how much of these so-called dividends are actually cash adjustments or redundant premium returns, your position is that that should be free from tax, the principle you approve, and the burden then is on this committee to determine what amount comes within the meaning of that principle.

Mr. CONNOLLY. Yes, sir.

Senator KERR. Any difference between us, if we believed that, would be as to your interpretation or our interpretation of what part of that dividend is actually adjustment of premiums?

Mr. CONNOLLY. Yes, sir.

Senator KERR. Thank you very much.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. I have just one question in connection with these two charts of company A and B.

You show company A paying $589,000 tax more than company B . . .

Mr. CONNOLLY. Yes, sir.

Senator WILLIAMS. But in the same chart you indicate that company B's expenses would be about $1.790 million greater than—I notice you say that that is in recognition that mutual expenses are going to be greater.

If their expenses are greater, you would expect their tax likewise to be less, would you not, because in your item 13 you have $11.188 million, and $6 million of that would be accounted for by increased premiums, which you admit should be taxed, deductible when sent back, and that would leave $1.790 million as expenses.

Mr. CONNOLLY. Yes, sir.

Senator WILLIAMS. And would that not account for the fact there would be less tax in company A than B?

Mr. CONNOLLY. It would certainly have an influence on it.

Senator WILLIAMS. That is all.

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Swift, you say every witness has found fault with the bill and none have defended it without major amendments. Many of the witnesses have opposed the bill outright. Do you recall any?

Mr. SWIFT. No, I don't, Senator Gore. It seems to me that the refrain has been, "I am in favor of H.R. 4245 with or but," with certain amendments, but for certain exceptions.

Senator GORE. Do you sing that same refrain?

Mr. SWIFT. I do, Senator. I am not concerned whether the tax be imposed under H.R. 4245 or any of the prior laws or some new formula not yet devised, or at least not yet evidenced.

My sole consideration is that the tax be equally imposed.

I think the stock companies of this country have performed a terrific service for people in their areas all over this country.

Senator GORE. But you haven't given us any definition of what you mean by the term "equally imposed."

Mr. SWIFT. Well, it doesn't seem to me that that is a very complicated situation.

Senator GORE. If you mean that all of the income should be taxed alike and no deductions permitted for refund or dividends to stockholders, then why don't you say so?

Mr. SWIFT. Well, I think in fact in effect I have. I have said that the distinction between stock and mutuals occurs in phase 2 of the tax, and the reason that that distinction or differential occurs is that the stock companies pay on a tax base which the mutuals do not pay on.

Now, that is a highly complicated situation as to how much of that base that the stock companies pay on should be paid on by the mutuals, or vice versa. But there is some—so I am told by the actuaries—I suppose I am somewhat in the same situation you are, Senator, I believe you are a lawyer and I am a lawyer, and in that sense we are both advocates, and we can only find out about those things by inquiring and I have inquired of many actuaries and many accountants, and that is the solution I get from them.

Senator GORE. As a lawyer you have told us three times in your appearance that if this bill is enacted in its present form that it, and I read, "could sooner or later eliminate us from the private enterprise area of our national economy."

You haven't said it would; you have said it could.

Do you think you would be willing to substitute "would" as a prediction of the dire results that would flow from the enactment of this bill?

Mr. SWIFT. No, I don't believe I would, Senator, and I don't believe you would.

Senator GORE. I would not.

Mr. SWIFT. I don't believe this committee wants to discriminate or that Congress wants to discriminate.

I don't think, if the discrimination is in this bill today, I don't think it would break Southwestern Life Insurance Co. in the next few years, because we have been a pretty conservative company. We are carrying in capital and surplus a 15 percent ratio with our reserves. We have been conservative and we can take some losses.

We may get some from the tax, and we may get some also from the thing that this Congress is afraid of. This Congress now is appropriating tremendous sums of money, I don't know the percentage, in the budget, that have been appropriated here for defense against an atomic war.

Now, if that is a reality, if that is a true, proper fear, then I say to you that our life insurance company reserves, as required by the statutes of the States, have a good chance of being insufficient, if we have an atomic war fought here on our home field. Maybe our reserves aren't going to be enough.

If that isn't a reality, if we aren't in real danger of an atomic war on our home grounds, then we can cut the appropriations and we can cut the taxes. Maybe we could get this thing down to a pretty insignificant problem, Senator.

Senator GORE. I am afraid that is a question we cannot settle here.

You say that stock companies do not—I will read your whole sentence:

> Stock companies are allowed some reductions for some gains, but are not enough to escape a step 2 tax.

Do you think that stock companies should escape tax on phase 2?

Mr. SWIFT. Senator, I think they should escape tax on phase 2 from income if the mutuals are going to escape in income situations. If in the policy dividend——

Senator GORE. Wait a moment, and listen to what you have said. If you take that position seriously, then your answer must be "Yes" to Senator Kerr's question, if you think that policyholders' dividends should be treated taxwise in the same way as distribution to stockholders.

Mr. SWIFT. I guess I have gotten off the track somewhere. My answer to Senator Kerr was——

Senator GORE. I think you are on the track, but I think you are on a double track.

We have mutual companies and stock companies. I take it you do not advocate that Congress pass a law prohibiting mutual companies from operating.

Mr. SWIFT. Certainly not.

Senator GORE. Therefore, we must devise a tax bill that fits the operations of both. But you have said that you think that stock companies should escape all taxes under phase 2 if mutuals do.

Mr. SWIFT. Well, that isn't what I intended to say. If I said that I did not——

Senator GORE. Will you say what you intended to say?

Mr. SWIFT. Yes. I think, and I believe what I said in answer to Senator Kerr's question was that it is my opinion that the mutual companies rightfully escape tax under phase 2 to the extent of the redundancy of the premium. But that on any other gains they are the same type of gains that are made by the stock company, and that the mutuals and the stocks should be equally taxed on those gains.

Senator GORE. Again you say:

> A tax differential could force many stock companies out of business.

Do you make the prediction that it will or that it would?

Mr. SWIFT. Oh, yes, I think that ultimately, if the stock companies, a stock company doing the same operations as a mutual company, had to pay 47 percent more in its cost of operations because of a tax differential, year in and year out, that it couldn't go too long.

Senator GORE. Well, now, the tax under phase 2 applies to only a portion of the net profits.

Mr. SWIFT. That is right.

Senator GORE. How is a man forced out of business by paying taxes on only a portion of the profits he makes from the conduct of the business?

Mr. SWIFT. Because sooner or later the mutual that pays 47 percent less tax is going to reduce its premiums down to where the stock companies can't compete.

Senator GORE. As long as it was making a profit competing, and paying a tax on only part of that profit, how would the tax force it out of business?

Mr. SWIFT. Because the mutual is not paying any tax on that profit. Therefore, it has got that much tax money with which to reduce its price.

Senator GORE. I know. Let's just keep going as far down the line as you want to go.

Your company is paying taxes on only a part of the profit it makes from its business, which is in competition with the mutuals, and so long as you continue to make a profit and so long as you continue to pay a tax on only a portion of that profit, how is the tax going to force you out of business? Could it, or would it?

Mr. SWIFT. Well, I think it could, and I think it would for the reason I tried to state.

Senator GORE. If you decided to quit of your own volition, that is one thing, but I don't know how a tax that applies to only a portion of your profits is going to drive you into bankruptcy; if you have a profitable operation you don't have a bankrupt operation.

Mr. SWIFT. If the mutual companies had a more profitable operation because of a tax differential, then it seems to me that the mutuals are going to cut their price structure. That is going to reduce their profit; it is going to reduce the profit of the type of company that is paying more taxes, and it seems to me that ultimately you would get down to the point where the tax-free company would be making a pretty nice little reasonable profit, and the taxed company would be losing money, and at that point they would go out of business.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Swift.

Mr. SWIFT. Thank you, sir.

(Mr. Charles H. Connolly subsequently submitted the following for the record:)

This discussion concerns itself with the distribution of profits by a mutual company.

A mutual company has three sources of profits or loss which enter into the dividends it distributes in addition to premium redundancy it returns. These three sources are investment income, expenses, and mortality. The amount of profit from investment income is determined in the phase I base, but the other two profit sources are extremely difficult to analyze, and it would indeed be a feat if these items could be determined within the framework of a tax bill.

As long as the last two cannot be easily determined, we are led inevitably to an approximation as to the total profit from all sources which is distributed. One such approximation considered seriously some years ago was that 25 percent of dividends represented profits, but this does not properly treat companies with high or low, rather than average, levels of premium redundancy.. A figure approximately the same in aggregate and probably more equitable between individual companies would be taxable investment income in phase I after deduction of the tax. Admittedly, a large part of such interest will be distributed, and the balance is a fair representation of other profits distributed. Only two things can be done with profits as they accrue—either they must be paid out as a part of the dividend, or they must be added to surplus. This is true regarding each of the three sources of profits. This in effect says that all investment income profits after tax are paid out, and that all other profits are added to surplus. This says one profit is distributed and other profits go to surplus but the approximation in total is all that really matters.

How does this fit with the present tax law? After determining the phase I base, we deduct from the net gain from operations (1) the phase I base and (2) all dividends. We then tax half the remainder (if any). But in this process we have deducted the phase I base remaining after tax twice, once when we deducted the base itself, and again when we deducted the profit element of the dividends. This inadvertent double deduction results in understanding taxable gains in the mutual company under phase II.

As an example, compare the computations below under the present double deduction approach and the recommended approach:

| | "Double deduct" | Recommendation |
|---|---|---|
| (1) Taxable investment income | 671,903 | 671,903 |
| (2) Tax at 52 percent | 349,390 | 349,390 |
| (3) Taxable investment income after tax | 322,513 | 322,513 |
| Gain from operations before dividends | 1,859,085 | 1,859,085 |
| Subtract: Phase I base | 671,903 | 671,903 |
| Total | 1,187,182 | 1,187,182 |
| Subtract: Dividends | 1,372,988 | |
| or | | |
| Dividends minus (3) | | 1,050,475 |
| Total | −185,806 | 136,707 |
| Phase II tax at 26 percent | 0 | 35,544 |

NOTE.—Figures are the total of 84 mutuals in thousands as given in Mr. Guest's testimony before Senate Finance Committee.

(Mr. Swift subsequently submitted the following for the record:)

DALLAS, TEX., *March 24, 1959.*

SENATE FINANCE COMMITTEE,
*New Senate Office Building, Washington, D.C.:*

In my testimony on H.R. 4245 I suggested that the policyholder dividend which is entirely deductible by mutual companies in step 2 contains an element of profit and new wealth which is taxed in the hands of stock companies. Subsequent but incomplete studies by our Mr. Connolly indicate that this element of profit will average approximately 25 percent of the dividend. Mr. Lindsay testified, "I believe in 1958 there were about $1,400 million of dividends paid to policyholders." Twenty-five percent of this sum would be $350 million which, if not deductible would wipe out the negative balances in step 2 and produce more than $35 million in additional tax money. Details of our studies are available on request. Please include this telegram in the record as a part of my testimony.

JAMES P. SWIFT.

The CHAIRMAN. There is a joint session of the Congress, and we shall adjourn until 2:30.

(Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 2:30 p.m., this same day.)

AFTERNOON SESSION

Senator KERR (presiding). Senator Carlson.

Senator CARLSON. Laurens Williams, who formerly served in the Treasury, has made some—what he calls an analysis of this bill in what he calls some technical deficiencies, and I ask unanimous consent that his statement be made a part of the record.

Senator KERR. It will be made a part of the record.

(The document referred to follows:)

MEMORANDUM RE TECHNICAL DEFICIENCIES IN H.R. 4245

In our study of H.R. 4245 we have noted three areas in which we believe draft changes, of a technical nature, should be made. They are—

1. Distortions of deductions for dividends to policyholders in the opening year.
2. Bizarre and unintended results in application of section 817(b) relating to capital gain on dispositions of property acquired or deemed acquired before December 31, 1958, where the property has a "substituted" basis, especially where "boot" is involved.
3. Inadvertent taxation of capital gains realized after 1958 on pre-1959 sales.

We analyze these areas and make recommendations for corrections as follows:

I. DISTORTIONS IN DEDUCTION FOR DIVIDENDS TO POLICYHOLDERS

Section 809(d)(3) allows a deduction for dividends to policyholders in computing gain from operations. The amount of the deduction is determined under Section 811(b). In general, the deduction is an amount equal to the dividends paid to policyholders during the taxable years plus (or minus) any increase (or decrease) in the reserves held for policyholder dividends payable during the immediately succeeding taxable year.

An artificial distortion of the amount of the deduction will result for the first taxable year under the bill if the opening reserve (computed by the company at the end of the preceding taxable year, at a time when such reserve had no tax significance) was inaccurately estimated. If the opening reserve was overestimated and the closing reserve is accurately computed, there will be an automatic understatement of the deduction. Conversely, if the opening reserve was underestimated and the closing reserve is accurately computed, there will be an automatic overstatement of the deduction.

The problem is primarily significant only as to the opening reserve for the first year of H.R. 4245's application—errors in the reserves of later years will automatically "wash," or can be adjusted by the examining agent. But if provision is not made for correcting an erroneous overstatement of the opening dividend reserve, the taxpayer's deduction for dividends to policyholders for the first taxable year under the bill will be artificially reduced by whatever amount its opening dividend reserve was erroneously overstated. There will never be, of course, any possibility of future recoupment by the taxpayer of this artificial reduction of the amount of its first year dividend deduction. Moreover, unless provision is made in the bill for adjustment of the opening dividend reserve of any company which erroneously understated such reserve, the Government will never recoup any tax loss it sustains because of the excess deduction the bill as it now stands will create.

Our client has this problem. In 1957, it was in the process of installing a new electronic data processing system. As of December 31, 1957, data used for estimating the dividend reserve by the previous method were not available, but neither was the new system fully operative for this particular function. Accordingly, the dividend reserve calculation was made by an adaptation of the previously used method, in a conservative manner which was intended to avoid understatement. As a result, the 1957 year end dividend reserve was overstated by approximately $250,000. The new electronic data processing system was fully operative in 1958, hence the closing 1958 (and future reserves) will be accurately computed, in a manner consistent with NAIC requirements.

To avoid artificial distortion, provision should be made for redetermining the opening dividend reserve for the first taxable year under the bill. This could be accomplished by providing that the opening dividend reserve be adjusted to reflect the amounts actually paid out in dividends to policyholders during the period covered by the opening dividend reserve. Our alternative draft suggestions to cover this are:

(1) On page 34, line 4, of the bill, change the period at the end of the last sentence of section 811(b) (1) to a comma, and add:

"and the amounts held at the end of the taxable year preceding the first taxable year beginning after December 31, 1957 as reserves for dividends to policyholders payable during such first taxable year shall be adjusted to correct any overstatement or understatement of such reserves as may be indicated by reference to the amount actually paid as such dividends in respect of such reserves during the period for which such reserves were set aside."

(2) On page 52, beginning with line 14, of the bill, insert a new section 818(g) as follows:

"(g) FIRST YEAR'S RESERVE FOR DIVIDENDS TO POLICYHOLDERS.—For the purpose of section 811, the amounts held at the end of the taxable year preceding the first taxable year beginning after December 31, 1957, as reserves for dividends to policyholders (as defined in sec. 811(a)) payable during such first taxable year shall be adjusted to correct any overstatement or understatement of such reserves as may be indicated by reference to the amount actually paid as such dividends in respect of such reserves during the period for which such reserves were set aside."

## II. BIZARRE AND UNINTENDED RESULTS IN APPLICATION OF SECTION 817(B) RELATING TO CAPITAL GAINS ON DISPOSITIONS OF PROPERTY ACQUIRED OR DEEMED ACQUIRED BEFORE DECEMBER 31, 1958

We have had considerable difficulty trying to apply section 817(b) of H.R. 4245 to several properties a client of ours owned on December 31, 1958, and in trying to advise them on a transaction they now are considering involving a property they owned on December 31, 1958. The difficulties all stem from the second sentence of section 817(b), and, in the main, from the failure to differentiate between "substituted" basis and "transferred" basis. The provision is as follows:

"(b) GAIN ON PROPERTY HELD ON DECEMBER 31, 1958.—In the case of property acquired by the taxpayer before December 31, 1958, if—

"(1) the fair market value of such property on such date exceeds the adjusted basis for determining gain as of such date, and

"(2) the taxpayer has been a life insurance company at all times on and after December 31, 1958,

the gain on the sale or other disposition of such property shall be treated as an amount (not less than zero) equal to the amount by which the gain (determined without regard to this subsection) exceeds the difference between the fair market value on December 31, 1958, and the adjusted basis for determining gain as of such date. In the case of property having a substituted basis (within the meaning of sec. 1016(b)), the preceding sentence shall apply, but only if during the holding periods concerned the property or properties were held only by life insurance companies. For purposes of this subsection, the term 'property' does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in paragraph (1) of section 1221."

Five problems—largely arising out of the second sentence—are discussed below:

(1) *Pre-1959 tax-free acquisitions from nonlife insurance companies.*—You will note that the second sentence of section 817(b) limits application of the provision in the case of property acquired before December 31, 1958, where that property has a substituted basis (obviously intending to include "transferred" basis). Under these limitations, section 817(b) is not applicable to property acquired many years before December 31, 1958, from a nonlife insurance company in a tax-free exchange, notwithstanding that all of the policy considerations which led to approval of section 817 apply fully to such property. This seems to us an unintended result. Such property should be covered. For example, if an insurance company, in 1955, exchanged farm A, which it had acquired in the 1930's, for farm B, the fact that the exchange was not with another life insurance company should have no possible tax significance.

(2) *Post-1958 tax-free acquisitions—in general.*—If the second sentence of section 817(b) is read literally, the first sentence applies to property having a substituted basis only if such property was acquired before December 31, 1958 (and then only if certain other conditions are met). We also doubt that this was intended. We suppose that the second sentence was really intended to make the first sentence applicable to property acquired after December 31, 1958, in a tax-free exchange, but the second sentence does not do so if read literally. If it was not intended to make the section applicable to property acquired after December 31, 1958, in a tax-free exchange, the whole purpose of the section would be defeated in its application to a substantial segment of property held by life insurance companies on December 31, 1958. The result would be to restrict normal, ordinary, tax-free transactions of life insurance companies, to no proper purpose.

If the second sentence of section 817(b) is not read literally, but is construed to mean that the first sentence applies to property having a substituted basis notwithstanding that such property was acquired after December 31, 1958, a further (though very different) unintended result could follow—that is, a result of such construction could erroneously extend the benefit of section 817(b) to property acquired after December 31, 1958, in a tax-free exchange for other property also acquired after that date even though no property was held on December 31, 1958.

(3) *Post-1958 tax-free acquisitions—property with a "transferred" basis vis-a-vis "substituted" basis.*—There is no reason why property acquired after December 31, 1958, in a tax-free exchange for property actually held by the life insurance company on December 31, 1958, should be subject to the limitation of the second sentence of 817(b) that the acquired property shall have been held only by life insurance companies. Such a limitation is necessary (and desirable) only where property acquired after December 31, 1958, takes a "transferred" basis, i.e., a basis computed in whole or in part with reference to the basis of such property in the hands of a person from whom the property was acquired. As noted above, if a life insurance company in 1959 exchanges farm A, which is acquired in the 1930's, for farm B (a tax-free exchange), the fact that the other party to the exchange is not a life insurance company has no possible tax significance. Where there is a "substituted basis" as opposed to a "transferred basis," it can make no difference with whom the tax-free exchange was made. This is so because the new property received in the exchange takes the basis of the old property exchanged. Thus the basis of the tranferee is completely disregarded and has no bearing. On the other hand, where a life insurance company acquires, for part of its voting stock, substantially all of the properties of another corporation in a tax-free reorganization the provisions of section 817 (b) should be applicable only if the corporation from which the property was acquired was also a life insurance company. Likewise, where X, owner of all the stock of a life insurance company, transfers property to the life insurance company solely in exchange for its stock, section 817(b) should not apply. But, a limitation as to "transferred" basis exchanges, we submit, is the only sort of limitation needed to protect the Revenue Service against "gimmicking" in tax-free exchanges.

(4) *Post-1958 tax-free acquisitions—which "property" measures value and basis?*—If the second sentence of section 817(b) makes the first sentence applicable to property acquired after December 31, 1958, in a tax-free exchange for property held on December 31, 1958, then it is not clear whether the value and basis referred to in the first sentence of section 817(b) are that of the property held on December 31, 1958, or the property subsequently acquired in the tax-free exchange. Obviously, it should be the former, i.e., the property held on December 31, 1958.

(5) *Post-1958 tax free exchanges involving "boot."*—In the case of a partially tax-free exchange after December 1, 1958, involving "boot," section 817(b) has the incidental and unintentional effect of reducing the basis of the property in the hands of the transferee for purposes of depreciation and gain or loss. Moreover, there is apparently no limitation on the number of times the benefit of section 817(b) can be used in case of tax-free exchanges. In an exchange involving "boot," basis in the hands of the transferee is his prior basis, reduced by the amount of "boot" received, and increased by the gain recognized. The gain that ordinarily would be recognized (by reason of the "boot") is reduced by the operation of section 817(b) and as a consequence the basis both for depreciation and gain or loss purposes in the hands of the transferee will be less than the prior basis of the property involved (though never less than zero). This is the wrong result, and surely not intended. Logically, the basis of the property in the hands of the transferee should not be affected by the operation of section 817(b).

The problem is simply to prevent "double" use of the pre-1958 appreciation, i.e., double exemption from capital gains tax of the difference between adjusted basis and fair market value of property held on December 31, 1958. This can be accomplished, readily, without improper results such as are pointed out above. The following illustrations demonstrate the improper results under the present bill:

*Illustration 1*

Assume A life insurance company owns Blackacre with a basis of $1,000 and fair market value of $2,000 on December 31, 1958. In 1959 A exchanges Blackacre for Whiteacre, which then has a value of $900, and $1,100 cash. The gain to A on this exchange ($1,000) would be eliminated by the operation of section 817(b).

However, under the basis provisions of the code, the basis of Whiteacre to A is its basis in Blackacre ($1,000), minus the boot ($1,100), plus the gain recognized to A ($0). Presumably, the basis to A in Whiteacre therefore would be zero (not a minus basis, —$100). Thus, although basis is reduced, it is not reduced by an amount equal to the gain eliminated by section 817(b). This fact may produce a double benefit.

Suppose, A later sells Whiteacre for $1,000. Technically, the gain to A from this sale would be $1,000 (excess of amount realized over basis), but all of this gain would be eliminated by the operation of section 817(b). Thus, section 817(b) in conjunction with the basis rules will have operated to eliminate a total gain of $1,100, notwithstanding the fact that the difference between the fair market value and basis of Blackacre on December 31, 1958, was only $1,000. Obviously, adjustment should be made to prevent this unintended result.

It will not be sufficient, however, to provide that section 817(b) shall not effect the determination of basis and that the difference between the fair market value and basis of the property shall be reduced by the gain that would have been recognized in the prior "boot" transaction but for section 817(b). This is demonstrated by the following illustration:

*Illustration 2*

Assume that, as in Illustration 1, A life insurance company owns Blackacre with a basis of $1,000 and fair market value of $2,000 on December 31, 1958. In 1960, when Blackacre has increased in fair market value to $2,100, A exchanges Blackacre for Whiteacre, which then has a value of $1,600, and $500 cash. The gain to A on this exchange ($1,100) would be reduced to $100 by the operation of section 817(b), and that $100 gain would be recognized as a result of the "boot".[1] If it were provided that section 817(b) shall not affect the determination of basis, the basis of Whiteacre to A is the basis in Blackacre ($1,000), minus the boot ($500), plus the gain that would be recognized to A in the absence of section 817(b) ($500). Thus the basis to A in Whiteacre would be $1,000. Later A sells Whiteacre for $2,100. The gain from this sale ($1,100) should be reduced by $1,000 minus the excess of the gain that would have been recognized on the prior boot transaction but for section 817(b) ($500) over the gain that was recognized on such transaction ($100). Thus the taxable gain on the sale should be $1,100 minus ($1,000 (500-100)), or $500. In that way the total taxable gain on the two transactions would be $600, as is proper, rather than $700 as would be the case if the difference between value and basis, for the purpose of section 817(b), were simply reduced by the gain that would have been recognized in the prior "boot" transaction.

We believe the foregoing defects would be remedied if the second sentence in section 817(b) were deleted and the following inserted in lieu thereof:

"In the case of property acquired after December 31, 1958, and having a substituted basis (within the meaning of section 1016(b))—

"(1) for the purpose of the preceding sentence, such property shall be deemed acquired at the beginning of the holding period thereof, determined with reference to section 1223,

"(2) the value and basis referred to in the preceding sentence shall be that of the property, if any, by reference to which the property is deemed to have been held on December 31, 1958,

"(3) the preceding sentence shall apply only if the property or properties by reference to which the holding period is determined were held only by life insurance companies during the respective parts of the holding period concerned after December 31, 1958, and

"(4) on the sale or other disposition of such property, the difference between the value and basis referred to in the preceding sentence shall be reduced (not less than zero) by the excess of (i) the gain that would have been recognized on all prior sales or dispositions of such property after December 31, 1958 but for this subsection over (ii) the gain that was recognized on such sales or other dispositions.

This subsection shall not affect the determination of basis."

## III. INADVERTENT APPLICATION OF THE CAPITAL GAIN PROVISIONS TO PRE-1959 TRANSACTIONS

In connection with section 802(a)(2), section 804(b)(2), and section 809(c)(3), the provisions taxing capital gains, there is a problem analogous to the one which was involved in section 117(o) of the Internal Revenue Code of 1939 as added by section 328 of the Revenue Act of 1951. It provided that gain from the sale of depreciable property between spouses or between an individual and a controlled corporation should be treated as ordinary rather than capital gain. The provision was made applicable with respect to taxable years ending after April 30, 1951, but only with respect to sales or exchanges made after May 3, 1951. When the Internal Revenue Code of 1954 was adopted, section 117(o) of the 1939 Code was codified as section 1239, but the provision limiting its application to sales or exchanges made after May 3, 1951, was deleted. Thus, gain from sales made before May 4, 1951, which was realized after the 1954 code became effective (because, for example, the sale was made on the install-

[1] This accords with the literal language of sec. 817(b), which speaks in terms of "gain" rather than "gain otherwise recognized." It makes no difference in the ordinary tax-free exchange whether the statute speaks of "gain" or "gain otherwise recognized," but where—as in this illustration—there is "boot" and the "gain" exceeds the "gain otherwise recognized," it does make a difference because use of the term "gain" results in currently taxing part of the boot, whereas use of "gain otherwise recognized" would defer the tax to the time of the second sale in the illustration. In other words, instead of absorbing the whole $500 of "boot" and reserving for later use another $500 of the $1,000 spread between December 31, 1958, market value and adjusted basis of Blackacre, the use of the term "gain," rather than "gain otherwise recognized," operates to accelerate the time of taxability.

As a policy matter, this seems somewhat at variance with the philosophy back of sec. 817(b), and we think it would be wiser and provide more symmetrical treatment to use the "gain otherwise recognized" approach. However, in the draft amendment (infra), we have not made this change—on the assumption that a policy decision already has been made by the committee to the contrary.

ment or deferred payment basis) was taxable under the 1954 code as ordinary gain whereas such gain previously had been taxed under the 1939 code as capital gain. This unintended result was corrected by section 53 of the Technical Amendments Act of 1958 which added section 1239(c) to the 1954 code, providing that section 1239 shall be applicable only in the case of a sale or exchange made after May 3, 1951.

In the case of life insurance companies, capital gains are presently excluded from the tax base. Under H.R. 4245 capital gains realized in a taxable year prior to the first taxable year beginning after December 31, 1958, are not subject to tax. Furthermore, gain from the sale or other disposition of capital assets held on December 31, 1958, is subject to reduction by the operation of section 817(b). However, gain from the sale or other disposition of property before December 31, 1958, which is realized in a taxable year beginning after December 31, 1958 (because, for example, the "amount realized" on the sale was contingent upon future events) will be taxed in full under the provisions of H.R. 4245. To correct this clearly unintended result, we suggest the following amendment:

On page 45, beginning with line 23, add a section 817(d) as follows:

"(d) GAIN ON TRANSACTIONS OCCURRING PRIOR TO JANUARY 1, 1959.- For the purpose of sections 802(a)(2), 804(b)(2), and 809(c)(3), there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset, resulting from sales or other dispositions of property prior to January 1, 1959."

If there is a possibility of a like defect in the application of the present bill to fiscal year taxpayers, as to whom the tax on capital gains does not become effective until some date after January 1, 1959, it could be remedied by inserting immediately before the words "prior to" in the foregoing suggested amendment the words "in a taxable year beginning"; so that it reads:

"(d) GAIN ON TRANSACTIONS OCCURRING IN A TAXABLE YEAR BEGINNING PRIOR TO JANUARY 1, 1959. For the purpose of sections 802(a)(2), 804(b)(2), and 809(c)(3), there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset, resulting from sales or other dispositions of property in a taxable year beginning prior to January 1, 1959."

We would welcome the opportunity to discuss all or any facets of the points suggested above.

Respectfully submitted.

SUTHERLAND, ASBILL & BRENNAN,
LAURENS WILLIAMS.

Senator KERR. Mr. Easley.

## STATEMENT OF K. H. EASLEY, SECRETARY, AMICABLE LIFE INSURANCE CO., WACO, TEX.

Mr. EASLEY. Mr. Chairman, and gentlemen of the committee, my name is K. H. Easley. I am Secretary of the Amicable Life Insurance Co. of Waco, Tex. The Amicable is a legal reserve stock life insurance company incorporated under the laws of the State of Texas in the year 1909, at a time when it was necessary for local capital to provide a way for Texas people to be adequately insured. I have been employed by this company during the past 40 years of its 50-year history and have traveled over many of its rough roads. One of the roughest roads yet, appears to be ahead in H.R. 4245. Our good friend and neighbor, the Texas Life Insurance Co., has asked me to also represent them in this testimony.

I am appearing not alone as a stockholder, officer, director, employee and policyholder of my company, but also as a citizen interested in our free-enterprise system.

I appreciate the opportunity of appearing before you to discuss some of the problems presented by H.R. 4245, as I see them.

The Treasury, as it should, is attempting to assess the tax requested by the administration. To meet this tax goal, there appears a juggling of figures, and a sparring for position, within the industry. It amounts to just another version of taxing Joe, and letting me go.

Much has been said about the "framework" of H.R. 4245. The bill is encompassed in a beautiful frame, but the picture should be changed. Two of the characters should be removed from the picture, and the face of the other lifted to the point of recognition. With this accomplished, we should have a picture that does not "frame" the segment of our industry that is apparently being led to the gallows. The characters represented by phases 2 and 3 should be hung for horse stealing. When this is done, phase 1, without the influence of 2 and 3, can be cultivated into becoming a respectable citizen.

One area of face-lifting in phase 1 lies in the small business deduction. Many years may pass before a company with greatest need will receive the full benefit of this deduction to the extent of the limit of $25,000. A newly born life insurance company, like a newborn calf, needs this crutch while strengthening its legs. To delete the deduction out would be synonymous to a mother cow allowing her calf the use of only one dispenser when he needs all four to stay alive and grow. [Laughter.]

Mr. EASLEY. The limitation in H.R. 4245 alleged to prevent a double deduction of the yield on policyholders' funds invested in tax-exempt securities, partially tax-exempt securities, and corporate stocks should be corrected. The company's obligation to pay to, or credit policyholders with, the required interest on their funds is not altered by the type of security in which the funds are invested. A good practice for life insurance companies with only limited investment opportunities is to diversify their investments. The return received on investments is always commensurate with the risk involved and the tax feature.

To paraphrase the situation of a life insurance company having policyholders' funds invested in securities, the income from which is wholly or partially exempt from tax of other corporations, let us assume that the junior bovine referred to above has been successful in becoming a yearling. As he is looking for a diversified diet, he is lured by a three-prong pitchfork containing shares of clover, alfalfa, and millet hay. Upon approaching the apparent morsel and partaking of a few straws, he is shocked by the experience of having his nose punctured and his tail twisted. The moral is that he will no longer be in the market for these securities. This area of face-lifting in phase 1 is needed.

The use of each company's individual earned rate on investments applied to a policyholder's reserve adjusted to this rate according to the formula in phase 1 to determine the deduction for interest earned on policyholder's funds, should be more satisfactory than the use of industry and company assumed rates averaged with the company earned rate. The use of the company earned rate would be a more realistic method of determining the deduction, as it would correctly produce the proper deduction for each company. An averaging of the earned rate for the current and 4 preceding years would enable a company to more accurately forecast its income tax liability at year-end.

The greatest areas of controversy embodied in all three phases of H.R. 4245, as written and as attacked by proposed amendments, arise out of the treatment of dividends disbursed to owners of the business. The bill is too complicated to follow through the entire obstacle course, but when reduced to simple language, it is obvious that the following results appear.

One individual invests his money in the capital stock of a life insurance company and thereby becomes one of its owners. Another individual invests his money in a policy of a life insurance company having no capital stock and thereby becomes one of its owners. Both companies make a profit which is distributable to the owners. The owner in the first company is required to pay an income tax on the distribution of company profits made to him. The owner in the second company is not required to pay an income tax on the distribution of company profits that he receives. The company profits for the purpose of this illustration include only the profits arising from identical operations of both companies. The only identical operation of both companies from which profits are made is in the investment of funds. If you are going to assess an income tax against these two companies on a basis fair to both, it must be assessed on a balanced equation. To attempt to inject a foreign substance into the formula, no matter how well prepared or seasoned, will only upset the equation and result in discrimination.

You cannot get rid of the bedbugs in the three-room shanty of H.R. 4245 simply by patching up the cracks. The only way is to burn or renovate the house—not just pound on the boards. [Laughter.]

Mr. EASLEY. Phase 1 of H.R. 4245 distributes the tax between mutual and stock companies in about the same proportion as the invested assets. The corrections that I have recommended should not materially disturb this balance.

The need for taxes to protect our country and support our economy is apparent. I have no objection to paying my share of any tax that you may impose, so long as it is assessed in comparable proportion to all segments of the industry.

The CHAIRMAN (presiding). Thank you, Mr. Easley.

Senator Kerr.

Senator KERR. Mr. Easley, in your statement, you say:

> To meet this tax goal, there appears a juggling of figures, and a sparring for position, within the industry. It amounts to just another version of taxing Joe, and letting me go.

Is that your position or your complaint?

Mr. EASLEY. Sir, I have reference to neither a position nor a complaint, but I have reference to the many amendments that are offered by both segments of our industry to secure either an advantage or to balance the equation against the other.

My point is that it is impossible to do it except on the same type of income.

Senator KERR. I understand, but I wondered if you were describing your position, or criticizing that of someone else.

Mr. EASLEY. Sir, I do not intend to criticize anyone. I am only attempting——

Senator KERR. Or describing that of someone else.

Mr. EASLEY. No, sir, I am not describing the situation of anyone else. I am just offering that as a suggestion of a method to carry out my point that there is only one way really of properly assessing a tax on a fair basis between both segments of the industry.

Senator KERR. I don't know any witness before this committee but what has the identical postion as the foundation from which he started. Have you heard anybody here but what came in the spirit of all fairness with the sole purpose of securing a bill that was fair to everybody?

Mr. EASLEY. I haven't. I did not intend to cast any reflection on anyone.

Senator KERR. I didn't think you did, and I am not intimating that you did, nor does that necessarily then leave the only alternative that what you were doing is making an admission. But actually it does sound like either an accusation or an admission, and I just wanted to ask you if that were correct, and if so, which.

Mr. EASLEY. Senator, it is neither.

Senator KERR. Neither. [Laughter.]

Senator KERR. Well, that is the safe answer.

Now, you say:

The characters represented by phases 2 and 3 should be hung for horse stealing.

I understand that—do you refer to a whole horse there? [Laughter.]

Mr. EASLEY. Sir, I don't know, but if I would steal a horse I would look in his mouth first. [Laughter.]

Senator KERR. Well, he would have to be standing up if you did. [Laughter.]

The CHAIRMAN. Senator Carlson.

Mr. EASLEY. I might state I did not intend that as a reflection, sir, on the Treasury. [Laughter.]

Senator KERR. I am not right sure that your audience took you seriously. [Laughter.]

Mr. EASLEY. Neither am I, sir. [Laughter.]

The CHAIRMAN. Senator Carlson.

Senator CARLSON. Mr. Easley, only this:

I happened to have served some time in World War I at Waco. I think I know your country quite generally outside of the city sections, at least, and I know the terrain.

I was interested. Your company is 40 years old, and yet you talk about the sustenance needed to sustain a calf. Now, it doesn't take 40 years to grow a calf in Texas.

Mr. EASLEY. No, sir, it only takes 1 year to grow a yearling. [Laughter.]

Mr. EASLEY. As our company is 50 years old, and we have passed the period in which the additional small company deduction would be of any benefit to us, but having been a small company and knowing the necessity that a small company has to grow and get enough business on its books to make a profit and pay a dividend, that would be very significant, sir, and also if you permit that increased deduction and let the calf grow, he may get big enough sometime to cut a big beef steak off him.

Senator CARLSON. Mr. Easley, you will find me in your corner.

Senator KERR. Do you go on the theory you can shear a sheep every year if you take care of him, but you can't skin him but once?

(Laughter.)

The CHAIRMAN. Thank you, Mr. Easley.

Mr. W. W. Wilson, Jr.

## STATEMENT OF W. W. WILSON, JR., PRESIDENT, COLORADO LIFE CONVENTION, AND PRESIDENT, UNITED AMERICAN LIFE INSURANCE CO., DENVER, COLO.

Mr. WILSON. It is alway a little difficult to follow Mr. Easley.

Senator KERR. You mean as a witness, or as a talker?

Mr. WILSON. As a talker. He is a dandy.

My name is Wilmer W. Wilson, Jr. I am president of the United American Life Insurance Co., Denver, Colo., a stock company, and president of the Colorado Life Convention, an organization of life companies in the State of Colorado. Fifteen stock companies belong to this organization. There are no mutual life insurance companies domiciled in the State of Colorado.

I have asked the privilege to testify to your committee as president of the Colorado Life Convention and as president of my own company. A list of the 15 members of the Colorado Life Convention is attached as appendix I to this testimony. While I am sure that no two representatives of the Colorado Life Convention would testify in exactly the same manner, I am equally sure that the majority of the members of the Colorado Life Convention will find themselves in accord with my testimony.

My company is a small company and due to lack of time the testimony I give will primarily be opinion based on readily available information, without my being able to furnish you with the projected results of suggested amendments to the proposed legislation; as has been suggested, gentlemen, this tax formula is a very complicated formula.

Last Monday I reported to my directors, and 2 weeks ago I reported to my stockholders. In these reports I stated in part as follows:

> It looks as if Federal income tax this year will be increased and that our taxes will be up more than 80 percent. Unfortunately, this tax is so worded as to penalize stock companies. I presume the effect of the discrimination between companies will be more adverse to your company than the effect of the increased tax.

Needless to say, I would not make such a report to my stockholders or to my board of directors unless this was my considered opinion.

It is the feeling of the Colorado life companies that the tax the industry as a whole is asked to bear is out of proportion to that paid by other industries if consideration be given to the amount of State tax which the industry pays. Much testimony has been given on this point and I shall not make further reference to it.

It appears that my company and 12 of the other 14 stock companies of the Colorado Life Convention would pay more under the 1942 law than under the proposed legislation, and, while we recognize that there is much of merit in the proposed legislation, we feel that unless it is so amended so as to effectively eliminate the discrimination, we would rather be taxed under the 1942 legislation, hoping that in a later year a more equitable tax could be established.

The report of the Committee on Ways and Means of the House of Representatives on this bill, as shown on page 8, reflects in part the table, appendix II hereof. The figures in this report relate to the revenues to be derived for 1958. Inasmuch as phase 3 of the bill is not applicable to 1958 operations, the table as shown in the ways and means report shows no income from phase 3. In the testimony to your committee the early part of this month it was brought out that the Treasury Department feels this phase 3 might have resulted in as much as $50 million of additional taxes if it had been applicable. I have, therefore, extended this table so as to show the relative effect of the tax burden if this $50 million were applicable.

The bill also provides that in subsequent years adjustment will be made so as to eliminate the taxes from pension trust cases. It is estimated this will reduce the total tax take by approximately $60 million. I have seen no figures as to distribution of this $60 million. It is, however, my considered opinion that by far the greatest amount of this tax relief would go to the large mutual companies. In the schedule, appendix II, I have arbitrarily shown the division between mutuals and stocks as being $50 million on the mutuals and $10 million on the stocks.

If you gentlemen will turn to appendix II, I would like to review it with you.

The first five lines of appendix II are taken directly from the report of the Ways and Means Committee. The sixth line shows the increase in percent of tax over the present law. The seventh line is the $50 million of adjustment which might be anticipated from phase 3. The eighth line shows totals with the $50 million adjustment. The ninth line shows the percentage of increase after this adjustment. The tenth line shows the $60 million adjustment from tax relief on pension trusts. The bill as it is now written, if no changes are made on the assumptions hereinbefore stated, shows an increase in stock companies' tax of 55.2 percent under the existing law and a decrease of tax in mutual companies of 9.1 percent.

The bill as now written is more favorable to the beginning companies, to those who are in the time of their development where they are losing money, and I am certainly sure we are all in favor of that. The companies which suffer most under the bill are those that have recently established themselves to the place there they show some earnings and, being anxious to expand their business, need to have these earnings to increase their policyholders' surplus so as to justify further expansion.

I might say our company increased its business by better than 37 percent last year, and we certainly are in need of all the surplus funds we can muster in order to justify such an increase.

Phase 2 of the bill takes away from the growing companies a substantial part of their earnings and seriously impairs their growth potential. It has been testified that the competition of all companies is the large mutual companies. These mutuals are given a great competitive advantage under phase 2. They can adjust their dividends so as to avoid taxation under this phase and only pay taxes under phase 1. These companies are also given an undue advantage under phase 1.

Phase 1 does not tax companies on the excess interest earnings over those required to maintain policy obligations. In lieu of doing this it applies a complicated formula, which results in disproportionate favor to those companies with a required rate of interest which is less than the average for the industry. This is to the competitive disadvantage of those companies that have chosen to assume a more realistic rate of interest. The giant mutuals are especially favored in this respect as their assumed rates of interest are less than those of most other companies in the industry.

Much was said in the testimony before this committee the early part of this month in favor of discouraging the use of realistic interest rates in calculating the premiums. At the same time it has been suggested that the use of the "Commissioner's Standard Ordinary Table" based on the experience in the thirties was improper due to unduly increasing the premiums. It was suggested there is a good deal of glory in having a more modern table in the calculation of these premiums because of the fact that such a table would be more realistic in the anticipation of true mortality. The difference in opinion on the use of an overly conservative interest rate rather than an overly conservative mortality somewhat surprises me.

Today Government bonds with 21-year maturity and a 4-percent coupon can be purchased at a discount, yet it seems that an interest assumption of 3.5 percent is frowned on. The net level annual premium according to the "Commissioner's Standard Ordinary Table," based on 1930 experience, with a 3.5 percent interest assumption for a 20-payment life policy issued at age 35 is $24.89 a thousand. The net level annual premium according to the 1958 "Commissioner's Standard Ordinary Table," based on 1950 experience, with a 2.5 percent interest assumption for 20-payment life issued at age 35 is $27.24 a thousand.

I put these figures in to some extent due to the questions Senator Douglas asked here the first part of the month. I am sorry the Senator is not here.

Dividends paid by mutual companies are allowed as a deduction under phase 2. It has been suggested in testimony before this committee that these dividends are primarily savings in operating costs and savings in mortality. It has been further suggested that there would be very little interest earning included in these dividends.

I have attached to this testimony as appendix III a statement of the projected dividends for the 20-payment life contract issued at age 20 for three prominent mutual companies, all of which testified before your committee. This dividend information is obtained from a publication entitled, "Diamond Life Bulletins." All of these projections show that the cash surrender value of such a policy at age 65 will be substantially more than the total of the premiums paid in. In addition to this cash surrender value substantial dividends are indicated. For instance, the Massachusetts Mutual shows a premium of $30.02 a year—this is per thousand.

At the end of 20 years the cash value indicated is $503 and the dividend accumulation is $189.69, making a total at the end of 20 years of $92.29 more in cash value and dividends than the premiums paid. The cash value of this policy at age 65 is $753.73. This is $153.33 more than the entire premiums the policyholder has paid in, and in addition to this cash value the company projects that the accumulated dividends if left at interest would amount to $761.97, giving this man a total excess of $915.30 more than the amount of premiums he has paid in. This profit of $915.30 is in addition to the insurance protection which he enjoyed during the years. Surely if this man is considered to have a similar position in a mutual company to a stockholder in a stock company, he has had some gain from his proprietary interest.

It is our belief this bill should be adjusted so as to be less discriminatory in favor of the giant mutual companies. It is our further belief that if the amendments suggested herewith are made they will alleviate the competitive discrimination against the small- and medium-size mutual companies as well as the small- and medium-size stock companies. These companies do not ask a competitive advantage over the giant mutuals—they just ask a chance for fair competition.

We would recommend:

1. That phase 1 of this legislation be so amended as to tax companies on the excess of their net interest earnings over and above the interest required to maintain their policy obligations.
2. That phase 2 of this legislation be so amended as to disallow the deduction of dividends to policyholders, and be further amended to give a percentage reduction for the increase in reserves on participating business, as is allowed on nonparticipating business.

There was some testimony here this morning and the other day relative to permitting the mutual companies to have a deduction of dividends which might properly reflect the redundancy in their premiums. I can see this point of view and I am sure most stock companies can see this point of view, and possibly there should be some deduction, but it appears to me that complete deduction gives entirely too much favor to the mutuals.

3. That phase 3 of this legislation be so amended as to permit all amounts of capital or surplus held by a stock company on December 31, 1958, which were contributed by stockholders and are in excess of the total amount paid to that date in dividends to stockholders to be placed into the shareholders' surplus account, and to permit any subsequent contributions to surplus made by stockholders to go directly into the shareholders' surplus account.

Thank you for the privilege of having presented this information to you. If there are any questions, I should be pleased to try to answer.

The CHAIRMAN. Thank you, Mr. Wilson.

Are there any questions?

Senator KERR. I take it, as I read your third recommendation, that has to do with permitting the use of all amounts of capital or surplus held by a stock company on December 31 to be available to payment to stockholders either in the form of dividends, redemption of special issues of stock, or reimbursement of other advances by the stockholder without that act alone creating a tax liability to the company.

Mr. WILSON. Yes, Senator. In my opinion, it seems that these are amounts which have been paid in by the stockholders; they are not getting back earnings, they are simply getting back what they did pay in.

Senator KERR. Do you think that ought to apply to the amount of capital, the amount of funds they have put in to buy their stock?

Mr. WILSON. Yes, I would say so, if I understand your question correctly.

Senator KERR. If I understand your proposal, it would permit a situation whereby a stock company could pay out dividends to its stockholders not only as a return on their investment, but as a retirement of their investment without the funds used by the corporation for that purpose having been subjected to tax, although they are obtained by profit.

Mr. WILSON. Senator, I didn't get the last three words of your question.

Senator KERR. Read it.

(The record was read by the reporter.)

Mr. WILSON. Well, it is my feeling that they would not be obtained by profit.

Senator KERR. They would have to be obtained by its operation or by return of the capital, itself, would they not?

Mr. WILSON. It would be a return of capital paid in, I would say, yes.

Senator KERR. Can the company do that either if it is holding the business it has got or increasing the business? I believe you made a statement about the necessity of additional reserves.

Mr. WILSON. It would be my presumption that they couldn't do that for many, many years to come, and that whenever they did take the position, it would be evidence that they had had considerable earnings and probably paid a good deal in taxes by that time.

Senator KERR. But under this bill, under phase 2, they pay tax on only half of the earnings in excess of what would come under phase 1 until certain events trigger the requirement for the payment of additional taxes, do they not?

Mr. WILSON. Right.

Senator KERR. I would presume that you were addressing yourself to that provision in the law, are you not?

Mr. WILSON. Yes, I would say, I am not trying to restate it, Senator, I apparently haven't said it very clearly, it seems to me that if capital is increased and if throughout the years the company has some earnings and they wish to make this distribution, take our particular company, for instance, we have a great deal of contributed surplus which was contributed to get our company off the ground.

Senator KERR. I can understand the basis for requesting that some provision be made for the return of contributed surplus to a shareholder or stockholder which he or they had put in to the company for the temporary use of, or for the use temporarily of providing reserves against liabilities.

I must say that I believe that you are the first witness, and I am certain you are the first one that I know of who has asked for the privilege to return earnings which are tax-free to the stockholders to such an extent that they have been reimbursed not only for these extraordinary reserves that may have been required temporarily, but also to the extent of reimbursing them their entire capital investment.

Mr. WILSON. Now, Senator, I didn't mean to suggest that any earnings could be disbursed without being taxed. If I have done so, then my testimony does not properly reflect my opinion.

Senator KERR. There is nothing in the bill to keep you from disbursing earnings on which you pay taxes, is there?

Mr. WILSON. I am sorry. You say there is nothing in the bill——

Senator KERR. There is nothing in the bill that penalizes the distribution of earnings remaining after taxes in the form of dividends, is there? I thought the amendment you were seeking was to that part of thet bill which required the payment of taxes on earnings that had not been taxed prior to their being used in the form of dividends.

Mr. WILSON. That is not my position, and I do not so recommend.

May I just reread for my own information, Senator, to see if it implies something I didn't mean to?

"That phase 3 of this legislation be so amended as to permit all amounts of capital or surplus held by a stock company on December 31, 1958, which were contributed by stockholders"—only that which has been contributed by stockholders.

Senator KERR. Where does a company get capital? Isn't that what they get when they sell stock?

Mr. WILSON. Yes, of course, all the capital money would come from the stockholders; certain of the surplus wouldn't.

Senator KERR. I understand that.

The Senator from Utah has very appropriately asked what did you mean by "contributed." You meant provided?

Mr. WILSON. If I may define that in my terms of thinking, Senator, from the amount received from stock at the time it is sold the company obtains a certain amount which goes into capital at the par value of the stock, and the excess amount goes into the surplus.

Senator KERR. That is just another word to define what the stockholder does when he buys a stock and puts in his part of required surplus or agreed surplus in the begining or at some phase in the life of the company, is it not?

Mr. WILSON. Yes, I would say so.

Senator KERR. Contributed.

Mr. WILSON. I am going to switch positions. This sun makes me look brighter than I am. You don't have the curtains as yet.

Senator KERR. We haven't got them yet, but the experience so far in the construction of this building is such that it would make it very risky for anybody to say when.

Mr. WILSON. I understand what you mean, Senator, I surely do. [Laughter.]

Senator KERR. I think I understand your position.

Mr. WILSON. Thank you, Senator.

The CHAIRMAN. If there are no other questions, thank you.

Mr. WILSON. Thank you, gentlemen, it is a pleasure to be here.

(The appendixes referred to follows:)

APPENDIX I

American Founders Life Insurance Co.
Bankers Union Life Insurance Co.
Capitol Co-Operative Life Insurance Co.
Capitol Life Insurance Co.
Colorado Credit Life, Inc.
Howard Life Insurance Co.
Mile High Life Insurance Co.
National Farmers Union Life Insurance Co.
National Western Life Insurance Co.
Olinger Life Insurance Co.
Perpetual Life Insurance Co.

Security Life & Accident Co.
United American Life Insurance Co.
Western Farm Bureau Life Insurance Co.
Western Reserve Life Insurance Co.

## APPENDIX II

| | Total receipts | Mutual companies | | Stock companies | |
|---|---|---|---|---|---|
| | | Amount | Percent | Amount | Percent |
| 1942 formula | $500 | $375 | 75 | $125 | 25 |
| 1955 formula | $319 | $239 | 75 | $80 | 25 |
| The bill: | | | | | |
| Phase 1 | $505 | $379 | 75 | $126 | 25 |
| Phase 2 | $40 | $12 | 30 | $28 | 70 |
| Total | $545 | $391 | 72 | $154 | 28 |
| Percent of increase over present law | 9.0 | | 4.3 | | 23.2 |
| Effect of subsequent year adjustments provided in the bill phase 3 | $50 | None | None | $50 | 100 |
| Total | $595 | $391 | 66 | $204 | 34 |
| Percent after adjustment for phase 3 | 119 | 4.3 | | 63.2 | |
| $60 million adjustment for pension trust | $60 | $50 | 83 | $10 | 17 |
| Total | $535 | $341 | 64 | $194 | 36 |
| Percent of increase | 7.0 | [1] 9.1 | | 55.2 | |

[1] Decrease.

NOTE.—The bill as it now stands if no changes are made on the assumptions hereinbefore stated shows an increase in the tax for stock companies over the existing law of 55.2 percent and a decrease in tax for the mutuals of 9.1 percent.

## APPENDIX III

[20-payment life—age 20]

| | Prudential | Massachusetts Mutual | National Life Insurance Co. of Vermont |
|---|---|---|---|
| Annual premium | $31.19 | $30.02 | $30.69 |
| 20-year dividend | 89.02 | 143.80 | 166.47 |
| 20-year accumulated dividend | 110.00 | 189.69 | 221.11 |
| 20-year cash value | 503.00 | 503.00 | 508.00 |
| Dividends accumulated to age 65 | 614.00 | 761.97 | 778.78 |
| Cash value at age 65 | 753.73 | 753.73 | 763.00 |
| 20 years premiums | 623.80 | 600.40 | 613.80 |
| Excess cash value at 65 over total premiums | 129.93 | 153.33 | 149.20 |
| Excess plus accumulated dividends | 743.93 | 915.30 | 927.98 |

Diamond Life bulletins: Prudential Dividends, p. 5, June 1958; Surrender Values, p. 3, December 1957. Massachusetts Mutual Dividends, p. 3, February 1958; Surrender Values, p. 2, February 1958. National Life Insurance Co. (Vermont) Dividends, p. 4, March 1958; Surrender Values, p. 3, October 1950.

The CHAIRMAN. Mr. William B. Carssow, Texas Legal Reserve Officials Association.

## STATEMENT OF WILLIAM BENTON CARSSOW, SR., GENERAL COUNSEL, TEXAS LEGAL RESERVE OFFICIALS ASSOCIATION, AUSTIN, TEX.

Mr. CARSSOW. Mr. Chairman, I checked with Mrs. Springer and asked if it didn't do any violence to your protocol, I would like to stand. She said it would be all right.

Senator KERR. Any damage to whose what?

Mr. CARSSOW. Violence to any rules, sir. She added, by the way, that—

It would be all right if you told the committee that you thought you could think better on your feet than seated.

I said I would go that far, but I wanted to be sure it was understood just better.

My name is William Carssow. I am an attorney in the general practice of law. Our firm is retained by the Texas Legal Reserve Officials Association as its counsel in such legal matters as present themselves. Offices of the association are in Austin, Tex., which city is also my hometown.

The association has a membership of officials from some 78 Texas legal reserve life insurance companies. These companies are all small and many of them are young companies, and I would like to say to the chairman and the members of the committee that I have a list of those companies that I can put in the record if the committee would want them in the record, and it would not burden the record.

The CHAIRMAN. Without objection, it will be inserted in the record.

(The document referred to follows:)

APPENDIX A

(Companies by cities)

Abilene:
- Key-Western Life Insurance Co.
- Texas Independence Life Insurance Co.

Arlington:
- American Interstate Life Insurance Co.
- Great Charter Insurance Co.

Austin:
- American Empire Life Insurance Co.
- International Life Insurance Co.
- United Federal Life Insurance Co.
- Universal Bankers Life Insurance Co.

Bryan: Texas Central Life Insurance Co.

Clarksville: Fidelity Life Insurance Co.

Coleman: Coleman Life Insurance Co.

Corpus Christi:
- Colonial American Life Insurance Co.
- Southern Guaranty Life Insurance Co.
- Southern Union Life Insurance Co.

Crockett: Crockett National Life Insurance Co.

Dallas:
- Bankers General Life Insurance Co.
- Certified Life Insurance Co.
- Commercial Travelers Life & Accident Insurance Co.
- First National Life Insurance Co.
- Great Commonwealth Life Insurance Co.
- Great United Life Insurance Co.
- Justice Life Insurance Co.
- Legal Security Life Insurance Co.
- Mercury United Life Insurance Co.
- National Security Life & Accident Insurance Co.
- Presidential Life Insurance Co.
- Robert E. Lee Life Insurance Co.
- State National Life Insurance Co.
- Union Bankers Insurance Co.
- United Bankers Life Insurance Co.
- Fidelity National Life Insurance Co.

Denton: Security National Life Insurance Co.

Fort Worth:
American Standard Life Insurance Co.
Commercial Standard Life Insurance Co.
Family Security Insurance Co. of America
Greenwood Life Insurance Co.
International Bankers Life Insurance Co.
National Underwriters Life Insurance Co.
Shannon Life Insurance Co.
Southwest Capitol Life Insurance Co.
Western Fidelity Life Insurance Co.
Morris Plan Life Insurance Co.
Houston:
American Investors Life Insurance Co.
American Capitol Insurance Co.
American States Life Insurance Co.
Boulevard Insurance Co.
Capital National Life Insurance Co.
Central States Life Insurance Co.
Farm and Ranch Life Insurance Co.
Mid American Life Insurance Co.
National Health and Life Insurance Co.
Oil Industries Life Insurance Co.
Old National Insurance Co.
Southern States Life Insurance Co.
Southwest American Life Insurance Co.
Southwestern Fidelity Life Insurance Co.
Texas Home Insurance Co.
Union Standard Life Insurance Co.
Western Producers Life Insurance Co.
Universal Security Life Insurance Co.
North America Life Insurance Co.
Kirbyville: Sabine-Neches Insurance Co.
Longview: National Security Insurance Co.
Lubbock: Rix Life Insurance Co.
Lufkin: National Investment Life Insurance Co.
Marshall: Southern Fidelity Life Insurance Co.
Odessa: Permian Basin Life Insurance Co.
San Angelo: Continental Fidelity Life Insurance Co.
San Antonio:
Citizens Republic Insurance Co.
Great Coast Life Insurance Co.
Southwest Security Life Insurance Co.
Texas Continental Life Insurance Co.
Time Life Insurance Co.
Texarkana: Old Rockland Life Insurance Co.
Tyler: Empire Standard Life Insurance Co.
Waco:
American Bankers Insurance Co.
Citizens Fidelity Insurance Co.
Wichita Falls:
American Trust Life Insurance Co.
Continental Investors Life Insurance Co.

Mr. Carssow. We are not here today to complain of any segment of the industry or group of companies. We merely want to point to a treatment under H.R. 4245 which would place young companies at a competitive disadvantage with some other companies in this area of commerce.

Any legislation adopted should continue to allow the opportunity for the growth of the small and new companies throughout this country.

First, I would like to point out that the new companies should be permitted to earn a surplus which could be used in the development and growth of the company. Existing companies with large surpluses or companies which have "strengthened their reserves" have investment income available from these funds to use advantageously in the development of new business. I understand that "reserve strengthening," as that term is referred to in the industry, consists simply of taking sums out of surplus and transferring them to policy reserves, and that this has been a common practice among a goodly number of companies.

Understandably, the 1942 tax law, which is the present law, hits such companies pretty hard but it is our position that it is no fault of such law but rather the natural consequence of large surpluses or the reducing of the required interest rate on policy reserves. Now with the increase in the going interest rates, investment income is up, not down. If the smaller companies are not permitted to earn and retain a surplus that can be used in their growth, then these companies with large surpluses or those which have "strengthened reserves" will have sums of money to expend for agency development and policyholder dividends to the great disadvantage of the smaller and newer companies in this business. Small companies and others yet to be formed would not be able to sufficiently build their surplus or to so accumulate their reserves under the terms of H.R. 4245, which taps the underwriting gains.

The only gains to which these companies may look for growth are from their operating gains, and if they are heavily taxed their growth will understandably be slowed in comparison with those companies which have "strengthened reserves" or which have built up large surpluses.

Secondly, to the extent that there is a profit in policyholders' dividends of participating companies, comparable credit should be given nonparticipating companies and their stockholders. Where a profit does exist in policyholders' dividends, phase 2 of this legislation would not tax that profit and the policyholder receiving that profit would not pay any tax. We ask that a comparative allowance be made to nonparticipating companies and their shareholders. This might take the form of a nonparticipating premium deduction commensurate with the profit portion of dividends in participating business.

In closing, sir, I urge your diligent and sympathetic consideration of these problems affecting the new and smaller companies. You have had many proposals suggested which would more equitably treat these companies. Therefore, in addition to the two points set out above, I merely summarize them by reference and request your earnest study of each of them:

(1) We sincerely urge the 15-year "loss carryforward" provision, which I believe has been urged by many before this committee.

(2) We urge that the 2 percent accident and health credit now proposed for group business be extended to all such business, that is, business done on an individual basis.

(3) We urge the increase in the 5 percent small company exemption to 7 percent and that the maximum limitation be raised from $25,000 to $35,000.

(4) A nonparticipating premium deduction commensurate with the profit portion of dividends in participating business. An industrywide average would probably be accurate and acceptable for this credit.

I thank you, sir, for allowing me to present this statement for the Texas Legal Reserve Officials Association.

The CHAIRMAN. Thank you, Mr. Carssow.

Are there any questions?

(No response.)

The CHAIRMAN. Thank you very much, sir.

(Mr. Carssow subsequently supplied the following for the record:)

TEXAS LEGAL RESERVE OFFICIALS ASSOCIATION,
*Austin, Tex., March 23, 1959.*

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

DEAR SENATOR BYRD: On March 18, 1959, Texas Legal Reserve Officials Association presented to your committee its statement on life company taxation. It now asks that this supplemental information be inserted in the record.

A conservative study of "excess interest earnings" contained in dividends paid to policyholders reveals such earnings to appropriate 22 percent of dividends to policyholders and to total about $284 million out of total policyholder dividends of $1.3 billion. These figures are for the year 1957 and are industry averages.

The methods used produced the amount of excess interest earned. They do not determine the amount distributed in dividends. However, if such excess interest is equitably apportioned by the companies to the various reserve and surplus funds, then, in the absence of some special use for the earnings (reserve strengthening, unusual losses, et cetera), the 22 percent figure is a conservative minimum.

Excess interest was computed solely from policy reserve. Earnings on supplementary contracts, dividend accumulations, other types of reserve funds and capital and surplus funds were omitted. Also, the study embraced companies responsible for 72 percent of all policyholders dividends and thereby provides a reliable guide for the entire industry.

It is our position, as set out in our statement, that these untaxed earnings of participating companies provides them a direct advantage over nonparticipating companies and a second indirect advantage in that such earnings are not taxed to the recipient policyholders. Stock companies and their stockholders have no comparable relief in H.R. 4245 at present.

Details of our study are available if desired by your committee.

Very truly yours,

WILLIAM B. CARSSOW, *General Counsel.*

The CHAIRMAN. Mr. Frank A. Jordan.

## STATEMENT OF FRANK JORDAN, COUNSEL, THE SUREWAY LIFE INSURANCE CO. OF SOUTH CAROLINA, COLUMBIA, S.C.

Mr. JORDAN. My name is Frank Jordan. I reside in Columbia, S.C., and I am here representing the Sureway Life Insurance Co. of South Carolina as counsel.

The Sureway Life Insurance Co. is a new company organized in April 1957. In 1958 it realized a net gain from operations of $18,881.51. The company now writes credit life insurance and credit accident and health insurance. It has plans for growth and hopes for success, not only with respect to credit insurance, but the usual lines of ordinary insurance as well. It is our hope for future success in the insurance industry that brings me before this committee today, for unless time is given for adjustment to the discriminatory impact of the third step of H.R. 4245, so-called specialty companies will be placed in a position where they cannot compete with the multiple-line life insurance companies for the business which they specialize in, much less will they be able to compete for the lines of insurance in which the multiple-line companies specialize.

While there have been many allusions to "specialty companies" and "specialty business" in the hearings conducted to date before this committee, no one has so far attempted to explain to the committee precisely what credit life insurance is and how it serves the public. Instead, it has been suggested that credit insurance is not really insurance at all, that it is written only by specialty companies who control the business, reap fantastic profits, and have been receiving preferential tax treatment.

Credit life insurance may be described as that form of term insurance under which the life of a borrower of money or a purchaser of goods is insured in connection with a specific loan or credit transaction. As a line of coverage, it is a relatively new but rapidly expanding and developing service of the life insurance industry to the public. At the end of 1957 credit life insurance in force in the United States totaled $19.7 billion, written under 34 million policies and certificates.

Credit life insurance, in relation to total life insurance in force, amounted to much less than 1 percent in 1945 and 4 percent in 1957. This growth rate indicates that credit life insurance has not only matched the rapid expansion of the use of credit facilities to finance consumer spending, but has achieved widespread public acceptance as well in recognition of the value of obtaining protection to guarantee full payment of loan balances in the event of death.

The first credit life insurance policy was written November 10, 1917, by the Morris Plan Insurance Society of New York. This company was established by Arthur J. Morris, the founder of the first Morris Plan Bank. His vision foresaw the great expansion of consumer credit which was to come in the 20th century and the great need and social purpose to be served by a line of insurance coverage that would assure that no man's debt should live after him to burden his widow and children.

It is interesting to note that before establishing a company for the purpose of writing credit life insurance, Mr. Morris approached the Metropolitan Life Insurance Co. with the hope that the old and established life insurance companies of that day would provide the needed coverage. He was told that they were unwilling to provide such coverage. The established companies were unwilling to undertake the pioneering work in the credit life insurance field for two primary reasons. First, mortality experience was unknown for borrowers as a class of insurance risk, and, secondly, opportunities for selection against the company appeared great. Other factors which discouraged the entrance of the established companies into the field were that policies would be small in amount and consequently premiums would be small. Terms of policies would be relatively short and lapses great, and handling expenses would be high. However, notwithstanding the fact that the established companies were unwilling to assume the risk of pioneering the development of credit life insurance, Mr. Morris established his company and undertook development of the field. He was soon joined by other pioneering companies. These companies today find themselves in the position of facing discriminatory tax treatment as a reward for their pioneering activities in the life insurance field, while the Johnnys-come-lately to credit life insurance among the multiple line life insurance companies are to be given a competitive weapon in the form of a 26 percent tax advantage with respect to coverage in which they had no confidence and which they undertook to write only after others had assumed the risk of development.

Generally speaking credit life insurance policies are of two basic types, group and ordinary or individual, as it is sometimes called. Both types may be issued on a decreasing term or a level term basis.

Life insurance policies may be grouped into two general categories, whole life policies and term policies. A whole life policy, as its name implies, is a term policy for the whole of the life of the insured, while a term policy is written for a definite period of years, shorter than the whole of life.

All credit life insurance policies are term policies. That is, they are contracts which furnish life insurance protection for a limited number of years, the face value of the policy being payable only if death should occur during the stipulated term and nothing being paid in the event of survival beyond the stipulated term of years. Credit life insurance policies are designed specifically to protect the insured's family or estate against the contingency of paying the balance due on the insured's indebtedness in the event of death. Accordingly, such policies perform the basic function of term insurance.

The premium for credit life insurance is usually 75 cents per thousand dollars per month on a prepayment basis under group credit policies, and $1 per $100 per year on a prepayment basis under individual credit life policies. These premiums are competitive with other types of group life and ordinary term life insurance.

Credit insurance is generally available without the requirement of a physical examination for the insured, and no difference in the rate of protection exists between the sexes or among hazardous and nonhazardous occupations. Eligible age limits generally are from 18 through 65 years, inclusive. These are very liberal underwriting conditions, but they are made necessary in order to service the public at a reasonable premium and avoid administrative burden.

It has been said before thhis committee that the so-called specialty companies who write credit life insurance have received preferential tax treatment under the formulas in existence for the taxation of life insurance companies since 1921. This is a completely false statement. All companies, whether multiple line or specialty, generate underwriting income. Since the tax laws have not required that a tax be paid on underwriting income, no life insurance company has paid a tax on such income.

As I have said, credit insurance is term insurance. Figures placed in the record by Eugene M. Thore, vice president and general counsel of the Life Insurance Association of America, show that the percentage of term insurance in total ordinary insurance in force, excluding credit insurance, was 20.6 percent at the end of 1957 and that with credit insurance added, it was only 21.6 percent. His figures also show that for the years 1955–56, term insurance represented about 44 percent of ordinary new issues and that this percentage will probably be higher when 1957–58 figures are available. All of the companies who have written term insurance have done so in the hope of realizing a gain. Up to now they have paid no tax on these gains to the extent derived from underwriting income. Since this is the case, it is plain that the industry as a whole has enjoyed "preferential treatment," if it is to be called that, with respect to one kind of income—not just the specialty companies.

The third step of the bill purportedly is designed to impose a tax on the 50 percent of gains from operations not subject to tax under step 2. It becomes operative (1) upon the payment of a dividend which reduces the balance in the policyholders' surplus account, (2) when the company ceases to be a life insurance company, or (3) when the balance in the policyholders' surplus account exceeds either 25 percent of life reserves or 60 percent of the current years' premiums. You have been told that exempting 50 percent of gain from operations from the step 2 tax is made necessary because of the long-term nature of life insurance business and the difficulty of accounting for income on an annual basis when policyholders' claims may subsequently wipe out all gains and produce a loss. I do not quarrel with these arguments. However, balances in the policyholders' surplus account are impressed with a lien dischargeable only by the payment of the deferred tax to the Federal Government. Accountants and insurance commissioners will require that the amount of the tax deferred by reason of the operation of the bill be carried as a liability on the company's books and reflected in its statements. Thus, to denominate the bookkeeping fiction created by the third step of the bill a policyholders' surplus account is a misnomer. This is true because the balance in the account may not be used for the payment of policyholders' liabilities without satisfying the Treasury Department's claim for the amount of the tax deferred.

The accounting device created by the bill's third step, while having little to do with the protection of policyholders, does provide a fund of tax-deferred earnings which the company may use for business purposes. I do not have to stress the competitive value of a tax-deferred dollar to you gentlemen who deal every day with taxes. To you it is plain that those companies who will have full benefit of tax deferral will enjoy a real benefit. It is also plain to you that those companies who do not enjoy the privilege of tax deferral will be at a disadvantage in competing for business.

The large reserves maintained by multiple line insurance companies make a ceiling of 25 percent of reserves meaningless where they are concerned. I know of no multiple line insurance company that is concerned about the application of the step 3 tax. They can accumulate amounts in the policyholders' surplus account and defer the tax on these amounts in perpetuity without the application of the step 3 tax. Regrettably, this is not the case for those companies whose business mix does not require the maintenance of large reserves. The low reserve or "specialty" companies will have to rely on the alternative ceiling of 60 percent of the current year's premiums. Most of them will be on the ceiling in 2 or 3 years and will pay a straight 52-percent tax on their net gain from operations. Their multiple line competitors, who write the bulk of the specialty business, will be in a position to write specialty business, profit from it, and protect that profit from current taxation by reserves which have no relationship whatsoever to this business. They will enjoy a competitive advantage which will make it difficult for the specialty companies to compete with them.

The selective and discriminatory aspects of the third step are emphasized by its revenue potential. Of the more than 1,400 life insurance companies doing business in the United States today, not more than 50 companies, in my opinion, will ever be subject to tax under step 3. It is doubtful that these companies will provide more than $5 or $6 million a year in revenue for the Treasury Department under step 3. While the Treasury Department's representative has stated that step 3 has the potential of providing $50 million a year in revenue, I can only assume that this statement is based on the fact that approximately $50 million a year will be produced by step 2 of the bill and that a similar amount of tax is deferred subject to the liability of step 3. However, since the multiple line life insurance companies will have the privilege of unlimited deferral, I cannot for the life of me understand how the Treasury Department expects any substantial amount of revenue to be derived from the third step of the bill. As a matter of fact, it seems to me that the Treasury Department has admitted that the third step was not intended as a revenue device.

If the third step was intended as a regulatory device, it is ill-suited to that purpose. Only the strongest considerations of public policy justify the use of a tax statute as a regulatory device. No one has suggested that such consideration exists. If it is believed that the life insurance industry requires regulation, it would be better to leave such regulation to the State commissioners who have the experience and knowledge of the industry required for competent action. The State commissioners also know how to regulate the industry without disrupting competitive relationships.

If the life insurance industry was in its birth and the Congress was for the first time writing a statute to tax the industry, perhaps it would be possible to impose the third step tax without disrupting competitive relationships. If all companies were starting from scratch, each would have the same opportunity to balance its business mix in such a fashion as to obtain maximum advantage under this bill. It is not now possible to begin anew, and I urge you to take competitive relationships into account in your deliberations.

While I believe sincerely that the third step tax will create gross competitive inequalities in the industry and advocate that it be stricken from the bill, I realize that it may now be too late to gain adequate support for my position. At the very least, however, I hope that the members of this committee will find it possible to give us a little time to adjust our business in an attempt to live under the third step. If we are granted a little turnaround time, some of the companies who will feel the bite of the third step tax may be able to survive. We may be able to change our methods of doing business in such a fashion as to acquire multiple lines of insurance. Granting us a small grace period would also permit us to rearrange some of our long-term commitments—commitments to stockholders and creditors which were entered into without any possible opportunity for considering the impact of the third step proposal on our methods of doing business. Even if we are to be forced to sell out to a multiple line insurance company, at least we need the time in which to do so in an orderly fashion.

I have attached to my statement an amendment which would have the effect of applying the third step tax to taxable years beginning after

December 31, 1959, and which would place the tax into effect over a period of the 4 years, 1960, 1961, 1962, and 1963. It would carry into the policyholders' surplus account the amount of the net gain from operations not subject to tax by reason of step 2 at a rate of 25 percent per year until in the fourth year, the full 50 percent would be carried into the account and made subject to the provisions of subpart D of the bill.

This amendment would give us the time that we need to adapt our methods of doing business to the bill's provisions and to give us an opportunity to become the multiple line life insurance companies that the industry evidently believes we should become. Since little or no revenue will be produced by the third step tax in the next 5 years, it cannot be said that the Treasury Department would suffer as a result of the small grace period that my amendment would provide. I sincerely urge upon you the necessity of giving us this help. Surely, considering the radical nature of the third step tax as a revenue device, this is not too much to ask, in fairness.

Thank you.

(The amendment to H.R. 4245 follows:)

AMENDMENTS TO H.R. 4245

On page 30, line 7, strike out "1959", and insert in lieu thereof "1960".

On page 30, strike out lines 8 through 12 and insert in lieu thereof, the following:

"(2) ADDITIONS TO ACCOUNT.—If the gain from operations exceeds the taxable investment income there shall be added to the policyholders surplus account an amount equal to—

"(A) In the case of a taxable year beginning after December 31, 1959, and before January 1, 1960, 12½ percent of such excess;

"(B) In the case of a taxable year beginning after December 31, 1960, and before January 1, 1961, 25 percent of such excess;

"(C) In the case of a taxable year beginning after December 31, 1961, and before January 1, 1962, 37½ percent of such excess;

"(D) In the case of a taxable year beginning after December 31, 1962, and before January 1, 1963, 50 percent of such excess."

The CHAIRMAN. Thank you, Mr. Jordan. Your suggested amendment will be given full consideration in executive session.

Mr. JORDAN. Thank you, sir.

The CHAIRMAN. Are there any questions?

(No response.)

The CHAIRMAN. Thank you.

Mr. John J. Magovern, Jr.

## STATEMENT OF JOHN J. MAGOVERN, JR., VICE PRESIDENT AND COUNSEL, MUTUAL BENEFIT LIFE INSURANCE CO., NEWARK, N.J.

Mr. MAGOVERN. My name is John J. Magovern, Jr. I am vice president and counsel of the Mutual Benefit Life Insurance Co. of Newark, N.J.

During these present hearings before your committee, as well as the hearings last November before the House Ways and Means Committee, the demand for revenue of $500 million has been heard with disturbing frequency.

Members of this committee have clearly stated that the preparation of a fair and equitable tax law is of primary concern. Mr. David

Lindsay, Assistant to the Secretary of the Treasury, has testified that "picking a fair formula and the right formula for a permanent bill is more important than the immediate revenue effect." Nevertheless we must recognize the effect on revenue of each modification proposed. The validity of the $500 million as a tax target in the light of certain revisions suggested for H.R. 4245 is therefore of importance.

As I understand it, this figure represents an estimate of the amount that would be produced for 1958 by the discredited 1942 formula.

We thus see that the $500 million figure bears no relationship to sound tax principles, but is merely a target supported by a discriminatory framework on an incongruous base.

But for purposes of this presentation, I would like to consider the revenue estimates under the 1942 law and their relationship to amendments which have been proposed for H.R. 4245. In doing so, I cannot too strongly emphasize my agreement with the witnesses who have testified as to the inequity and arbitrary character of the 1942 law.

First, let us consider revenue estimates under H.R. 4245 and certain proposed amendments. For 1958, revenue under the bill has been estimated to be about $560 million. Two major amendments have wide support. The first would substitute an individual company 5-year average interest rate for the present artificial mean rate in calculating the policy and contract liability deduction; this would reduce the revenue by about $45 million. The second would modify the limitation on the deductibility of dividends to policyholders; this would reduce revenue by about $35 million more. Thus, if these two amendments were adopted the net revenue would be $480 million for 1958. I might add at this point that this figure would represent an increase of 64 percent over 1957 taxes.

A few companies have proposed an amendment to change the treatmetn of tax-exempt interest. This would reduce the 1958 revenue by about $35 million more. The main argument advanced for this amendment is that the treatment of tax-exempt interest in H.R. 4245 may be unconstitutional.

Without attempting to get into the pros and cons of this question, let me define its relationship to the assumed tax target. If the treatment of tax-exempt interest in H.R. 4245 is unconstitutional, I fail to understand why the treatment of tax-exempt interest in the 1942 law is not likewise unconstitutional. While the 1942 law and H.R. 4245 treat tax-exempt interest somewhat differently, the end result in both cases is to exclude tax-exempt interest in one part of the computation of taxable income and to deny a deduction for such tax-exempt interest insofar as it constitutes part of the "policy and contract liability deduction." Approximately the same treatment—and therefore the same constitutional question—prevailed under the stopgap law for 1955 to 1957.

It is not therefore realistic to consider the tax-exempt adjustment as a reduction in revenue under H.R. 4245. Nor is it realistic to compare revenue under that bill with revenue under the 1942 law unless the tax-exempt adjustment is assumed in both cases.

If changes in the treatment of tax-exempt interest, similar to those proposed for H.R. 4245, were made in the 1942 law the resulting loss of revenue would be about $30 million under the 1942 law. This rather clearly demonstrates that when we consider the effect of such a change as this, the assumed target is not $500 million but actually $30 million less. If the more accurate estimate and later estimate of $492 million under the 1942 law were used, the assumed tax target would thus be $462 million.

Thus, the first two major amendments, and even the change in the treatment of tax-exempt interest, if that is felt to be constitutionally necessary, can be adopted and the revenue kept close to that produced under the 1942 law modified to provide similar treatment for tax-exempt interest. Indeed, with the adoption of all three amendments, the estimated revenue would be over 96 percent of the assumed tax target of $462 million.

If it should be felt that the estimated revenue of $445 million, which would result if all three changes were made in H.R. 4245, is not sufficiently close to the 1958 assumed target of $462 million, there are several ways by which revenue could be increased. One possibility would be to accelerate the payment of amounts due as a result of changes in the method of accounting. H.R. 4245 provides for the spreading of the additional tax, resulting from the change from cash to accrual accounting, over a period of 10 years beginning in 1959. If this were changed to a 2-year period beginning in 1958 the tax yield for 1958 would be increased by about $25 million. This would bring the 1958 revenue under H.R. 4245 up to $470 million which is more than the 1942 law would produce after adjustment for tax-free interest.

Thank you very much.

The CHAIRMAN. Thank you.

Are there any questions?

Senator KERR. Mr. Magovern, you say that if amendments 1 and 2 were adopted, the revenue would be reduced by the amounts of $45 million and $35 million for a total of $80 million.

Mr. MAGOVERN. Yes, sir.

Senator KERR. Have you made a detailed study to see whether those two figures have been arrived at assuming that only one of them is added or that both are added?

Mr. MAGOVERN. The second amendment reflects the addition of the first, sir.

Senator KERR. The amount you give, then, as to the cost of the second is on the assumption that the first has already been approved?

Mr. MAGOVERN. Yes, sir.

Senator KERR. Do you have the figures for your own company?

Mr. MAGOVERN. Yes, sir; I do.

Senator KERR. Can you give them to us on the basis of what would be the saving, No. 1, if only the first amendment is adopted; No. 2, if only the second amendment is adopted; No. 3, if both are adopted?

Mr. MAGOVERN. If the first amendment, that is the 5-year average——

Senator KERR. Yes.

Mr. MAGOVERN. Were adopted, the tax on the mutual benefit would be $6.452 million.

Senator KERR. That would be the reduction brought about by No. 1?

Mr. MAGOVERN. Sir?

Senator KERR. If it alone is adopted?

Mr. MAGOVERN. No, sir; that is not the reduction, that would be the tax payable in lieu of, I didn't quite complete my answer.

Senator KERR. The question I asked is this:

Do you have the figures, No. 1, as to what your company would save if only the first amendment is adopted?

Mr. MAGOVERN. Yes, sir.

Senator KERR. No. 2, if only the second amendment were adopted; No. 3, the total saving if both are adopted?

Mr. MAGOVERN. If amendment 1, the 5-year company average, were adopted, the saving to the mutual benefit would be about $1.1 million.

If amendment 2 were adopted——

Senator KERR. Only No. 2, now.

Mr. MAGOVERN. I do not have the figure without the use of No. 1, sir; I am sorry.

Senator KERR. I see. Then give it to us.

Mr. MAGOVERN. That would mean approximately $900,000 more.

Senator KERR. A total of about $2 million?

Mr. MAGOVERN. That is right, sir.

Senator KERR. Would you supply for the record what No. 2 alone would save your company?

Mr. MAGOVERN. Yes, sir; I should be glad to.

(The information referred to was subsequently received for the record as follows:)

If amendment No. 2 alone were adopted, the reduction in the tax of the Mutual Benefit Life Insurance Co. would be approximately $1,500,000.

Senator BENNETT. I have just one comment, Mr. Chairman.

You propose the very interesting idea that in order to make up some revenue, if your proposals are adopted, we should reduce the 10-year period allowed to change accounting systems to a 2-year period.

Do you know why we have the 10-year suggested in the bill?

Mr. MAGOVERN. I can only assume, sir; I don't know what actually prompted the House Ways and Means Committee to put it in.

Senator BENNETT. What do you assume?

Mr. MAGOVERN. I would assume that it is to ease the burden of a transitional period from cash to accrual accounting.

Senator BENNETT. You are not aware, then, that under section 481 of the present law, that whenever we force a company to change from cash to accrual accounting, regardless of the industry, we allow 10 years?

Mr. MAGOVERN. I do know that it conforms with the general rules of the code, yes, sir, in that respect.

Senator BENNETT. You think we should make it tougher on the insurance company, on the insurance industry than we do on the other industries?

Mr. MAGOVERN. No, sir, I do not think that in this respect it is particularly making it tougher on the insurance industry because of the nature of the insurance business.

Although I am not an actuary, it would be my opinion that a company under the provisions of this law will in any event be required to set up a liability for the payment that they will have to make over the next 10 years. So that in effect you are not imposing a tremendous burden on a life insurance company.

Senator BENNETT. But you think the life insurance industry can well afford to pay us additional revenue of about $25 million a year in this 2-year period, and that that will be no burden?

Mr. MAGOVERN. All that they are paying, Senator Bennett, is the interest that they would be able to—if it was set up as a liability, it would be discounted for interest, so that actually all that you are calling upon the life insurance companies to pay is the discounted interest factor. You are not asking them to—they would have to set that up as a liability in any event, $25 million.

Senator BENNETT. One of the objectives of this bill is to bring the taxation of life insurance companies more nearly into the pattern of that applied to other corporations, and this would represent a very radical departure from the program this committee worked out for handling this problem of forced change of accounting.

Mr. MAGOVERN. But still it would not have—it would not be burdensome since the life insurance company would, unlike another corporation, have to set up this as a definite liability in its statement, anyway, and set the funds aside.

Senator BENNETT. Well, does it have to set the funds aside the first year?

Mr. MAGOVERN. I would—as I read the bill, sir, it becomes a liability at that time and they would have to set the funds aside, yes, sir.

Senator BENNETT. Those funds are not available to the company for general use by the company. Isn't it just a stated liability in the company's report with the funds remaining in the discretion of the management of the company until they are actually needed?

Mr. MAGOVERN. It is taken out of the surplus account. It becomes a liability, sir. It is not available for discretionary use. It is part of the assets, are taken and put into that liability.

Senator BENNETT. But the actual cash is still in your hands until you owe them. That part of the money which isn't owed until the 10th year is not sequestered, you can use it, invest it, do anything else you want with it.

Mr. MAGOVERN. As I said, the loss is the loss of the interest, that is correct, sir.

Senator BENNETT. No further questions, Mr. Chairman.

Senator KERR. The Committee will recess until 10 o'clock in the morning.

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

JACKSONVILLE, FLA., *March 19, 1959.*

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

Urgently request Senate avoid impairing municipal bond market and increasing cost of municipal financing through indirect repeal of section 103 in proposed life insurance company tax bill, H.R. 4245. Such action would have very serious consequences for Jacksonville's progressing urban redevelopment program, a program being financed entirely through our own credit and revenues and without 1 penny of Federal aid.

HAYDON BURNS,
*Mayor, Jacksonville, Fla.*

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STATEMENT ON BEHALF OF INTERNATIONAL LIFE INSURANCE CO., AUSTIN, TEX.

International Life Insurance Co. is a capital stock life insurance company organized in 1942. It is a very small company with total assets as of December 31, 1958, of $2,404,116. It writes ordinary forms of life, health, and accident, and hospitalization insurance almost exclusively on the individual basis. The company is owned by some 3,300 stockholders, and no one person, or group, has as much as a 1 percent equity. From 1942 until 1953, the company was very limited in its operations and had at December 31, 1953, an accumulated net loss from operation of $149,038.64. By 1954, the capital stock had been increased to finance an expansion program.

During the next 4 years the following figures illustrate the results of operations:

| Year | Loss from operations | Federal income tax |
|---|---|---|
| 1954 | $246,512.88 | $5,526.32 |
| 1955 | 62,624.94 | 5,381.48 |
| 1956 | 248,807.21 | 6,181.61 |
| 1957 | 209,397.46 | 3,391.19 |
| Total | 767,342.49 | 20,480.60 |

Thus by December 31, 1957, the company had an accumulated net loss from operations from the date of organization of $916,381.13. Paradoxically, however, because of the previous tax laws, the company had paid considerable Federal income tax all during that period.

During 1958, the company finally began to realize a gain in operations in the amount of $146,090. H.R. 4245 as proposed would tax these gains without any regard for the heavy losses incurred immediately prior to 1958. This causes two inequities: First, the company is denied the ability to offset the present gains against the previous losses merely to get even with the board, and, secondly, its chance to further expand is correspondingly diminished by taxation of these present gains which in this company's case is actually a replacement of capital and/or contributed surplus previously expended to get the business started.

I would respectfully ask for the following amendment:

"To provide that any company with an accumulated net loss from operations from the date of its inception to December 31, 1957, be permitted to carry forward such accumulated net loss from operations for a period not to exceed 5 years, commencing with the year 1958, as an offset against taxable income as a result of the operation of phases 1 and/or 2 of H.R. 4245 as proposed."

This would have the effect of affording small and young companies an opportunity to at least recover a portion of their initial losses before subjecting them to taxation. It would surely serve to strengthen them and would be an equitable provision.

Or, an alternative amendment:

"To provide that any company with a total net loss from operations for the 5-year period (1953, 1954, 1955, 1956, 1957) be given an opportunity to offset such total net losses against taxable income as a result of the operation of phases 1 and/or 2 of H.R. 4245 as proposed, much in the same manner as if H.R. 4245 had become effective in the year 1953, in which event such losses would have been allowed as carryforward credits as presently provided in H.R. 4245 as proposed."

I would make only one further comment with respect to H.R. 4245 as proposed. It would definitely seem that small companies are at a disadvantage with respect to the 2 percent deduction on group accident and health and hospitalization premiums. They cannot enter the group field until they become very large—but, on a regional basis can serve individual needs, and it would seem that this deduction should extend to individual business, or it obviously will favor the large companies, and this is never a desirable feature in any tax legislation.

Respectfully submitted.

JAMES E. DUNNE II,
*President, International Life Insurance Co.*

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## STATEMENT OF ARTHUR J. CADE, EXECUTIVE VICE PRESIDENT, OLD REPUBLIC LIFE INSURANCE CO., CHICAGO, ILL.

Mr. Chairman and members of the committee, I am Arthur J. Cade, executive vice president of the Old Republic Life Insurance Co. of Chicago, Ill.

As executive vice president of Old Republic, my principal responsibility is for the successful operation of our sales and agency organization leading to increased production and, we hope, greater profits.

Unfortunately, I possess neither a legal nor an actuarial background and it has not been easy for me to understand H.R. 4245 which even the experts, I believe, will agree is a very complicated bill.

In the hearings before the subcommittee of the House Ways and Means Committee and thus far during the hearings before your committee there has been much discussion concerning the competitive problems which may be created if H.R. 4245 is enacted. It is to the competitive problem that most of my remarks will be directed.

Throughout the hearings frequent references have been made to the so-called specialty companies. The term has been loosely used but never clearly defined. It would appear, however, that those using the term had Old Republic in mind along with other companies.

Therefore, before proceeding with my testimony, I would like to tell you a little bit about my company.

Old Republic was organized in 1931 but through its three predecessors its history dates back to 1923. For the first 10 years of operation, the company specialized in the sale of ordinary life insurance. Frankly, we did not sell very much. During the early years of the depression it became apparent that our financial resources would not withstand the continuing drain inherent in the operation of a new life insurance company, particularly one seeking to develop primarily ordinary life insurance.

Consequently, a decision was made in 1933 to diversify the company's operation and to concentrate on the development of a portfolio of credit life insurance, which at that time was still a comparatively new type of life insurance.

Our early efforts to expand in this new field were successful and led to a greater concentration in that area. We are proud of the fact we are today one of the largest writers of this popular form of life insurance.

At the time we entered the field of credit life insurance there were only three other companies active in that field. All three are still active; one of them is larger than we are—it is a mutual company. The other two, like Old Republic, are stock companies. Less than 8 years ago there were only approximately 50 companies active in the field of credit life insurance. Today there are over 300 active in the field and the great majority of them are companies whose histories date back prior to the founding of our company.

Old Republic is a stock company and our stock is publicly owned. In the past few years the company has endeavored to diversify its portfolio of life insurance and we have been successful to date in placing approximately $10 million of ordinary life insurance on our books and hope, during the year 1959, to increase that figure to approximately $30 million.

As our financial resources permit, we will continue to diversify our business so as to enable us to participate in the profits that are to be made in other lines of life insurance. In every respect we have always considered and still do consider Old Republic to be a life insurance company.

Life insurance is a specialized business and life insurance companies cannot be successfully operated without a staff comprised of many specialists.

Testimony here presented would indicate that the bulk of group annuity business is at present concentrated in the hands of a small number of companies. To me that is quite understandable. To successfully offer a group annuity program on a competitive basis requires the employment of skilled and expensive technicians. We look forward to the day when our resources will permit us to employ such technicians so that we can compete for annuity business.

The sale of employer-employee group life insurance and the sale of group life insurance in connection with union welfare funds likewise require skilled technicians with specialized ability and knowledge. Again, it is our fervent hope that Old Republic may one day be staffed so as to successfully compete for such business.

Credit life insurance is also a specialized business and in that particular area we are well staffed with personnel who understand the business and who have successfully competed for our share of the market.

The majority of witnesses who have testified during the course of hearings on the pending tax bill have been men of experience in the life insurance business who must certainly appreciate the tremendous importance of specialization to the successful operation of such business. Yet many of these witnesses have used words of derision when referring to so-called specialty companies.

Term life insurance is the only pure form of life insurence. In every policy of life insurance there is a term element. When the term element, providing pure protection, is combined with the savings element, providing funds for eventual retirement and security, we may describe it as a whole life or endowment policy. Regardless of what it is called, a life insurance policy always contains the term element.

Much has been said concerning the impact the proposed bill might have in discouraging the use of life insurance as a form of voluntary savings. Comparatively little has been said concerning the impact it might have in discouraging the use of life insurance as a much-needed form of family protection. I regard the protective feature of life insurance as the more important feature.

That the public regards the protective feature of life insurance as more important and of ever increasing importance, is reflected in the statistics heretofore presented by other witnesses indicating that an ever increasing percentage of the new issues of life insurance are on a term basis.

Some of these witnesses would have you believe that the trend referred to is the result of past tax laws which failed to tax the underwriting profit on term insurance.

That is not true.

The increasing volume of term insurance reflects the fact that insurance sales are today being tailored to the public need.

The average man who is head of a family has as his principal objective in life the desire to provide security for his family. He is desirous of providing such security even though death may strike him prematurely. It is only through the instrument of life insurance that he can hope to attain that objective and even with life insurance, the objective is becoming increasingly difficult to attain by reason of the inflationary trend which we have all witnessed.

A man with a $7,000 a year income and with a wife age 40 and two children ages 9 and 10 who wished to provide $3,000 of life insurance for burial and cleanup purposes, approximately $6,000 of life insurance to cover expenses during the first year following his death to allow for a period of readjustment, approximately $3,500 a year for each year until the children became self-supporting, and $2,250 a year thereafter for the support of his widow, even after allowing for social security benefits, would require approximately $75,000 of life insurance to attain his objective. Few men with an income of $7,000 a year could hope to attain that objective and certainly they could not do so unless their insurance portfolio included a substantial element of term insurance. This explains in part the widespread use of combination policies which provide a substantial element of pure term insurance in combination with a basic element of ordinary life insurance.

A statement by Mr. Eugene M. Thoré of the Life Insurance Association of America is set forth on page 212 of the transcript of hearings before the House Subcommittee on Internal Revenue Taxation. Mr. Thoré therein indicates that the percentage of term insurance in relation to total ordinary insurance in force, excluding credit insurance is 20.6.

The Life Insurance Fact Book, published by the Institute of Life Insurance, indicates that there were approximately $265 billions of ordinary life insurance in force at the close of 1957. Hence it is etimated that approximately $55 billions of such insurance was term insurance.

The same Fact Book sets forth figures indicating there were approximately $135 billions of group life insurance in force at the close of 1957, approximately 90.9 percent of which was on the term plan. Hence it is estimated that approximately $123 billions of such insurance was term insurance.

The Fact Book also indicates that there were approximately $20 billions of credit life insurance in force at the close of 1957, all of which business was on the term basis.

We thus find that there was a total of approximately $198 billions of term life insurance in force at the close of 1957.

Credit life insurance represented approximately 10 percent of all term life insurance in force and approximately 4½ percent of all life insurance in force at the close of 1957.

In connection with the $20 billions of credit life insurance in force, there were outstanding approximately $34 million credit life insurance policies and certificates. Old Republic had in force approximately $2 billions of such insurance and we had outstanding 3,400,000 policies and certificates.

The remaining $18 billions of credit life insurance in force was widely distributed among our 300 competitors with a very substantial portion of such business being held by mutual life insurance companies and still another substantial portion of such business being held by stock life insurance companies offering a diversified portfolio of life insurance. The remainder of such business was held by companies like Old Republic and by companies affiliated with financial institutions.

We believe that these statistics are of importance to you in your considerations since there would appear to have been a deliberate attempt on the part of some witnesses to direct attention from the overall aspects of the problems relating to the taxation of life insurance companies by directing attention primarily to the problem as it relates to the so-called specialty companies. As indicated in the above statistics, these companies account for a minute fraction of the total of term insurance in force, a fact recognized by the House Ways and Means Committee.

Old Republic recognizes its obligation and is fully prepared to pay its fair share of Federal taxes. It also recognizes the importance and necessity of paying taxes for the support of State and local governments.

We are, however, concerned lest a tax bill be enacted which discriminates against a particular company or a particular type of company, thereby destroying competitive balance. Our fears are not without foundation.

In many of the early proposals offered by industry, as well as by the Treasury, formulas were suggested which would have levied a discriminatory tax against Old Republic placing us at a severe competitive disadvantage. For example, under the Treasury formula initially presented to the House Ways and Means Subcommittee, we estimated that our tax on 1957 income would have been $690,000. The same block of business written under identical circumstances as a part of the portfolio of several of our competitors would have developed a tax of only approximately $415,000.

Old Republic was thus confronted with a tax burden 67 percent greater than that imposed on its competitors.

It was that problem which prompted us to request an opportunity to be heard by the House Ways and Means Subcommittee.

In subsequent considerations, the Ways and Means Committee sought to correct that inequity.

It is true that Old Republic had paid relatively little Federal income tax in comparison to its total operating gains in past years. This resulted from the fact that the bulk of our writings were in term life insurance which tends to develop relatively little investment income and relatively high underwriting income. There are those who might have you believe that our concentration in the field of term life insurance was prompted by a desire to avoid Federal income taxes. Nothing could be further from the truth.

Our decision to concentrate on the sale of term life insurance has heretofore been explained, and it was a decision made without consideration of the impact of Federal taxes.

There are those who might have you believe that only the so-called specialty companies have paid relatively little Federal income tax in relation to the operating gains they have enjoyed. This is an erroneous impression. All companies writing term life insurance have paid relatively little Federal income tax on the operating gains derived from the sale of such insurance.

It is true that the deficiencies of a tax based solely on investment income are more apparent in the case of a company writing principally term insurance than would be the case with companies having a diversified portfolio of insurance. It is important, however, to understand that all companies writing term insurance paid relatively little tax in connection with that portion of their portfolio.

It should be recognized that there are normally two elements of income in connection with the sale of any form of life insurance. There is the element of investment income and there is the element of underwriting income. In the case of term insurance, the element of underwriting income is the more important; in the case of other forms of life insurance, the element of investment income is the more important. However, there is also an element of investment income in connection with term life insurance, just as there is an element of underwriting income in connection with other forms of life insurance.

Many witnesses who in the current hearings have been prone to direct attention to Old Republic are persons who in past hearings have testified that there was only one element of taxable income in the sale of life insurance and that element was investment income. I am appalled that these men who in the past have advised Congress in its tax considerations should now be critical of a company that paid relatively little Federal income tax by reason of the fact that it had little investment income and substantial underwriting income. It was their own past testimony which caused the situation to exist.

Old Republic has never testified before any congressional committee in an attempt to preclude the taxation of underwriting income and we are not here to do so at this time.

In our opinion it is proper to lexy taves against operating gain including both the element of investment income and the element of underwriting income.

However, that objective is not easy to achieve without destroying the competitive balance which exists in the industry today. This, in part, explains the complexities of H.R. 4245.

In my testimony to this point I have endeavored to provide you with background information that is considered essential to the sound evaluation of the remainder of my testimony.

I would now like to direct my testimony to a discussion of H.R. 4245, both as to its basic pattern and structure as well as to certain of its specific provisions.

A sound Federal income tax law should (1) raise adequate and proper revenue, and (2) provide tax equality and preserve competitive balance.

In our analysis of H.R. 4245 we have endeavored to determine whether it will meet that twofold test.

We believe H.R. 4245 effectively corrects one glaring deficiency that existed in the tax laws that applied during the past several decades; it levies a tax on underwriting income as well as on investment income.

The tax on investment income is dealt with under phase 1 of the bill.

To the extent that phase 1 retains the use of industry averages in computing the tax on investment income it remains deficient and the recommendation heretofore made by other witnesses to eliminate the use of industry averages should receive your favorable consideration. That change is essential if companies are to be taxed according to their own individual ability to pay.

H.R. 4245 does not allow any deduction for policyholder dividend distributions in connection with the calculation of the tax on taxable investment income. This feature must be retained and must not be modified if competitive balance is to be maintained.

At this point I would like to disgress for a moment and discuss the policyholder dividend paid by mutual companies and by stock companies writing participating insurance.

The big mutual companies provide the principal competition to all other companies. This is true whether it be competition for ordinary life insurance, group life insurance, group annuities, or credit life insurance, or for that matter any other line of insurance.

It is essential to any discussion of the competitive problem that the nature of the policyholder dividend be understood.

Some spokesmen for mutual companies would have you believe that the dividend is simply a return of the excess premium deposit made by the policyholder. That is not true.

A policyholder dividend contains two elements. One element of the dividend may be considered a return to the policyholder of the excess premium deposit that the same policyholder was required to contribute when he joined the mutual organization. There is, however, a second element which mutual spokesmen frequently do not mention. That second element is a distribution to the policyholder of a portion of the profits earned from dealing with third parties. This element may consist of investment income, underwriting income, or both. Usually it consists of both investment income and underwriting income.

The mutual policyholder in reality plays a dual role. He is both a policyholder and, in essence, a shareholder in the mutual company for it is the excess premium deposits which provide the continuing source of capital for mutual companies.

Against that element of the dividend distribution which is a return of the excess premium deposit paid by the policyholder, no tax should be levied with respect to either the corporation or the policyholder. The situation is similar to the treatment accorded the capital investment of a shareholder.

Against that element of the dividend which consists of investment income, underwriting income, or both, taxes should be levied. Taxes should be levied against such income to the corporation, whether stock or mutual, and thereafter taxes should be levied against the residue of such income when it is distributed as personal income to either the individual policyholder or to the shareholder.

If, however, for sound reason the tax on corporate income is not, or cannot be, levied in the case of the mutual operation, then relief must be provided to the stock company in order to maintain competitive balance.

With the benefit of the foregoing discussion of the nature of the policyholder dividend, I would like to return to our consideration of H.R. 4245.

As drafted, it will not, and properly so, tax that element of the dividend distribution which is a return of the excess premium deposit.

It will exact from the mutual company and stock company alike a tax on investment income to the corporation.

It will, however, permit the mutual company, particularly the large mutual, to minimize or completely avoid the payment of taxes on its underwriting income.

Recognizing that it would be extremely difficult, if not impossible, to remedy that situation, H.R. 4245 has provided necessary relief to the stock company in phase 2 by allowing a deduction equal to 10 percent of the annual increase in reserves with respect to nonparticipating business (other than group and annuity business).

That is the logical place to provide such relief since H.R. 4245, in levying a tax against underwriting income, does so in two steps. Those steps are referred to as phase 2 and phase 3 of the bill.

I would also like to comment briefly on a second deduction that is allowed in phase 2. That is the deduction allowed for group insurance equal to 2 percent of the premium income from this type of insurance until the cumulative amount of the deduction equals 50 percent of the current year's premium income from that source. That special deduction is patterned after reserve requirements of at least two States. In the case of Old Republic, we have at present accumulated nearly $1 million in that account. It would be difficult, if not impossible, to maintain the required funds if such a deduction were not authorized under the Federal tax statute.

Neither the 10 percent reserve deduction nor the 2 percent group deduction can be utilized to reduce the tax on investment income nor to create a loss to be carried over.

After determining the underwriting gain in phase 2, one-half of such amount is then added to the taxable investment income to reach the combined tax base under phases 1 and 2. The 50 percent reduction in underwriting gain is allowed by reason of the difficulty experienced in establishing with certainty the actual annual income of a life insurance company. The difficulty, in part, results from the long-term nature of the life insurance business. By reason of the uncertainties which may be encountered, it is essential that a substantial surplus be maintained for the protection of policyholders.

We believe that this feature is equally important with respect to term coverage. When term life insurance is written, the amount of reserve established is relatively low, particularly in relation to the exposure assumed. For that reason a greater surplus is required in connection with term insurance if the policyholder is to have a full margin of safety.

In phase 3 of H.R. 4245 it is provided that one-half of underwriting gains not taxed currently under phase 2 will be transferred to what is therein designated as the policyholders' surplus account. A subtraction in that account as provided in the bill creates the third-phase portion of a life insurance company's tax.

A second account provided for in phase 3 is called the shareholders' surplus account and it is, in essence, a record of all tax-paid amounts (less the amount paid in taxes) for calendar years beginning on and after January 1, 1959. When dividends are paid to shareholders, the balance in this tax-paid account is reduced first and this does not result in any further tax under phase 3.

By limiting the amount which may be accumulated in the policyholders' surplus account to 25 percent of life insurance reserves or 60 percent of net premiums received in the current year, whichever is higher, H.R. 4245 would automatically force the transfer of funds from the policyholders' surplus account to the shareholders' surplus account, thereby requiring payment of taxes out of the funds so transferred.

We believe that certain amendments should be considered with respect to phases 2 and 3 of H.R. 4245 if competitive balance is to be maintained.

Consideration should be given to the advisability of allowing a partial distribution of existing surplus on a year-to-year basis without first requiring the payment of the entire tax liability which accrues under the policyholders' surplus account.

The smaller company may, from time to time, find it desirable to issue a call for additional paid-in surplus. In this connection, maintenance of a dividend program is important. To require the company to pay the full tax on all current income, before any portion of such dividend could be paid from previously accumulated surplus, may create a serious competitive problem for the smaller company.

There is one feature of H.R. 4245 which gives us cause for grave concern. The bill fails to recognize that life insurance companies are already heavily taxed by the States; more heavily, we believe, than any other industry.

To illustrate the impact of combined State taxes and Federal income taxes as they will be levied under H.R. 4245, I would like to quickly review the past history of Old Republic.

During the 27-year period following its incorporation, Old Republic has had a net operating gain of $9,510,000. Its net operating gain has been utilized as follows:

In 1931 the company had approximately $438,000 of policyholders' surplus as the result of paid-in capital and surplus. During the ensuing 27 years, policyholders' surplus was increased by $180,000 through paid-in capital and surplus. Of the $9,510,000 of operating gain, approximately $3,478,000 was distributed in the form of cash dividends. Of the remaining $6,032,000, approximately $1,489,000 was utilized to defray capital losses and to provide for the statutory reserves required in connection with unauthorized reinsurance. The balance of $4,543,000 has been contributed to policyholders' surplus which as of December 31, 1957, stood at approximately $5,161,000. Such surplus provides an essential margin of safety to the company's millions of insureds protected by its $2 billion of insurance in force.

During the 27-year period in question, all management decisions were made without consideration of tax consequences. It is apparent that funds were available which could have been utilized to increase cash dividends had management not felt that it was essential to retain such funds for the protection of policyholders and the growth and development of the company.

During that 27-year period, Old Republic paid in State premium and Federal income taxes $3,522,000. Substantial additional amounts were paid in the form of licensing fees and other taxes to Federal, State and local governments.

Had H.R. 4245 been applicable to the business of Old Republic during that 27-year period, it is estimated that our Federal income tax under phases 1 and 2 would have been increased by approximately $2,300,000.

As a consequence, in order to pay this Federal tax of $2,300,000, without reducing the policyholders' surplus deemed essential to the protection of policyholders and the growth and development of the company, it would have been necessary to reduce the cash dividend by such amount which, in effect, would have been a 67-percent reduction in cash dividends.

Moreover, had phase 3 been applicable, additional deferred Federal income tax liability of approximately $2 million would have existed.

That tax liability could not have been discharged without a considerable reduction in the company's surplus funds deemed essential to the protection of its policyholders and the growth and development of the company. Even if we had not paid any cash dividends whatsoever, a reduction of approximately $800,000 in our surplus funds would have been required in order to discharge that tax liability.

It would seem apparent that the impact of a Federal income tax levied at the full corporate rate, when combined with the heavy State premium taxes required of life insurance companies, might seriously impair the company in its operations.

A life insurance company renders a real service to the American public and is unique in its nature. It is the only type of institution that can provide essential security to the family should death strike the family head prematurely. It combines with this protective feature the element of savings.

It seems obvious to us, on the basis of our own experience, that some portion of the tax burden which will arise under H.R. 4245 as drafted will, of necessity, need to be shifted to the American public if a company is to maintain surplus necessary to protect its policyholders and for its future growth and development.

It is with reluctance that I make that statement for as I have frankly indicated, Old Republic has in the past paid relatively little Federal income tax in relation to its earnings, and you might, therefore, conclude that we have no reason to complain.

However, I do believe it is the sincere desire of this committee, just as I am convinced it is the sincere desire of the House Ways and Means Committee and of the Treasury Department, to enact a sound bill that will provide a permanent formula for the Federal income taxation of life insurance companies. We have candidly discussed figures relating to our operation because we believe they tend to clearly demonstrate the impact that this tax bill may have on the future operation of life insurance companies, particularly the small life insurance companies.

We believe that your committee may wish to give consideration to this problem and provide some relief to industry in light of the heavy burden of State taxes it bears.

We recognize the practical difficulties encountered if State premium taxes were allowed as a deduction against Federal income taxes. We believe it would enable the States to eventually dry up Federal income tax revenue from the life insurance industry. However, the necessary relief could be provided through modification of phases 2 and 3 of the bill.

## CONCLUSION

We have endeavored to demonstrate the impact H.R. 4245 will have on the smaller life insurance companies.

The severity of the impact is clearly demonstrated on pages 15 through 17 of this statement where, for purposes of illustration, we have calculated the tax which would have been paid by Old Republic had H.R. 4245 been in effect throughout the 27 years our company has operated.

Even though we had paid no dividends whatsoever to our shareholders, we nevertheless would have been unable to accumulate the surplus we deem necessary to the protection of our policyholders. Faced with a similar prospect, most small companies cannot hope to survive unless H.R. 4245 is amended to some degree.

This substantiates the concern of several members of the House Ways and Means Committee expressed in paragraph 2 on page 88 of the report of the Committee on Ways and Means on H.R. 4245.

Therefore we recommend that this committee consider amending H.R. 4245 in the following particulars:

1. Eliminate phase 3 in its entirety. This will cause little loss of revenue and will leave surplus free of any Federal tax lien so that it may be utilized for the growth and development of the company as well as the protection of its policyholders. A second reason for eliminating phase 3 is that it is clearly discriminatory with respect to the smaller companies.

2. If phase 3 is not eliminated in its entirety, at least mitigate its discriminatory impact on small companies by amending phase 3 to provide for its gradual application over a period of 5 years. This may be accomplished through the adoption of the amendment suggested by Mr. Frank Jordan in his testimony before this committee on March 18, 1959.

3. Amend phase 2 of the bill to provide for its gradual application over a period of 5 years. This suggestion has been made by several other witnesses including Mr. Leonard H. Savage in his testimony before this committee on March 17, 1959. Funds thus released should be placed in the shareholders' surplus account.

4. Amend the bill to permit partial distribution of existing surplus on a year-to-year basis without first requiring the payment of the entire tax liability which accrues under the policyholders' surplus account, provided such partial distribution in any year shall not exceed 5 percent of the existing surplus.

By permitting a transition period of 5 years with respect to the impact of phases 2 and 3, the smaller companies will be given an opportunity to achieve a greater degree of parity with their larger competitors. They will have an opportunity to achieve a mix of business to some degree comparable to that of their large competitors. They will have some opportunity to strengthen their free surplus position. They will have some opportunity to consider merger or sale if it appears that competitive equality is beyond their reach.

The suggestions we have made are not prompted solely by reason of our own company position, but are made because of their importance to all small companies.

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## Statement of W. L. Newton, Executive Vice President, Kentucky Central Life & Accident Insurance Co., Anchorage, Ky.

The company of which I am executive vice president is not a new company, nor is it a small company in the strict sense; but with assets slightly in excess of $23½ million, we must be considered a small company by relative standards. We are members of the Life Insurers Conference and the American Life Convention, but the views presented in this statement purport to be the views of our company only. Toward the close of our statement, we will specifically request consideration of an amendment to H.R. 4245. This amendment would in no way impair the budget requirements and objectives of our Government, nor alter the general pattern of the bill.

The bill which the House of Representatives has sent to the U.S. Senate for its consideration would tax the total income of life insurance companies at regular corporate rates. It is a well-conceived and well-drafted tax bill, and reflects much study and a great deal of understanding of the multiplicity of problems incident to the taxation of life insurance companies.

There is nothing actually new in the theory of tax nor the tax approach under phase 1 of the bill, although the method of determining the credit for reserve interest requirements and the treatment of tax-exempt securities result in producing substantially greater revenue than the Mills-Curtis formula.

Phases 2 and 3 are entirely new, and are designed to tax underwriting gains. The bill very wisely recognizes the difficulty of determining at what point such gains are realized by deferring the tax on a portion of the gains until clearly identifiable as such. We would not be foolish enough to argue that the net income of life insurance companies, whether resulting from investment income or underwriting gains, is not a proper object of Federal income tax. But this fact does not necessarily warrant the conclusion that such income should be subject to a tax rate of 52 percent. Equality of tax treatment does not demand such a conclusion, and tax legislation should look always to the nature of the taxpayer's business, its ability to pay, its position in the economic society, and its contributions to such society. In our view, the real and fundamental issue in this matter is the effective tax rate, and we submit that there are sound and compelling reasons why Congress, to this date, has refrained from taxing life insurance companies to the extent of this present bill. Some of these reasons are as follows:

(1) Congress has always recognized life insurance companies as one of the major bulwarks of private thrift and practical economy, and their most important contribution to our country's expanding economy through their investment of these savings. Congress has encouraged the continued accumulation of these capital funds by fair and equitable tax treatment in past years.

H.R. 4245 according to latest conservative estimates, would produce tax receipts of $554 million for the 1958 tax year, compared to $310 million under the law in effect for the prior 8 tax years. This sudden and excessive increase is, to our knowledge, without precedent in the tax treatment of other industries.

(2) Congress has always taken cognizance of the tremendous tax burden already imposed on insurance companies at State and other governmental levels. State premium taxes alone for 1958 will approximate $300 million. Such taxes are unique and are unparalleled in the case of other thrift institutions.

(3) Congress, in past years, has recognized that "profits" of life insurance companies, whether from free investment income or from underwriting gains, and whether retained by the companies or declared to the investor stockholder as dividends, are not necessarily "profits like any other corporation profits." The product sold by life insurance companies, whether in the form of pure insurance protection or in the form of savings, is future dollars. An increase in the tax burden cannot be shifted to the consumer-policyholder without seriously impairing the attractiveness of the purchase. Furthermore, the underwriting gains, if any, of a life insurance company on any particular block of business, are not attributable to any one year nor to any several years, but gradually emerge over a long-term period of many years, and require the maintenance of large amounts of capital funds for the protection of policyholders during the period of emergence. In many respects, underwriting gains resemble long-term capital gains.

(4) Finally, Congress has, in the past, wisely provided a tax climate which permitted the maintenance of the competitive position of stock companies in relation to mutuals. Congress has encouraged and fostered the healthy competition which has been manifest in the industry these many years. It must be remembered that the entry of new companies into the industry is almost exclusively by stock companies, and a great number of our fine mutuals were once stock companies themselves.

Seventy percent of the new tax burden under phase 2 of the bill under consideration is imposed on stock companies. This is totally inconsistent with the relative positions of stocks and mutuals when it is considered that mutuals own 75 percent of the total assets.

Furthermore, phase 3 of the bill creates an actual or deferred tax liability on the part of stock companies, and such liability equals approximately the taxes paid under phase 2. This additional tax cannot be ignored insofar as it affects the industry, the insuring public, and the public economy merely because it may be deferred. If phase 3 were applicable to 1958 as it would apply to subsequent years, an additional tax liability of approximately $28 million is created. Stock companies would now assume approximately 82 percent of the new tax burden imposed by phases 2 and 3.

Our company does not desire a "tax shelter." We do want a fair, equitable, and permanent tax bill which will permit our company a healthy growth and which will permit a reasonable return to our investor stockholders.

The changes in H.R. 4245 suggested by other member companies of the Life Insurer's Conference are fine insofar as they go. However, for the reason stated above, we feel most strongly that the bill, even with such changes, represents a much too drastic departure from the fundamental tax principles underlying all past legislation, and that a more realistic approach is required. We therefore respectfully and earnestly submit that the tax rate applicable to phases 2 and 3 of this bill should be modified. We specifically recommend that the bill be amended to provide for a tax imposed, in addition to the tax on capital gains, to consist of the corporation normal tax applicable to all taxable income under the bill, plus the corporation surtax applicable to the taxable investment income or the gain from operations, whichever is smaller, less $25,000. This amendment would reduce the tax rate under phases 2 and 3 from 52 percent to 30 percent and the reduction in tax receipts would amount to $18 million. The total tax receipts under the bill would be $538 million, still well in excess of the Treasury's announced objectives. Although relatively modest in its immediate application, this amendment would do much to alleviate the total impact of this new law, and the inequity of its application.

We would like to endorse and to comment briefly on two proposals previously submitted to the committee. While we confess that our interpretation of the provisions relative to tax-exempt securities could be in error, we have been unable to find where we are not receiving a full exemption for these earnings. Nevertheless, it does represent a change in the prior treatment of such securities, and, as a practical matter, make such securities considerably less attractive as an investment. Congress could, in the public interest, and to further encourage the continued participation of life insurance companies in these issues, permit the deduction of tax exempt interest without the "adjustment to prevent double deductions" provided the deduction does not exceed invested funds in excess of policy reserves.

Regardless of what is done with respect to these and all other proposals, it would seem to us that the immediate impact of a new tax law which so sharply increases taxes should be buffered by : transition period. The increase on some companies is proportionately much greater than on others. A transition period as suggested in the letter of the Secretary of the Treasury of April 10, 1958, would be most helpful.

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U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
*March 16, 1959.*

Senator HARRY FLOOD BYRD,
*Chairman, Senate Committee on Finance,*
*Washington, D.C.*

DEAR HARRY: I know you must be receiving thousands of letters in connection with the committee's study of H.R. 4245. The enclosed letter is one of many which have come to my office and I have singled it out for your attention for the reason that it comments specifically, and, I think, convincingly, on a special aspect of this proposed legislation. I have assured Mr. Jensen that the committee will assess very carefully the impact on small underwriters, such as the one he represents, of the section to which he refers. If it is convenient, I would like to ask that you include this letter in the printed record of the hearings so that it may readily be brought to the attention of other interested Senators.

My warmest good wishes to you.

Sincerely,

FRANK CHURCH,
*United States Senator.*

BOISE, IDAHO, *March 10, 1959.*

Senator FRANK CHURCH,
*Senate Office Building,*
*Washington, D.C.*

DEAR FRANK: One of my present duties is to represent an insurance company which may be adversely affected by H.R. 4245, which is now in the hands of the Senate Finance Committee. It is my understanding that a second series of hearings will be scheduled on March 17.

This company presently writes a limited form of life insurance called credit life in the States of Washington, Oregon, California, Utah, Nevada, and Idaho. Step 3 of the proposed bill will make it difficult, if not impossible, for smaller life insurance companies, such as ours, to stay in business.

The same type of insurance is written by large companies, but they will not be taxed on this type of business due to their investment income being taxed.

Actually, it is my understanding that this portion of the tax proposal is expected to produce about $20 million in revenue, but when contrasted with its impact on the smaller companies, it is apparent that it is not a revenue proposal, but a device to force companies such as ours to dispose of them to the larger companies.

It may be of interest to you to know that six large mutuals have more than 50 percent of the life insurance in force and an even larger proportion of the total assets of all companies.

The proposal in H.R. 4245 will accelerate the trend toward concentration of business into the hands of these tremendously large companies.

We are bringing in thousands of dollars into Idaho each month, which is invested in this State. If we are to be put out of business by this approach, the same type of coverage will be written, but it will be done by the larger companies who will channel the funds back East. Other companies such as ours in Idaho will likewise be affected.

There is no doubt that an overhauling of the tax measures for insurance companies is long over due, and we are willing to pay our way. But the discrimination, suddenness, and enormity of this proposal is breathtaking.

I trust that you will give your earnest consideration to influence the voting against step 3 of H.R. 4245.

Trusting that all is going well with you, and with warm personal regards, I am

Sincerely yours,

BERNE K. JENSEN, *Attorney at Law.*

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THE TRAVELERS

THE TRAVELERS INSURANCE CO.

THE TRAVELERS INDEMNITY CO.

MARCH 19, 1959.

Re H.R. 4245

Hon. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building,*
*Washington, D.C.*

DEAR SENATOR BYRD: Enclosed herewith is a copy of a statement regarding the above bill which I am filing today on behalf of The Travelers Insurance Co. of Hartford, Conn.

This bill appears to us to be defective in two important areas: (1) It fails to provide adequate treatment for capital losses and (2) it could impose a high excise tax on a stock company in a bad year and deny, as a practical matter, any effective carryback relief.

A suggested amendment of section 809(g)(1) is annexed to my statement which would correct the second point by permitting a company to take certain deductions in a bad year to the extent that its taxable income had exceeded its investment income floor in prior years.

We believe that these points deserve consideration by the committee and are taking this means of bringing them to the committee's attention. We respectfully request that this letter and the attached statement be incorporated in the printed hearing record.

Sincerely yours,

MILLARD BARTELS,
*Chairman, Insurance Executive Committee.*

STATEMENT ON H.R. 4245 BY MILLARD BARTELS, CHAIRMAN, INSURANCE EXECUTIVE COMMITTEE, THE TRAVELERS INSURANCE CO., HARTFORD, CONN.

This bill, in its present form, contains a dangerous defect from the stock company viewpoint. It could impose a high level of taxes on many stock companies even though they sustain large operating and capital losses. This demonstrates that the bill is not an income tax based on the business experience of each company; instead it imposes a steeply increased excise tax on certain of these companies in a manner which could undermine their financial strength in bad times.

In the first place, the bill should recognize that investment losses are real operating losses to life insurance companies. Investments are their stock in trade and are essential to the fulfillment of their contracts. The only protection against capital losses afforded by H.R. 4245 as passed by the House is an offset against capital gains during a period which is much too limited. Life insurance companies invest for the most part in long-term dollar investments which are not speculative in nature. There is little opportunity for capital gains of any kind but a major depression would certainly bring heavy losses on bonds and mortgages.

How should the bill be corrected to afford reasonable protection against such capital losses? There has not been time since the passage of this bill by the House to work out the solution which would be best for the entire business. One way would be to permit the deduction of capital losses from taxable income with limitations to prevent abuses. Another way would be to permit the accumulation of a securities valuation reserve similar to that required by State regulation but extended to include mortgages. Such an account could be credited or charged with all capital gains and losses as they occur. A carryback and carryover period of at least 10 years should also be considered.

The bill should be modified also to provide tax relief during periods with severe losses from operations due to adverse underwriting experience. The present provisions for carrybacks and carryovers are ineffective because for many companies the operations loss deduction applies to phase 2 only in practical operation. The recomputation of tax for the prior year then involves the section 809(g) limitation on certain deductions so that the net result is no, or very little, tax relief through a carryback or carryover. In essence this carryback cycle completely negates the purpose of the deductions of 2 percent of group insurance premiums and 10 percent of the increases in nonparticipating reserves which were allowed to provide a contingency reserve for bad loss years. In the year when the loss occurs, such deductions are disallowed retroactively for the carryback year. This could be remedied by the transfer of the operations loss deduction from phase 2, section 809(d)(4), to make it a direct deduction from taxable income in section 802(b).

Another unrealistic treatment of a long-term business is the application of the limitation in section 809(g) on certain deductions with respect to each year's results separately. This limitation should be smoothed out over a period of at least 10 years since for many companies the gain from operations will fluctuate over and under taxable investment income even though the accumulative result is on the high side.

A simple illustration of the need for this change follows:

| Company A | Year 1 | Year 2 | Year 3 | Year 4 | Total |
|---|---|---|---|---|---|
| Deductions (3), (6) and (7) of sec. 809(d) | $200,000 | $200,000 | $200,000 | $200,000 | $800,000 |
| Taxable investment income | 500,000 | 500,000 | 500,000 | 500,000 | 2,000,000 |
| Gain from operations, without sec. 809(g) limitation | 800,000 | 800,000 | 800,000 | 300,000 | 2,700,000 |
| Taxable income | 650,000 | 650,000 | 650,000 | 500,000 | 2,450,000 |
| Additions to policyholders, surplus account | 150,000 | 150,000 | 150,000 | 0 | 450,000 |

Company A would have paid tax for the 4 years on assumed income of $2,450,000 and would have added $450,000 to its policyholders surplus account. Since its entire gain for the period was $2,700,000, the denial of $200,000 in deductions in year 4 has resulted in its being taxed on an additional spurious gain of $200,000.

The attached draft of an amendment to section 809(g) would allow a company to take these deductions in such a year to the extent of half of the excess of its gain from operations over its taxable investment income during the preceding years. The effect of this proposal may be illustrated as follows:

| Company A | Year 1 | Year 2 | Year 3 | Year 4 | Total |
|---|---|---|---|---|---|
| Deductions (3), (6) and (7) of sec. 809(d) | $200,000 | $200,000 | $200,000 | $200,000 | $800,000 |
| Taxable investment income | 500,000 | 500,000 | 500,000 | 500,000 | 2,000,000 |
| Gain from operations, without sec. 809(g) limitation | 800,000 | 800,000 | 800,000 | 300,000 | 2,700,000 |
| Taxable income | 650,000 | 650,000 | 650,000 | 300,000 | 2,250,000 |
| Additions to policyholders' surplus account | 150,000 | 150,000 | 150,000 | 0 | 450,000 |

Under the proposal, company A would be permitted to take the $200,000 of deductions shown for year 4 without limitation. As a result, its taxable income for that year would be $200,000 less than its taxable investment income. This would be a partial offset for the $450,000 excess of its taxable income over its taxable investment income in previous years. Company A would have paid tax for the 4 years on $2,250,000 and would have added $450,000 to its policyholders surplus account. This accounts for its entire gain for the 4 years.

No tax law applying to life insurance companies should be regarded as satisfactory permanent legislation which fails to protect the companies in times of adversity. A mutual company may reduce dividends to policyholders but a stock company may not increase premiums on existing policies. History and prudence require us to realize that good times do not continue forever. If a depression and an epidemic should come at the same time, as well they might, all companies would suffer severe strain. These possibilities emphasize the need for essential modifications in the bill. The amendments suggested above would not materially affect the tax revenues in 1958 or in other years with good operating results.

PROPOSED DRAFT FOR AMENDED SECTION 809(g)(1)

(g) LIMITATION ON CERTAIN DEDUCTIONS.—

(1) IN GENERAL.—The amount of the deductions under paragraphs (3), (6), and (7) of subsection (d) shall not (after the application of subsection (f)) exceed the sum of—

(A) the amount by which—

(i) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

(ii) the taxable investment income for the taxable year, and

(B) 50 percent of the total for the preceding 10 taxable years excluding any taxable year beginning before January 1, 1958, of the excesses, if any for each year, of the gain from operations as determined by subsection (a) over the taxable investment income for such year, less any portion of such excesses applied in accordance with this provision in previous years. In this application such excesses will be used to the extent needed in sequential order starting with the earliest year.

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THE LINCOLN NATIONAL LIFE INSURANCE CO.,
*Fort Wayne, Ind., March 4, 1959.*

Hon. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building, Washington, D.C.*

DEAR SENATOR BYRD: Attached is a statement outlining a technical problem which exists under H.R. 4245 in connection with a certain type of reinsurance.

May I respectfully request that it be printed in the record of the hearings of the Senate Finance Committee on life insurance company taxation.

Sincerely,

HENRY F. ROOD,
*Senior Vice President.*

STATEMENT OF HENRY F. ROOD, SENIOR VICE PRESIDENT, THE LINCOLN NATIONAL LIFE INSURANCE CO., FORT WAYNE, IND.

The Lincoln National Life Insurance Co. provides reinsurance facilities to a large number of life insurance companies. Under a certain type of reinsurance agreement, the reinsurer reimburses the reinsured for Federal income taxes paid on policies reinsured. This creates a problem of pyramiding of taxes similar to that covered by section 110 of the 1954 code. This statement describes the problem and suggests an amendment to H.R. 4245 to correct it.

SECTION 820, INDEMNITY REINSURANCE WHEN RESERVES ARE HELD BY REINSURED

When under an indemnity reinsurance contract, treaty, or arrangement, the reinsured retains possession and ownership of the reserve funds in relation to the reinsurance, and when, under such contract, treaty, or arrangement the reinsurer is obligated to reimburse the reinsured for taxes paid under this part on investment income derived from such reserve funds, the reinsurer, in lieu of reimbursing the reinsured, and with the consent of the reinsured, may elect to include in its taxable investment income an amount derived by dividing the amount of such reimbursement by the average percentage of tax paid by the reinsured upon its taxable income. The reinsurer's election to accept the right conferred by this section shall be made by mailing in duplicate, before the first day of the third month following the taxable year, a written notice of such election to the reinsured. The reinsurer in preparing its return for the year, shall indicate which portion of its taxable income was covered by the reimbursement agreement and shall attach to its return a copy of the letter of election. On fulfilling these conditions, the reinsured shall exclude from its taxable investment income an amount equal to the amount included in taxable investment income by the reinsurer pursuant to this section. On payment by the reinsurer of its tax for the year, inclusive of the amount of tax produced by the amount included in investment income pursuant to this section, the reinsured shall be finally discharged from liability respecting such amount.

*(1) Concerning Indemnity Reinsurance in General*

This form of reinsurance (to be contrasted with assumption reinsurance) is a response to a sensed need on the part of an insurer for indemnity against a risk it has assumed. The sensed need for indemnity on the part of an insurer may arise from one or more circumstances as, for example:

The insurance risk may be of a magnitude out of keeping with the insurer's financial ability.

The insurance risk may be of such a quality outside the normal scope of the insurer's underwriting.

The indemnity provided is to the insurer on account of its risk exposure, not to the person to whom the insurance was granted. Accordingly, the reinsured alone is obligated to fulfill the insurance contract with the original insured and must do so regardless of the existence or nonexistence of reinsurance. On the other side, the reinsurer is obligated to fulfill its indemnity contract with the reinsured, regardless of the latter's ability or lack of ability to fulfill its contract with the original insured.

Inasmuch as the wellspring of all economic values (income, benefits, gains, and profits) arising under a life insurance policy is the premium paid by the original insured, it follows that reinsurance does not create additional values but rather it effects a division of those preexisting between two insurers—the reinsured and the reinsurer. The premium for the original insurance presents several aspects of potential gains—

from a possible overstatement of the mortality risk,

from a possible overstatement of the expense element,

from a possible understatement of earnings on the portion of the premiums going into the policy reserves for investment.

While the original insurance contract and risk is entirely separate and distinct from the contract and risk presented under the reinsurance contract, yet both contracts are measured, fed, and sustained by the identical sources of income, the premium and its use. The original insurer, desiring indemnity, is content to share its policies' earning potentials; the reinsured, willing to accept a risk under a collateral indemnity contract, can rightfully name its price in terms of a share in the earnings and profits of the contractual adventure. No other basis for such a price can be conceived.

*(2) Forms of indemnity reinsurance*

A. *Coinsurance.*—The most natural, and certainly the most ancient, form of indemnity reinsurance is styled coinsurance, the concept being that for the purpose of the reinsurance, the original insurance is to be regarded as shared—coinsured—by the reinsurer and the reinsured. Under this concept, the premium on the original reinsurance is divided between the reinsurer and the reinsured on whatever basis the reinsurance contract calls for, after which, each company carries out the reinsurance procedures as in the case of direct insurance untouched by reinsurance. Naturally, in pursuing such a method, the reinsured has to be reimbursed for expenses it had to bear in writing the original policy and those which it will be subject to throughout the years in maintaining the policy in effect. Under this form of reinsurance, the reinsurer and reinsured each have values and income potentials, measured in terms of the factor of division employed in the reinsurance contract.

The reinsurer usually assumes all of the obligations under its share of the policy including the investment risk as well as the mortality risk. If the policy is participating, the reinsurer reimburses the reinsured for any dividends paid to the policyholder. Under this type of policy the reinsured is completely indemnified. The reinsurer maintains the reserve and pays all taxes under both phases 1 and 2.

B. *Yearly renewable term reinsurance.*—Of more recent origin and use is yearly renewable term reinsurance. This form of reinsurance focuses its attention, not upon the form of the original policy, but rather upon the life contingency involved. Employing such a form of reinsurance, a reinsurer can say to the original insurer, "You may keep all of the values of your policy in your own office, as I am alone interested in the life contingency risk element. Beginning with an accurate evaluation of that element, I can determine an annual renewable premium and, with the aid of procedures to be defined in a reinsurance contract, I can indemnify you against the risks of death you have assumed." Involving no element of premium in excess of the charge for pure indemnity coverage, this plan generates no investment income in the hands of the reinsurer because the annual premium covers the entire risk, theoretically and contractually, at least.

Under this plan the reinsured purchases 1-year renewable term insurance from the reinsurer. The amount of insurance purchased each year is usually the face amount of the policy less the reserve at the end of that year. The premium per thousand dollars increases each year as the age of the policyholder increases. Under this plan of reinsurance, the reinsurer assumes only the mortality risk under the policy. The reinsured maintains the reserve and retains its obligations with respect to all other contractual provisions. The Federal income tax on taxable investment income would be paid by the reinsured. The reinsurer would pay tax primarily under phase 2 on its underwriting gain.

C. *Modified coinsurance.*—Of even more recent origin is a form of indemnity reinsurance which in nature lies somewhere between conventional coinsurance and conventional yearly renewable term reinsurance. Though sometimes referred to as modified coinsurance, it is best considered as having a nature and effect peculiarly its own.

This form of indemnity reinsurance has been widely used for many years and is likely to be of even greater importance in the future. It has stood the rigorous testings of insurance departments and has never been found wanting in any of its principles or effects upon the parties, their policyholders, or the public generally. While involved in its assumptions and premises, it represents an extension of the indemnity reinsurance concept approaching the ultimate.

Under the modified coinsurance plan the reinsurer accepts all of the obligations which it would assume under a coinsurance policy except that the reinsured retains the reserve and administers the investment of the reserve funds. This plan of reinsurance was developed because certain companies such as the Lincoln National Life Insurance Co. were not then licensed to operate in New York and the reinsured could not take credit in New York on business reinsured with unlicensed reinsurers. Since large amounts of reserves are frequently involved, it has the added advantage, which has now become more important, of permitting the reinsured to retain full control over the investment of its reserves while still receiving full indemnification under its policies. It is recognized that most companies are reluctant to transfer the trusteeship of large amounts of policyholder funds to another company. The total of the 1958 mean reserves for modified coinsurance with the Lincoln National Life Insurance Co. amounted to more than $300 million.

An analysis of the plan will show that the reinsurer receives the full premium collected from the policyholder by the reinsured less the increase in reserve during the calendar year with appropriate adjustment for interest at a rate approximating the reinsured's earned rate.[1] By reimbursing the reinsured for all of its expenses, including premium taxes, social security taxes paid on agents' commissions and other similar items, the reinsurer has assumed at the premium rate charged the policyholder by the reinsured all of the obligations of that company with the exception of the management of the investments. It, however, is put in the same position as the reinsured with respect to the risk on these investments since it receives from the reinsured interest on the reserves at a rate approximately equal to that earned by the reinsured. If the original policy is issued on the participating basis, the reinsurer agrees to reimburse the reinsured for the actual dividends it pays its policyholders.

It is thus clear that the reinsurer assumes every obligation under the original policy except the actual custody and administration of the assets backing the reserves.

Contractually, modified coinsurance has been worked out to fully protect the reserve funds of the reinsured in event of the insolvency of the reinsurer, and to eliminate any need of the reinsurer to carry duplicate reserves under the reinsured policies. For these reasons, the reinsurance agreement spells out that the insurance shall be considered yearly renewable term insurance and that the reinsurer shall have no claim upon the reserves.

This plan was developed in 1938 when life insurance companies were paying little if any Federal income tax. Since that time, taxes have been paid only on investment income and treatment of modified coinsurance as yearly renewable term worked out satisfactorily inasmuch as the entire tax was paid by the reinsured and reimbursement was made, without any effect on the tax, by the reinsurer.

The intention of the parties to provide for full indemnity of the reinsured in exactly the same manner as if the contract were coinsurance is readily apparent, however, as provision is made for the reinsured to turn over to the reinsurer premium and investment income and for the reinsurer to pay all obligations under the policies either directly or indirectly. These obligations include claims, commissions, administrative expenses, premium taxes and even Federal income taxes.

*(3) Tax problems under H.R. 4245 for modified coinsurance*

Under modified coinsurance the reinsurer agrees to assume all of the obligations of the reinsured including reimbursement for the payment of any Federal income taxes. This creates a problem inasmuch as the reinsured will pay a tax on taxable investment income under phase 1 while the reinsurer will be required to pay a tax on the same income under phase 2 since the income it receives from the reinsured is treated as underwriting income. Consequently, this will result in a pyramiding of taxation.

It is understood that a somewhat similar situation exists in connection with income taxes paid by lessee corporations and that appropriate relief was given section 110 of the 1954 code.

Relief of this payramiding of taxation can be accomplished in several ways. However, the most practical method is to provide that the taxable income under phase 1 for the reinsured may be transferred to the reinsurer. If this is done, the taxable income of both companies under phase 1 and phase 2 will be handled in exactly the same manner as under coinsurance. This is proper inasmuch as this form of reinsurance is intended to place the reinsured and the reinsurer in exactly the same position as under coinsurance with the exception that the reserves remain in the hands and under the control of the reinsured.

*(4) Proposal to amend H.R. 4245 by addition of section 820*

An amendment is attached providing for the addition of section 820 which is designed to eliminate the pyramiding of taxes under H.R. 4245 as it relates to modified coinsurance.

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[1] The formula for computing the interest rate is not identical in all contracts but in each case it produces a rate close to the earned rate of the reinsured.

If accepted, this new section would permit the reinsurer and the reinsured to make a transfer between the taxable investment incomes of the two companies, in lieu of reimbursement by the reinsurer to the reinsured.

Justification for this result is found in these facts:

1. The reinsurers many years ago, when only investment income was subject to the income tax, developed the so-called modified coinsurance contract.

2. The tax at that time came about as the result of earnings on premiums set aside in a reserve fund which the reinsured retained and invested but which nevertheless worked hand in hand with the reinsurer's contract of indemnity.

3. House bill 4245 in its present form has the effect of taxing the investment earnings on the reserve funds in the tax return of both the reinsured and the reinsurer.

4. Viewed generally, reinsurance has the effect of dividing a single source of income into segments; the total of the tax applied to the segments in the hands of the separate taxpayers should not be greater than would be presented had all the income remained in the hands of the reinsured.

5. When two parties have a relation to a single source of income, it is within their right to stipulate how the tax burden should be borne between them.

6. The Government loses nothing inasmuch as it is only entitled to one tax in relation to all income tax incidents of the total insurance situation.

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MORTGAGE BANKERS ASSOCIATION OF AMERICA,
OFFICE OF THE GENERAL COUNSEL,
*Washington, D.C., March 19, 1959.*

HON. HARRY FLOOD BYRD,
*Chairman, Committee on Finance,*
*U.S. Senate, Washington, D.C.*

DEAR SENATOR BYRD: On behalf of this association I addressed a letter to you on March 5, 1959, with reference to the provisions of H.R. 4245.

There has been an expression that the text of that letter might be interpreted to indicate that this association, although opposed to the general effect of the bill, was endorsing those provisions of the bill which change the method of taxing tax exempt securities held by life insurance companies.

I case there should be any such misinterpretation I would appreciate your having this letter filed among the records of the committee in considering H.R. 4245, since this association, of course, did not intend in its letter of March 5 to endorse the novel and discriminatory treatment in H.R. 4245 which would deprive life insurance companies of their full tax exemption privileges heretofore extended to all holders of State and municipal bonds.

Sincerely yours,

SAMUEL E. NEEL.

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STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

We support, in general, the principles of H.R. 4245 provided that certain revisions are made in the bill.

We recommend that the definition of the "deduction rate" in phase I of the bill be changed to a 5-year average reserve adjustment method. Under our proposal the deduction rate would be determined on the basis of the individual company's average earned rate of interest for the tax year and the four immediately preceding years. This would establish the tax of each company on a base completely independent of the operations of other companies. We believe that the deduction rate in the present bill may encourage management of insurance companies to make unsound decisions affecting the security of their policyholder funds in the hope of reducing tax liabilities.

The proponents of this bill have stated that "there will be no tax imposed at any stage on the tax-free interest that a life insurance company may earn, just as no tax is imposed on any other corporation or individual on that tax-free interest." Our interpretation of the bill does not support this conclusion. We therefore recommend that the provisions of the bill be clarified so that full credit will be given for tax-exempt interest.

The report of the House Ways and Means Committee on H.R. 4245 includes the following statement relative to pension-plan reserves: "The special deduction for investment income attributable to pension-plan reserves is designed to remove discrimination against pension plans of small employers, which are likely to be insured through insurance companies. At the present time where an employer is large enough to establish a trusteed pension plan entirely separate from an insurance company, investment income received by such a trust (in the case of a qualified pension plan) is free of income tax." We recommend that the full deduction on qualified pension reserves be made effective immediately instead of delaying its full availability until the calendar year 1961.

STATEMENT ON BEHALF OF THE MEMBER COMPANIES OF THE KANSAS LIFE INSURANCE EXECUTIVES' ASSOCIATION WITH RESPECT TO H.R. 4245, LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959, BEFORE THE SENATE COMMITTEE ON FINANCE

The member companies of the Kansas Life Insurance Executives' Association respectfully submit the following statement with respect to H.R. 4245, the Life Insurance Company Income Tax Act of 1959.

GENERAL STATEMENT

Kansas has 13 domestic life insurance companies of which 10 are stock and 3 are mutual companies. Attached hereto, marked "Exhibit No. 1" is a list of these companies, plus an additional company, National Reserve Life Insurance Co., which, although a South Dakota corporation, has its principal office in Topeka, Kans. This company along with 9 of the Kansas domestic life insurance companies, making 10 in all, are the member companies of the Kansas Life Insurance Executives' Association on whose behalf this statement is filed.

In view of the fact that the life insurance industry, because of its large aggregate dollar volumes, is commonly thought of and referred to in terms of a great aggregation of dollar wealth, it appears to us that it is advisable to place the industry before the committee in its proper perspective. For that purpose we have analyzed the statement of all of the companies as to which pertinent figures are contained in the 53d annual edition, 1958, of Bests' Life Insurance Reports and classified them by States, categories of asset size, and stock versus mutual, and have set forth the study thus made in exhibit No. 2, attached herewith. Attention is invited to these facts shown thereon: that of the 952 companies, 830 are stock and 122 are mutual; and that 254 companies have assets under $500,000; 144 more companies have assets between $500,000 and $1 million; 243 more companies have assets between $1 million and $5 million; 69 more companies have assets between $5 million and $10 million; 89 more companies have assets between $10 million and $25 million; 39 more companies have assets between $25 million and $50 million.

From these figures, it will be observed that of the 952 companies, 641 have assets under $5 million; 710 have assets under $10 million; 799 have assets under $25 million; and 838 have assets under $50 million. These figures show beyond any doubt that the life insurance industry is predominately one of small companies; as a $25 million or even a $50 million company is a small one in this business. Although it is reported that, as of December 31, 1958, there were 1,371 life insurance companies in the United States, since about 144 new ones were organized during the year 1958, the 952 companies tabulated on exhibit No. 2 represent a sizable percentage of the 1,227 companies as of December 31, 1958. Due to the fact that the companies for which no figures are shown in Bests, in all probability are small ones, the inclusion of figures as to them would further emphasize the great preponderance of small life insurance companies.

The purpose of this analysis is to show and emphasize the fact that the impact of H.R. 4245 on the life insurance business should be gaged by its effect upon a lot of small companies, rather than a few large ones. With respect to Kansas, all of its life insurance companies are small ones.

We would neither be true to ourselves nor fair to the committee did we not state that, in our opinion, the "tax take" of H.R. 4245, is an unconscionable levy against the thrift institution of life insurance and its millions of savers. Particularly is this the case in the light of the heavy State premium taxes paid by the life insurance companies, and the fact that savings and loan associations, savings banks and other saving media with whom the life insurance companies compete for a share of the "saving dollar," are tax exempt. The daily mail is flooded with evidences from such institutions offering gifts of silverware, linens, cutlery and other premium merchandise for the opening of a savings account in a specified amount. Sound and fair tax policy would appear to compel that these other tax-free, competing sources of revenue should be brought into the income tax structure before the income tax on the life insurance industry be increased by some 85 percent, all in one fell swoop.

We are in accord with the program of bringing into the income tax base structure the earnings which do not fall in the category of "investment income." However, considering that "investment income" has so long been the basis for income taxation of life insurance companies, it is difficult to understand why a few small holes in the dike could not have been plugged without resorting to the long, complex H.R. 4245, which hardly anyone appears to be able to interpret, or understand, and the application of which has given rise to so many variations in the computation of life insurance company income taxes.

Certainly not one Kansas company, as of today, knows with any degree of satisfaction or certainty, the impact of this bill on its operations, other than to know that its Federal income taxes will be greatly increased whereas the savings institutions with which it competes for a share of the saving dollar, continues to operate "tax free."

The Kansas life insurance companies, both individually and collectively, have given careful consideration to H.R. 4245, and respectfully invite the committee's attention to their desires and positions with respect to the several items in H.R. 4245, as follows:

A. ITEMS NOW IN H.R. 4245

*1. Deduction equal to 10 percent of increase in nonpar reserves (sec. 809(d)(6))*

Retain in the bill.

Reason: A mutual company sells an insurance policy at a high premium rate with the expectation of returning part of that price to its policyholder as a dividend. This gives it a built-in cushion for emergencies due to the fact that, when necessary, it can reduce future dividends. Stock companies selling nonparticipating business, and a fixed rate, do not have this leeway. In order to have a fund equivalent to the mutual company's redundant premiums, a stock company must maintain a relatively larger surplus. This must be provided out of taxable income. The purpose of the 10 percent deduction of nonpar reserves is to compensate for this by permitting it also to have a contingency fund for the same purpose.

*2. Deduction—equal to 2 percent of net premiums attributable to group life insurance contracts and group accident and health insurance contracts (sec. 809(d)(7))*

Retain in the bill.

Reason: This special deduction is patterned after the reserve requirements of the States of New York and Missouri, and its purpose is to compensate for the fact that in group insurance there is less than the usual diversification of risk.

*3. Deduction for the investment yield on pension plan reserves (sec. 805(e))*

Retain in the bill.

Reason: The Kansas companies are not in the pension plan business. However, they look forward to the time when they will be. In the meantime, realizing that they must learn to crawl before they can walk and to walk before they can run, they are neither critical nor envious of the large life insurance companies who, in the underwriting of pension business, are meeting the demand for this pension service with a competence and fidelity which reflects credit on the institution of life insurance. The problem presented is a competitive one. It arises from the fact that a life insurance company must pay a tax on the income derived from funds which it holds under a qualified pension plan, whereas trustees, banks, and trust companies do not pay such tax on such funds. On the contrary, such income in their hands is tax exempt. The effect of the Federal income tax, compared with the tax-exempt trust enjoying the same rate of earnings before tax, is to increase the cost of insured plans by 7.2 to 7.7 percent over the trustee plans (hearings, House Ways and Means Committee, Nov. 17-20, 1958, p. 280). Consequently, at present, with respect to qualified pension plans, the life insurance company not only is being discriminated against, but also is at a very serious competitive disadvantage.

The handicap thus placed upon the life insurance company operated pension plan is particularly detrimental to the small employer and the small insurance company which may aspire to enter the pension plan business. (See above hearings, pp. 279–282.) Therefore, since this special deduction is designed to remove the competitive disadvantage now faced by life insurance companies, and to remove the discrimination presently existing against pension plans of small employers, that are more likely to be insured by life insurance companies, the Kansas companies support this special deduction as a matter of principle, rather than to snipe at and use it as a whipping post for the purpose of making a whipping boy of the big companies through the use of the unfounded charge of unfair competition.

*4. Deferment of tax on one-half of operating gains for the protection of policyholders (sec. 802(b)(2))*

Retain in the bill.

Reason: In phase II, one-half of the net gain from operations is added to the tax base and taxed at 52 percent. The other one-half is added to the policyholders' surplus account. This is done for the reason that, due to the long-term nature of insurance contracts, amounts which may appear as income in the current year and as proper additions to surplus, may, as a result of subsequent events, be needed to fulfill life insurance contracts. That is to say, there is an uncertainty as to whether or not what appears to be income, is in fact income, until the long-term contingencies have been eliminated. Consequently due to the difficulty in arriving at true underwriting gains on an annual basis, the tax on the 50 percent is deferred. Should the company later indicate that any of it is not needed in the business by distributing it to the stockholders, then such amount carries back into the tax base and is subject to tax.

B. SUGGESTED AMENDMENTS TO H.R. 4245

*5. Small-business deduction—increase from 5 percent to 25 percent of net investment income (sec. 804(c)(9))*

There appears to be a unanimity of opinion that, in recognition of the problems present both in developing a small company and in meeting the competition of the large companies, special relief should be accorded them. The 5 percent of net investment income does not appear to be adequate for a small company. From exhibit No. 1, it will be observed that 10 of the 13 Kansas companies will not reach the maximum of $25,000 fixed in the above section, and that, as to 7 of them, that 5 percent will provide a deduction under $10,000, and that only 3 reach the $25,000 maximum. It will be most helpful to the Kansas companies, and they need a deduction rate of 25 percent.

*6. Five-year average of earned interest rate in calculating reserves (sec. 805(b)(4))*

This proposes that, instead of using the mean of the company's earned rate and assumed rate for the taxable year, each company will adjust its reserves and compute its deduction on the basis of its average earned interest rate for the taxable year and the preceding 4 years. Its adoption would level off the impact of the heavy increase in the tax; avoid variations that might occur from the use of a single year's earned rate; determine the tax according to the investment earnings of the company uninfluenced by assumptions made by management, and without the artificial application of the experience of other companies, through the use of the industry average.

*7. Tax-free interest—Full credit for, or exclusion of, tax-free interest on State and municipal bonds*

Despite the statement to the contrary made by Chairman Mills of the House Ways and Means Committee (Congressional Record, Feb. 18, 1959, p. 2388), the universal opinion of actuaries and tax counsel who have made computations under H.R. 4245, is that about 70 percent of the tax-free interest of a life insurance company is subjected to income tax under the bill. In fact, one small Kansas company, whose 1958 operations have been computed by a recognizedly, outstanding firm of consulting life insurance actuaries, has been advised that 82.9 percent of its tax-free interest is not exempt, but is taxed, under phase I, and that 77.1 percent is not exempt, but is taxed under phase II.

The Federal Government has no power to tax income derived from State or municipal bonds (27 Am. Jur. 340). In *Pollock* v. *Farmers' Loan and Trust Co.* (157 U.S. 429, 39 L. Ed. 759, 15 S. Ct. 673), the U.S. Supreme Court said:

"The Constitution contemplates the independent exercise by the Nation, and the States, severally, of their constitutional powers. As the States cannot tax the powers, the operations, or the property, of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States has no power under the Constitution to tax either the instrumentalities or the property of a State.

"A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenue of municipal corporations are not subject to Federal taxation * * * the same want of power to tax the property or revenue from the States or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason * * *.

"Syllabus 4. A tax upon the income derived from municipal bonds is a tax on the power of the States and their instrumentalities to borrow money and is consequently repugnant to the U.S. Constitution."

The principle is recognized in section 103 of the Internal Revenue Code of 1954, which provides specifically that "gross income does not include interest on the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia."

The constitutional inhibition against taxing the interest on State and municipal bonds is applicable although the tax is imposed indirectly, as by limiting the amount of a deduction (*National Life Ins. Co.* v. *U.S.*, 277 N.S. 508, 72 L. Ed. 968, 48 S. Ct. 591). This rule is basic and fundamental in our system of dual sovereignty of the Nation and the States. It has its root in the principle that one sovereign does not posses the power to impose its will on another sovereign.

What we do not understand is, since the tax-free character of the interest on State and municipal bonds is specifically recognized by excluding such from "gross income" (I.R.C., sec. 103), what is the purpose or motive of the Treasury Department in including such in "gross income" with respect to the income taxation of life insurance companies?

We challenge the committee's attention to the situation presented—interest on State and municipal bonds is tax-free interest; a Federal income tax cannot be imposed thereon for the reason that such exercise of the Federal will impairs the borrowing power of the State and their subdivisions; neither all nor a small amount of it can be taxed; and, if, in the application of the adjustment sections of H.R. 4245 (sec. 805(e) and sec. 809(f)), any of such interest is subjected to the income tax, H.R. 4245, in that respect, is unconstitutional and void, both with respect (1) to such bonds heretofore purchased on the faith that the interest therefrom was tax free, and (2) to such bonds as may be purchased in the future.

The Kansas companies see neither sense nor logic in attempting to correct this situation by involved credits and/or deductions. The interest is tax free and should not be taken into the tax base at any stage.

*8. Extend operations loss carryover from 5 to 15 years (sec. 812(b)(1)(B))*

The record before the committee is clear and undisputed that a life insurance company operates at a loss for quite a number of years after it begins business and that its operations carry on for about 10 years before it begins to operate in the black. Because of this fact, the period during which it may carry forward its losses should be increased to 15 years, rather than the 5 years stated in H.R. 4245.

*9. Five-year transition period*

Due to the fact that H.R. 4245 substantially increases the amount of income tax to be paid, and changes the incidence of the tax greatly by company, the 5-year transition period, as was suggested in the letter of the Secretary of the Treasury of April 10, 1958, should be provided to lessen the impact of the heavy tax increase.

*10. Deduction—of an amount equal to 5 percent of nonpar premiums as an alternate to the 10 percent of nopar reserves deduction (sec. 809(d)(6))*

Many small companies have contracts of a hazardous and long-term character in which the reserves carried are small in comparison to the risk involved. Such contracts which run for 5 years or more and as to which company cannot elect to get off the risk. In these instances the 10 percent deduction of the annual increase in nonpar reserves does not provide adequate security for the company. To meet such situations, a deduction of 5 percent of the premiums in nonparticipating contracts whose duration is 5 years or more, as an alternate, would better enable small companies to meet the competitive situation which they face with mutual companies and provide a fund to be used to absorb bad losses which they are bound to suffer.

*11. Deduction—for security valuation reserves*

H.R. 4245 allows a deduction for life insurance reserves required by law (sec. 801(b)(2)), but reserves required by a State insurance department may not be deducted. In order that policyholders may be fully protected, State insurance departments often require a life insurance company to maintain reserves which are adequate to protect policyholders. Such requirements generally have their origin in rules prescribed by the National Association of Insurance Commissioners. Such a reserve commonly required is the "security valuation reserve," to protect against losses occasioned with respect to bonds and stocks held by the company. Not being required by law, a company would have to throw out such reserve in computing its gains from operation for the purpose of arriving at its tax base under H.R. 4245. In this instance, a company would be penalized for complying with an order of the insurance commissioner in maintaining a reserve necessary for a sound company operation. Unless a deduction for such a reserve is allowed in H.R. 4245, the Federal tax authorities will ignore such reserve, the integrity of the State regulatory authority will be impaired, and the company which complies with the Commissioner's order in that respect will incure the penalty of the disallowance of a merited tax deduction.

*12. Transfer tax free to shareholders surplus account of 5 percent or 10 percent annually of the company surplus accumulated price to January 1, 1958 (sec. 815(b)(2))*

The amount of both the "shareholders surplus account" and the "policyholders surplus account," on January 1, 1959, is zero (sec. 815 (b) (1) and (c) (1)). Consequently, all additions to such accounts will be derived from current operations. Under section 815(a), distributions to shareholders shall be made (1) first out of the shareholders surplus account to the extent thereof, (2) then out of the policyholders account, to the extent thereof, and (3) finally, out of other accounts.

Since the shareholders and policyholders accounts start with zero, the capital and surplus had by a company on the effective date of the act will go into "other accounts." Since distributions to shareholders must be paid out of the shareholders account until it is exhausted, and then out of the policyholders account until it is exhausted, the result is that present capital and surplus will be "locked in" other accounts from which no distribution can be made to shareholders as long as there are any funds in the shareholders and policyholders accounts.

Capital and surplus of the company on the effective date of the act belongs to the shareholders. The capital was contributed by the shareholders, and the surplus has been set aside from earnings on which income tax has been paid. To "lock it up," as provided in H.R. 4254, in such manner that there is no certainty if, or when, its owners, the shareholders, will ever be able to get it out, is a confiscation of their property.

To obviate this, it is recommended that provision be made in the bill that present or "old surplus" may be transferred to the shareholders account at some specified rate each year, such as 5 percent each year for a period of 20 years or 10 percent each year for a period of 10 years, without payment of tax.

*13. Tax credit—against the tax attributable to phase II for some part of State premium taxes paid (sec. 802)*

Premium taxes paid to the State by life insurance companies, to the extent of $300 million annually—a "gross tax"—are an unusually heavy burden upon life insurance companies and should be recognized in the calculation of Federal income taxes. Added to the $558 million estimated revenue under H.R. 4245, the result is an $858 million "take" from the life insurance industry. No fair consideration can be had with respect to the Federal income taxation of life insurance companies, unless the amount and the impact of the State premium taxes paid by the life insurance companies is taken into consideration.

The analogy of the credit for State inheritance taxes against Federal estate taxes appears to be particularly appropriate. Both the State premium tax and the Federal income tax, eventually must be paid by the policyholders. These premiums go into the tax base structure under phase II. Consequently, it is only fair and just that, as in inheritance taxes, some credit for premium taxes paid be allowed against the income tax paid under phase II. We recommend that 25 percent of all State premium taxes paid be credited against Federal income taxes payable under phase II.

*14. Recoupment of early losses without payment of tax*

This has reference to an amendment recommended by the witn .s, Reitz, executive vice president of the Great Southern Life Insurance Co., to be inserted following line 7 on page 42 of H.R. 4245. The subject matter may be embraced in paragraph 8 above, with respect to less carryover. We regret that neither the text of Mr. Reitz' testimony nor the amendment suggested by him, are available to us. However, since at the time, it appeared to us to have merit, we make mention of it with the hope that it will be given consideration.

Anxious to continue to encourage thrift on a voluntary basis, and to thus contribute to the economic well being of our people, we urge that you give favorable consideration to the foregoing suggestions and recommendations.

Respectfully submitted.

American Home Life Insurance Co., Central Plains Life Insurance Co., Farmers & Bankers Life Insurance Co., Kansas Farm Life Insurance Co., Great American Life Insurance Co., Manhattan Mutual Life Insurance Co., National Reserve Life Insurance Co., Pioneer National Life Insurance Co., Security Benefit Life Insurance Co., Victory Life Insurance Co.; Harry W. Colmery, Counsel.

EXHIBIT No. 1

*Kansas life insurance companies*

[Figures as of Dec. 31, 1957]

| Name | Principal office | Administrative assets | Capital surplus | Insurance in force | Investment income | Net operating gain |
|---|---|---|---|---|---|---|
| 1. Midland Empire Life Insurance Co. | Atchison | $541,619 | $458,167 | $6,692,857 | $9,170 | $104,076 |
| 2. Liberty Life and Casualty Co. | Denver, Colo. | 311,067 | 226,271 | 950,413 | 7,398 | −57,240 |
| 3. *Central Plains Life Insurance Co. | Hutchinson | 870,510 | 559,450 | 35,838,530 | 24,170 | 202,130 |
| 4. *Great American Life Insurance Co. | do | 6,587,462 | 717,450 | 22,309,734 | 236,376 | 71,941 |
| 5. Crusader Life Insurance Co | Kansas City | 169,152 | 167,091 | | 2,719 | −28,458 |
| 6. Pyramid Life Insurance Co. | do | 7,657,927 | 721,129 | 53,789,525 | 272,745 | 182,881 |
| 7. *Kansas Farm Life Insurance Co. | Manhattan | 6,040,915 | 506,599 | 68,367,965 | 184,915 | 287,793 |
| 8. *Manhattan Mutual Life Insurance Co. | do | 4,700,862 | 400,119 | 20,831,649 | 159,906 | 87,035 |
| 9. *American Home Life Insurance Co. | Topeka | 8,548,697 | 339,480 | 40,174,925 | 290,798 | 22,682 |
| 10. *Pioneer National Life Insurance Co. | do | 3,810,981 | 498,792 | 13,421,909 | 118,867 | 127,665 |
| 11. *Security Benefit Life Insurance Co. | do | 49,516,972 | 6,334,977 | 322,135,966 | 1,684,305 | 1,384,366 |
| 12. *Victory Life Insurance Co | do | 38,780,163 | 1,638,062 | 150,404,336 | 1,145,624 | 248,830 |
| 13. *National Reserve Life Insurance Co. | do | 57,321,805 | 4,720,416 | 222,184,082 | 1,867,611 | 949,656 |
| 14. *Farmers and Bankers Life Insurance Co. | Wichita | 40,306,334 | 4,421,473 | 141,014,663 | 1,821,874 | 593,530 |

NOTE.—Company No. 13 is a South Dakota company, but which has its principal office in Topeka, Kans., and is a member of the Kansas Life Insurance Executives Association.

Company No. 2, although a Kansas company, has its principal office in Denver, Colo.

*Indicates the 10 member companies of the Kansas Life Insurance Executives Association.

Companies 8, 9 and 11 are mutual companies.

Companies 1, 2, 3, 4, 5, 6, 7, 10, 12, 13 and 14 are stock companies.

EXHIBIT NO. 2

*Life insurance companies (U.S. domestic) classified re assets*

| State | (1) Under $500,000 | (2) $500,000 to $1,000,000 | (3) $1,000,000 to $5,000,000 | (4) $5,000,000 to $10,000,000 | (5) $10,000,000 to $25,000,000 | (6) $25,000,000 to $50,000,000 | (7) $50,000,000 to $100,000,000 | (8) $100,000,000 to $500,000,000 | (9) $500,000,000 to $1,000,000,000 | (10) Over $1,000,000,000 | (11) Total number companies | (12) Stock companies | (13) Mutual companies |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Alabama | 5 | 9 | 9 | 1 | 3 | 1 | 1 | | | | 29 | 29 | 0 |
| Arizona | 13 | 3 | 6 | | | | | | | | 22 | 22 | 0 |
| Arkansas | 12 | 4 | 7 | 1 | | 1 | | | | | 25 | 25 | 0 |
| California | 1 | 2 | 7 | 2 | 2 | 1 | 1 | 1 | 2 | | 19 | 17 | 2 |
| Colorado | 5 | 2 | 4 | 2 | 2 | 2 | | | | | 17 | 17 | 0 |
| Connecticut | | 1 | 1 | 1 | | | | | 1 | 4 | 8 | 6 | 2 |
| Delaware | 5 | 1 | 2 | 3 | | | 1 | | | | 12 | 11 | 1 |
| District of Columbia | 2 | 3 | 1 | 1 | | 1 | | 3 | | | 11 | 9 | 2 |
| Florida | 7 | 7 | 7 | 1 | | 1 | 1 | 1 | | | 25 | 25 | 0 |
| Georgia | 11 | 5 | 6 | 4 | 4 | 1 | | 1 | | | 32 | 32 | 0 |
| Idaho | | | 1 | 1 | | | | | | | 2 | 1 | 1 |
| Illinois | 3 | 3 | 11 | 4 | 7 | 3 | 2 | 6 | 1 | | 40 | 29 | 11 |
| Indiana | 12 | 6 | 11 | 3 | 6 | 4 | 1 | 2 | | 1 | 46 | 40 | 6 |
| Iowa | 1 | | 2 | 2 | 2 | 2 | 1 | 1 | 2 | | 13 | 4 | 9 |
| Kansas | 2 | 2 | 2 | 4 | | 3 | | | | | 13 | 10 | 3 |
| Kentucky | 1 | 1 | 1 | 2 | 4 | 1 | | 1 | | | 11 | 10 | 1 |
| Louisiana | 16 | 9 | 15 | 1 | 1 | | | 1 | | | 43 | 41 | 2 |
| Maine | | 1 | | | | | 1 | | | | 2 | 1 | 1 |
| Maryland | 2 | 2 | 2 | 2 | 2 | | 2 | 1 | | | 13 | 10 | 3 |
| Massachusetts | | | | | | 2 | 2 | 4 | 1 | 3 | 12 | 5 | 7 |
| Michigan | | 2 | 5 | 2 | 2 | | | | | | 11 | 5 | 6 |
| Minnesota | 1 | 1 | 4 | 1 | 2 | 1 | | 2 | | | 12 | 7 | 5 |
| Mississippi | 8 | 3 | 2 | 1 | 1 | | 1 | | | | 16 | 15 | 1 |
| Missouri | 11 | 4 | 7 | 1 | 4 | 1 | | 3 | | | 31 | 29 | 2 |
| Montana | | 2 | | | | | 1 | | | | 3 | 3 | 0 |
| Nebraska | 1 | 2 | 4 | 2 | 3 | 3 | | 3 | | | 18 | 11 | 7 |
| Nevada | | 1 | | | | | | | | | 1 | 1 | 0 |
| New Hampshire | | | 1 | | | 1 | | | | | 2 | 1 | 1 |
| New Jersey | 2 | 1 | | 1 | | | 2 | | | 2 | 8 | 4 | 4 |
| New Mexico | | 1 | 1 | | | | | | | | 2 | 2 | 0 |
| New York | | | 5 | 4 | 6 | 2 | 3 | 4 | 1 | 4 | 29 | 18 | 11 |
| North Carolina | 7 | 4 | 3 | 1 | 3 | 2 | 3 | 2 | | | 25 | 23 | 2 |
| North Dakota | 1 | 1 | 2 | | 2 | 1 | | | | | 7 | 4 | 3 |
| Ohio | 2 | | 3 | 1 | | | 2 | 3 | 2 | | 13 | 9 | 4 |
| Oklahoma | 6 | 6 | 7 | 1 | 3 | | | | | | 23 | 23 | 0 |
| Oregon | 1 | 2 | 1 | | | | | | | | 4 | 3 | 1 |
| Pennsylvania | 12 | 3 | 9 | 3 | 2 | | 2 | 1 | 1 | 1 | 34 | 26 | 8 |
| Rhode Island | | | 2 | | | | | | | | 2 | 2 | 0 |
| South Carolina | 18 | 10 | 2 | 1 | 1 | | | | | | 32 | 32 | 0 |
| South Dakota | | 1 | 1 | 1 | 1 | | 1 | | | | 5 | 3 | 2 |
| Tennessee | 2 | 1 | 6 | 1 | 2 | 1 | 1 | 2 | 1 | | 17 | 17 | 0 |
| Texas | 75 | 30 | 58 | 7 | 18 | 2 | 4 | 3 | | | 197 | 193 | 4 |
| Utah | 3 | 3 | 4 | | 1 | | 1 | | | | 12 | 12 | 0 |
| Vermont | | | | | | | | | 1 | | 1 | 0 | 1 |
| Virginia | 1 | | 11 | 2 | 1 | 1 | 1 | 2 | | | 19 | 16 | 3 |
| Washington | 2 | 2 | 3 | 3 | 2 | 1 | 1 | | | | 14 | 13 | 1 |
| West Virginia | 1 | | | 1 | | | | | | | 2 | 2 | 0 |
| Wisconsin | | | 5 | | 2 | | 2 | | | 1 | 10 | 5 | 5 |
| Wyoming | 1 | 1 | | | | | | | | | 2 | 2 | 0 |
| Puerto Rico | | 1 | | | | | | | | | 1 | 1 | 0 |
| Guam | 1 | | | | | | | | | | 1 | 1 | 0 |
| Hawaii | | 1 | 2 | | | | | | | | 3 | 3 | 0 |
| | 254 | 144 | 243 | 69 | 89 | 39 | 38 | 47 | 13 | 16 | 952 | 830 | 122 |

Source: Bests Life Insurance Reports, 53d annual ed., 1958.

(Whereupon, at 3:55 p.m., the committee recessed, to reconvene at 10:15 a.m., Thursday, March 19, 1959.)

# TAX FORMULA FOR LIFE INSURANCE COMPANIES

THURSDAY, MARCH 19, 1959

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

The committee met, pursuant to recess, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Frear, Talmadge, Williams, Carlson, Butler, Cotton, and Curtis.

Also present: Elizabeth B. Springer, chief clerk.

Richard E. Slitor, economist, tax analysis staff, Treasury Department.

The CHAIRMAN. The committee will come to order.

The first witness is R. T. Stuart, Jr., of the Mid-Continent Life Insurance Co.

## STATEMENT OF R. T. STUART, JR., PRESIDENT, MID-CONTINENT LIFE INSURANCE CO., OKLAHOMA CITY, OKLA.

Mr. STUART. Mr. Chairman, my name is R. T. Stuart, Jr. I am president of the Mid-Continent Life Insurance Co. of Oklahoma City. This is a small stock company now in its 50th year of operation——

The CHAIRMAN. Will you suspend for a moment?

Senator Kerr is recognized to present the witness.

Senator KERR. Mr. Chairman, this is R. T. Stuart, Jr., a man whose father, I guess 50 years ago, started the Mid-Continent Life Insurance Co. and built it into a very substantial part of Oklahoma's industrial and economic life, and R. T. Stuart, Jr., now is carrying on in the operation of it in a very fine way, and I am proud to present him to this committee.

The CHAIRMAN. Thank you, Senator.

You may proceed, Mr. Stuart.

Mr. STUART. Thank you, Senator.

Although I am here primarily to testify in behalf of my company, I am also president of the Oklahoma Association of Life Insurance Companies composing 23 of the 27 companies domestic to Oklahoma. This group is in general agreement that the following matters deserve your careful consideration. These are matters upon which we agree and feel are of vital importance not only to Oklahoma companies, but to all small companies in general.

1. The small business deduction for young and growing companies to be effective should be based at least on 25 percent of the first $100,000 investment income rather than 5 percent of the first $500,000 as is now

provided in the bill. Further liberalization may be in order; however, this should be the minimum basis for consideration.

2. We concur with the statement presented to this committee by Mr. Leonard H. Savage of the Standard Life & Accident Insurance Co. of Oklahoma and most particularly as to the removal of the pension exemption in this bill. We feel that the allowance of this pension exemption in this bill must, of necessity, operate as a penalty on small companies. More simply stated, either pension business is profitable and entered into for profit, and the profits therefrom should be taxed, or if not profitable it should be abandoned by the life insurance industry.

3. The impact of sudden tax increase is always greater on small business in any field than it is on large business. The 70-percent industry increase that is estimated would in most cases apply in a much higher percentage on the smaller companies and, therefore, we respectfully request a transition period of 5 years for phase 2 of H.R. 4245.

4. Due to the nature of the life insurance business and the inevitable losses during the first year of operation the full benefit of a loss carryforward will not be gained by the small stock companies, who need it most, unless the period for the carryforward is extended to at least 10, possibly 15, years.

5. The competitive relationship within the industry as a whole must be preserved, and in our opinion the 10 percent deduction in increase in reserves should be increased to a minimum of 12 percent. This point I will later emphasize.

6. The method of taxing surplus in phase 3 should be amended to provide that prior accumulated surplus upon which taxes have already been paid could be distributed to shareholders when the surplus is no longer needed for the protection of the policyholders without being subjected to additional corporate tax thereon. This, too, I will discuss later.

The above points reflect the general feeling of the Oklahoma companies as being necessary to place small stock companies and mutual companies on a fair and equitable tax basis.

In behalf of my own company I would like to now make certain statements and observations for your consideration. It has been readily admitted by many that H.R. 4245 is a most complex bill. Certainly to me and my associates this is true. The reason for this complexity seems to stem from the fact there is an effort being made to place the insurance industry on an identical tax basis with any other type of corporation while at the same time admitting, at least to some extent, that the insurance industry is not like any other corporation because of the long-term nature of its obligations and the contingency of its liabilities.

I realize there have been many recommendations made before this committee and supporting statements presented. The principles and ideas I represent have for the most part already been presented to you for your consideration. However, I feel I have an obligation to my company and most certainly to my policyholders to maintain the position which will allow the Mid-Continent Life to compete on an equal and equitable tax basis and at the same time be in a position to provide financial strength and security for its policyholders.

Having been literally reared in the life insurance business, with the long-recognized fundamental principle that the only true income of life insurance companies is its investment income, I have found it most difficult to adjust my thinking to any so-called total income approach.

I still firmly believe in this approach and that there can be no method devised other than investment income basis of taxation which would eliminate all discrimination as between companies.

I would most sincerely recommend that the committee consider H.R. 4245 in the light that mutual companies will pay little, if any, tax under phase 2 of this bill and that stock companies will be paying a tax on income under phase 2 which cannot be definitely determined to be profits. If there is justification for taxing so-called underwriting gains of a stock company, such tax should be levied at the point where it can be said with certainty that the management of the company itself has determined such gains have been made.

The long-term obligations and commitments of a life insurance company have been presented adequately to this committee and I will not reiterate what has been said. I do wish to emphasize, however, that the one single point where a stock company has irrevocably committed itself to the proposition that a profit has been made is when it declares a dividend to shareholders. At that point any tax on the underwriting profit should apply. The elimination of phase 2 would accomplish this and I urge its elimination.

Being a realist, however, I am convinced the new approach is here and my purpose in this testimony is to urge that the fundamental principles of the life insurance business be kept in mind while considering H.R. 4245 and the numerous amendments which are being offered in connection with it.

If this committee disagrees with the philosophy of the investment income approach, then I urge certain amendments which I feel are necessary to place stock companies and particularly small ones on a parity taxwise with the mutuals and to free prior accumulated surplus when it is no longer necessary for the protection of policyholders without subjecting it to additional corporate taxation.

First, I feel it is absolutely necessary for the strength and security of small stock companies that the 10 percent reserve deduction be increased to a minimum of 12 percent.

In the interest of conservation of time I will not reiterate the basis for the 12 percent deduction offered in the statement of Mr. Henry F. Rood, vice president and actuary of the Lincoln National Life Insurance Co., but will adopt the same by reference.

In planning for the soundness of a life insurance company it is difficult to say or determine how safe is safe. Therefore, possibly this deduction in the case of smaller companies should be even higher, for even as the life insurance business itself is founded on actuarial averages, these same averages tend to work against the smaller company because of their inability to spread their risk on as broad a base as the larger companies.

According to the calculation on which this statement is based, the estimates are that for each 1 percent addition in the deduction rate there will only be a reduction of $1.4 million in revenue produced under this bill. This seems a very small reduction in taxes for the

Federal Government in proportion to the amount of additional security it will provide the policyholders of a stock life insurance company. This percentage of reserve deduction will primarily benefit the small stock companies and will leave them in a much less competitive disadvantage and certainly place the company in a much sounder position for the protection of its policyholders.

As to phase 3 of the bill, I am sure that only an oversight permitted this measure to pass the House without it being made clear that the surplus account of each company as of December 31, 1957, would always remain free from tax as far as the company was concerned, upon being distributed to the stockholders. This surplus fund is either a contributed surplus or has been subjected to tax under the laws which were in force during the years in which it was earned. The mere fact that prudent and conservative operation through those years has caused it to remain with the company should not now subject it to further tax.

In testimony presented to this committee it has been pointed out that the investment of surplus in the acquisition of new business from which profits are made at some later date creates a situation where phase 3 actually results in a tax on return of capital. I believe this is true when applied to the industry as a whole, but of course the tax involvement applies only to stock companies.

In my company the impact of phase 3, because of the mechanical workings therein, becomes even more a retroactive tax on money which is a return of capital.

We are now in our 50th year, completing a half century of conservative operation. We have attempted to maintain a sound and conservative investment portfolio and accumulate a large surplus so that our policyholders will always be protected. We are now in the process of a modest expansion program into other States in the southwestern area. It was felt that this expansion program would at some future date permit us to distribute a larger portion of these accumulated surplus funds because we would be spreading our risk over a larger geographical area. If phase 3 of H.R. 4245 becomes law, as written, it would have a tendency to freeze these accumulated earnings of the past 50 years which were left with the company for the protection of policyholders and would to some extent cause them to be taxed as though currently earned.

This decision of management to retain the surplus in our company was a wise one. During the war years we invested heavily in Government bonds, practically all of which do not mature until the years 1967–72. These Government bonds constitute almost one-third of our total assets and have a par value of $7.015 million; their market value December 31, 1958, was $6,491,607. Liquidation of these bonds, which we have no thought of doing, would immediately absorb more than one-half million dollars of surplus. Of these bonds, $325,000 bear interest at 3 percent and the remainder bear interest at 2.5 percent. Our current mean interest requirement is 3.26 percent. This interest deficiency can only be met by having large surpluses to invest to overcome it. However, at maturity when these bonds have been liquidated for par value, if the market is such that the funds can be reinvested at an earning figure more commensurate with our requirement, it would appear that some of these surplus funds could safely be released to the stockholders in the form of dividends. Again, however, under H.R. 4245 our company and, in turn, our stockholders, will be penalized by reason of the fact that these funds were left with the company for the protection of policyholders during the years when they were earned. We would urge the amendment of phase 3 to not penalize the shareholders and to permit these funds to go gradually into the shareholders' surplus account for distribution over a period of years, subject, of course, to sound management operations.

Thank you for the time granted my company to express its opinion and we will appreciate your serious consideration of the views presented herein.

The CHAIRMAN. Thank you, Mr. Stuart.

Are there any questions?

Senator KERR. Mr. Stuart, I notice your reference here to long-term Government bonds in your investment portfolio.

It just happens that I remember the time when at least some of these bonds were purchased by your father, your company, during the war years when I was Governor of Oklahoma and had something to do with the bond drive, and for some time now they have been considerably under par.

Mr. STUART. Yes.

Senator KERR. So that it is your feeling that if phase 3 does go into effect as written at a time when it would catch your company with these bonds with a loss in them of over half a million dollars, that since the account is pretty well frozen in those bonds, to avoid taking a loss by selling them or using them before maturity, you feel that phase in the law would have a peculiar penalizing effect on your company?

Mr. STUART. Yes, sir, or any company in the same position.

Senator KERR. Or similarly situated?

Mr. STUART. Yes, sir.

Senator KERR. That is all, Mr. Chairman.

The CHAIRMAN. Are there any questions?

Senator CURTIS. One question.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Mr. Stuart, in a stock company if a dividend is properly declared, it could never be policyholders' money, could it?

Mr. STUART. I am not sure I understand your question, Senator.

Senator CURTIS. What I am getting at is, I think there are two elemental tests in applying a tax law: One is, is something income, and if it is, who owns it.

Now, the money that you would pay out, a stock company would actually pay out in dividends, assuming that it was properly and lawfully made, that could never be policyholders' money, could it?

Mr. STUART. No, sir, it could not.

Senator CURTIS. That is all.

Senator KERR. There could have been a time, though, when that was being held for the benefit of the policyholders as a part of the reserve of assets that you considered adequate for their protection, but which over the years by reason of redundant premium payments could have been removed from the status of having been held in reserve for the protection of the stockholders to a posture where it would be available for dividends to the policyholders?

Mr. STUART. Yes, sir, that is very true. In our own company, for instance, we carry one-half million dollars in a policyholders' contingency fund which is held there, but theoretically that money does not belong to the policyholders but it is held in this contingency fund as an emergency fund if it should be needed.

Senator KERR. And although it was stockholders' money, it was put there for such time as it might be required to assure safety for the benefit and protection of the policyholders?

Mr. STUART. That is correct, sir.

Senator KERR. And when that urgency, or when the need for that special fund no longer existed, than it would still be just stockholders' money, but it would have been relieved of the lien or burden that you, yourself, had voluntarily attached to it of having put stockholders' money into a fund for the temporary protection of the policyholders?

Mr. STUART. That is correct, Senator Kerr.

Senator WILLIAMS. In setting aside this half-million dollar contingency reserve, did you pay tax on it at the time it was set aside?

Mr. STUART. Yes, sir. That money is in reality surplus. It could be transferred back at any time to the free surplus account.

However, good management would dictate that you should set up this contingency fund, and has done so.

Senator WILLIAMS. But it was included in your taxable income?

Mr. STUART. Yes, sir.

The CHAIRMAN. Are there further questions?

(No response.)

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

Mr. Claris Adams, executive vice president and general counsel of the American Life Convention, who was scheduled to testify today is unable to appear because of illness. His statement and accompanying letter is being incorporated in the record. Copies of the statement have been distributed to the press and to those in the audience.

(The letter and statement of Claris Adams follow:)

AMERICAN LIFE CONVENTION,
*Washington, D.C., March 18, 1959.*

HON. HARRY F. BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building, Washington, D.C.*

DEAR MR. CHAIRMAN: Much to my regret I was unable to testify on behalf of the American Life Convention at the first series of hearings on the life insurance company income tax bill because I was forced to undergo major surgery the week before such hearings commenced.

I had hoped to be able to appear at the hearings conducted this week on behalf of the 278 companies represented in my organization which have more than 95 percent of all the life insurance in force in the United States. I asked for time on the last day and prepared testimony during my convalescence.

It now appears that I was a little over optimistic because I have not regained my strength sufficiently to present this testimony; furthermore the operation left me temporarily under the handicap of some difficulty in speech.

Therefore, I am releasing the time which I asked for at the hearing and instead of presenting my testimony, I am hereby asking leave to file a statement instead which I hope you will do me the favor of including in the record.

Yours sincerely.

CLARIS ADAMS.

STATEMENT OF CLARIS ADAMS, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN LIFE CONVENTION, FILED WITH THE SENATE COMMITTEE ON FINANCE, U.S. SENATE, U.S. CONGRESS, MARCH 19, 1959

My name is Claris Adams. I am executive vice president and general counsel of the American Life Convention, a trade association composed of 278 life insurance companies, which, in the aggregate, have more than 95 percent of all the legal reserve life insurance in force in the United States. There are both stock and mutual companies in our membership. By numbers, the stock companies constitute almost three-fourths but, following the pattern of the industry, mutual members have approximately 75 percent of assets and two-thirds of the insurance in force.

All of the large companies belong to our organization, but at least 200 of the members would be classified in the business as small companies. The executive committee, which acts as our board of directors, consists of 15 men. The membership of this committee, elected by vote of the entire convention, is composed of nine officers of stock companies and six men who are officials of mutual companies. The companies which these men represent range from the very largest and oldest in the United States to the very small companies, some of which are relatively young. They represent a fair cross section of the membership of the entire convention. Since we have Canadian members, one of our directors represents a Canadian company. The president, who is elected annually, this year is Mr. Rolland E. Irish, president of the Union Mutual Life Insurance Co. of Portland, Maine.

I have no mandate from my organization to support H.R. 4245. Personally, I believe that the total tax levied thereunder, added to the unusual and extremely heavy taxation enacted by the various States, will constitute an oppressive burden upon life insurance.

However, I am conscious of the fact that this bill has the influence and prestige of the Treasury behind it. It was approved by the Ways and Means Committee and passed the House with only a scattering few dissenting votes. It has been supported with certain modifications at these hearings by a great preponderance of testimony from leaders of the industry. They greatly prefer it to the only practical alternative, to wit, the existing 1942 act. I agree that the 1942 law is an arbitrary, unstable, capricious, and inequitable law. Furthermore, I am under the impression that this committee is favorably inclined at least to the structure of this bill. Therefore I feel that I can best serve my constituency and all segments of the business by doing all that I can to help make H.R. 4245 as practicable, workable and as nearly equitable to all parts of the industry as possible.

One of the principal reasons that I believe this bill is superior in many respects to the 1942 law is that the 1942 law, with its high level of taxation levied independently of operating results, might easily become an intolerable burden to all companies in the case of a prolonged depression, such as we experienced in the thirties.

I agree unreservedly that phase I, which levies a tax on the gains from investment income, should be amended to substitute a 5-year average based on the surplus interest method of standardizing reserves, currently known as the Menge plan, as a substitute for the formula now provided in the bill. The latter is based upon a combination of the so-called Menge plan and the average interest requirements of the industry. I think that such change would make this part of the bill more logical, more equitable, and more just.

I thoroughly approve of what is known in the business as the pension cutout. This is necessary to remove a discrimination long existing in favor of banks, which compete for the administration of retirement plans on practically a tax-free basis. In this connection, I want to emphasize that the tax saving to the companies on this so-called pension cutout will be passed on in its entirety to the particular policyholders entrusting funds of this character to life insurance companies. It will not affect competition in any other area of operation and will add nothing to general operational gains in either a mutual or a stock company. Furthermore, the Treasury will recoup 52 percent of the taxes forgiven thereby because the policyholder, to wit, the corporation setting up the pension plan, receives a deduction as a business expense for premiums paid on such policies. Furthermore, I believe that if it is right to do it, it is right to do it now.

I now wish to discuss the philosophy and justification for the manner of taxing the excess of operational gains over the taxable investment income, as provided in phase II (sec. 809) of the bill before you. I am afraid that the record does not make sufficiently clear one simple and fundamental fact of supreme importance in this connection. It is this, that the so-called gains from operations as calculated under section 809, are not, and cannot be, from the very nature of the operation of a stock life insurance company, an accurate measure of its annual profit or loss.

The manner of arriving at such operating gains in the bill is borrowed largely from the official annual statement which all States require from life insurance companies. On the surface, this seems quite logical. However, such annual statement is and only purports to be a measure of solvency for the companies, according to an agreed and tested legal standard. It was not designed for, it is not intended to be, and as a matter of fact, it is not a profit-and-loss statement.

Both the annual statement and section 809 of this bill measure current gains from operations essentially as the annual increase in surplus, if any, as determined by the difference between the current value of assets owned by the companies and the liabilities set up by them for future contract obligations after all claims have been paid, expenses met, and in the case of participating policies, dividends distributed to policyholders.

However, 85 percent of a life insurance company's liabilities consist of estimates of future mortality experience and investment results on contracts, many of which will run for many years. The companies have a large discretion in estimating such future liabilities. Depending upon the free choice of a company in setting up its reserves on a 3½ percent, 3 percent, 2½ percent, or even 2-percent basis, as one very prominent company is now doing, such estimates of future liabilities on the same type of contract may vary as much as 15 percent in different companies.

Since all companies, whether stock or mutual, and regardless of the reserve standard used, must pay the same amount of money to the policyholder at maturity on contracts of the same type, the final results as to profit or loss do not depend upon interim estimates of future liabilities. They depend on how much money the company has received in premiums and what interest it has actually earned during the life of the policies as compared to expense incurred and claims paid. However, during the life of the policy, the tentative gains from operations resulting from the method used both in the annual statement and section 809 depend very largely on the estimate of future liabilities set up by the company and concerning which the management of the company has a very wide latitude. Since these estimates can vary as much as 15 percent, and frequently do vary as much as 10 percent, it is obvious that this is an extremely important factor in a business where on the average the total gains from operations after dividends to policyholders are considerably under 10 percent of annual income. The gain reported depends so much upon estimates that the result itself is essentially an estimate.

The company which sets up the largest estimated liabilities during the life of the policy will show the lowest interim gain and conversely, the company setting up the lowest reserves will show the highest gain currently, disassociated from actual experience. This is particularly true because the companies with the lowest reserves supplement them with the highest surplus, and those with the highest reserves carry the lowest surplus. This is not universally true, but this is the general pattern of the industry. Since under this bill any increase in reserves is deductible but any increase in surplus is taxable, it is obvious that unless some compensation is made for this factor, the bill would result in serious discrimination. The point is that the current tentative gains produced by the formula in section 809 bear no fixed nor accurate relationship to the actual realized profits, which is the only proper and valid basis upon which to levy a corporate income tax.

Let me illustrate by a specific example: On page 7 of the testimony of Richard C. Guest, vice president of the Massachusetts Mutual Life Insurance Co., he sets out a table showing as he states "that nonparticipating premiums differ very little from the average net costs of participating insurance after dividends have been deducted." In other words, stock and mutual companies provide the insuring public with the same product at effective prices which are extremely competitive. Over certain periods dependent upon uncontrollable mortality, expense, and investment factors, nonpar insurance has proved to be cheaper; in other periods the net cost of participating insurance has been lower.

This table demonstrates that over a 30-year period the average nonpar rate issued by the typical stock company has resulted in a lower cost on whole life and 20-pay life. On a 20-year basis, participating insurance has been cheaper on these policies but more expensive in regard to 20-year endowments. To take the extreme example, Mr. Guest shows that for a 20-year endowment issued in 1928 and maturing in 1948, the typical participating company charged an annual premium of $51.27. The typical stock price for nonpar insurance of this character was $41.48. The mutual company paid dividends sufficient to reduce the average annual net cost to surviving policyholders to $42.48. This was a dollar a thousand per year more than the cost of the nonparticipating policy.

The mutual companies, of course, provided this insurance at cost. Therefore, presumably the stock companies lost money on this particular segment of the business for that period of time. However, during the 20 years these policies were in force, if the mutual company put up higher reserves as an estimate of future liabilities than the typical stock company did, the stock company might well have shown a considerable interim net operating gain in most of the years that these policies were in force although the whole transaction resulted in a final loss. I am assuming in this argument that the typical stock company used a lower reserving basis and maintained a correspondingly higher surplus than the mutual company. Again, although this is not universally true, it is the general pattern of the business for historical, practical, and technical reasons which I shall explain in some detail later.

The above illustration shows graphically the reason for taxing stock companies currently on only one-half of tentative gains from operations in excess of their tax on net investment income under phase I which they and the mutuals both pay. The remainder of the tax is deferred not as a favor to the stock companies, but because the amount of profit as currently shown is tentative and deferral of the remainder is accorded until the actual amount of profit is established on these long-term contracts. The other half of the tentative operating gains over and above the net investment taxable income is put into a special suspense fund until it is determined what part thereof is really profit. However, when, if and as any part of this fund is established as a genuine profit and is devoted to the use of stockholders in any way it is taxed at the going corporate rate as the profits of all corporations are.

Mr. Guy H. Amerman, the actuary of the Continental American Life of Wilmington, Del., a small stock company, demonstrated in his testimony that his particular company would pay a tax of 52 percent on 91 percent of its net operating gains in 1958 and only 9 percent would be deferred. I do not have the figures for 1958 but in 1957 in the case of the Life Insurance Co. of Virginia, a medium-size typical conventional company whose president, Mr. Taylor, has already testified, the company would have paid the going corporate rate on 87 percent of its tentative gains had this law been in force and 13 percent would have been deferred until the actual realized gains were established. These illustrations are undoubtedly below average but they are typical of many companies whose business consists predominantly of the conventional and savings type of life insurance contracts rather than group or short term.

That so-called operating gains as calculated under section 809 of H.R. 4245 are not a valid measure of real profit and loss in stock companies is well understood in the business. It is readily admitted by officers of mutual companies. Mr. Deane C. Davis, president of the National Life Insurance Co. of Vermont (a mutual company), in his testimony before the Ways and Means Committee on November 18 last at page 192 of the record of hearings said:

"Furthermore, in a long-term business such as the life insurance business, even in a stock company statement gains are not necessarily all profits. A part of these statement gains in stock companies, computed solely to test solvency of a company from an insurance regulatory point of view, is needed and is used for additional protection of policyholders, just as is the case in mutual companies."

Mr. Carrol M. Shanks, president of the Prudential Insurance Co. of America, in these same hearings testified (pp. 218 and 219 of the record of the hearings) as follows:

"Next, I should like to revert to what I have called our main difficulty—certainly our main theoretical difficulty. That is our inability to agree on how to determine income for a life insurance company. The answer would seem to be simple, at least in the case of a stock life insurance company. Why not apply the same methods used by any other business which, in effect, means determine the increase in surplus before dividends to stockholders and use that as the tax base? It is not that simple.

"Except in most unusual circumstances, dividends paid to stockholders represent net income or profits which have accrued at some time in the past, although not always in the previous taxable year. But there may be a large increase in surplus even after these dividends are paid. And, if we may assume again for purposes of simplification that this company writes nothing but nonparticipating contracts, then it would appear that all this increase in surplus represents an accrual of undistributed profits for the stockholder. Again, it is not that simple.

"The reason for this is that this surplus differs from the profits in any other business. Its size depends so largely on management decision that no one can be sure when it is said to accrue, whether it really represents profits for the stockholder, or whether it, or at least some part of it, is in the nature of a reserve to enable the management to meet its contract obligations many years in the future. No one would deny that when, in a stock life insurance company, these accretions to surplus can be earmarked with certainty as being unnecessary for the payment of contract obligations, they represent profits and should be subject to the corporate income tax.

"To illustrate, let me refer again to the 30 nonparticipating stock companies' experience. The net gain from operations for these companies for the 5 years 1953–57 was $332,588,000. Out of this, they paid cash dividends to their stockholders of $82,357,000. According to the figures, this leaves $250,231,000 of what appear to be undistributed profits. But are they truly profits which should be subjected to corporate income tax? If subsequent events should show that some part of this $250,231,000 was needed to meet contract obligations, then this part should have been treated as an increase in reserves and should not have been subjected to that tax. It seem highly unlikely that all of this amount should have been so treated, but the basic problem is to determine just how much. On this question, there has been no general agreement."

So far as I know, no mutual life insurance man has taken exception to the manner of taxing the so-called operating gains of stock life insurance companies as set forth in H.R. 4245. Mr. Davis and Mr. Shanks both approved it inferentially in their testimony before this committee because they give strong support to the bill if amendments of other types were adopted.

The bill before you for consideration provides for a deduction of 10 percent of the increase each year on nonpar reserves from the tax base as determined in phase II (sec. 809) of H.R. 4245. The justification for this deduction grows out of the essential difference between participating and nonparticipating insurance. In participating insurance the policyholder is charged a premium in which there is a conscious overcharge to take care of contingencies. This device permits a price adjustment year by year depending upon the experience of the company in regard to mortality, expenses, and investment earnings. In nonparticipating policies on the other hand, a lower fixed premium is charged. Such premium when once determined is guaranteed and cannot be altered during the life of the policy regardless of circumstances.

If nonparticipating premiums were fixed at a sufficiently high level to take care of any possible catastrophe, any conceivable inflation of expenses or radical drop in investment return, the rate charged would not be competitive with the estimated net cost of participating insurance, reduced by dividends forecast on the basis of normal experience. During periods of normalcy, the cost to the insuring public of each type of policy has been remarkably close over a long period of time. However, the participating policy has a built-in safety factor against unusual and abnormal experience which a nonparticipating policy does not have. As a consequence it is conceded by both stock and mutual men that for purposes of safety, nonparticipating policies should be supported and the reserves thereon should be supplemented by a larger proportionate surplus or contingency fund than in the case of participating companies. Again I quote from the testimony of Mr. Deane C. Davis, president of National Life Insurance Co., of Vermont, before the Ways and Means Committee. Mr. Davis (p. 192 of the Record) said:

"It is true, however, that stock companies issuing guaranteed cost insurance, under which there are no dividends paid to policyholders, would have no opportunity to adjust the net gains from operations by increasing dividend distributions, and within reasonable limits this is a factor which must be kept in mind in choosing an equitable formula."

* * * * * * *

"Policyholders of a stock company must be protected by an accumulation of surplus and, furthermore, in the case of nonparticipating business, there is a need to build more surplus than in the case of participating business, as sold by mutual companies. Nonparticipating business has lower premium margins and, therefore, a greater margin of safety for policyholders must be provided by the stock company's surplus, and that is why you see relatively percentagewise much larger surpluses in stock companies, usually on a less conservative basis on the value of reserves."

Mr. Richard C. Guest, vice president of the Massachusetts Mutual Life Insurance Co., also testifying at the same hearing said (p. 237 of the Record), "Moreover, provision should be made for the special risk involved in long-range low nonparticipating premium guaranties."

In 1957 the stock companies in the American Life Convention carried an average surplus of approximately twice that carried by mutual companies. This practice was not influenced by any impact of income tax consequences because until now both mutual and stock companies have been taxed equally. The average capital and surplus of stock companies in the American Life Convention as of December 31, 1957, was 14 percent of reserves whereas the average mutual company carried a surplus of 7 percent of reserves. This constitutes a fair pragmatic test of the validity of this deduction.

These figures might seem to indicate that 7 percent rather than 10 percent is a proper deduction but analysis will show the error of that conclusion.

A substantial percentage of stock companies in the American Life Convention have a considerable proportion of participating business as well as nonparticipating insurance. Against their participating contracts, they need no larger surplus than mutual companies do. The percentage of participating insurance in stock companies is of sufficient magnitude that it makes the 10 percent figure a very reasonable one for nonparticipating contracts alone. In fact, if anything, it is a little on the low side because counting group insurance which is frequently written on what amounts to a participating basis, probably as much as 30 percent of the insurance in force in stock companies is participating.

There is another factor in the problem. The smaller companies are much more vulnerable to fluctuations in mortality experience than the large companies are because the law of averages requires large numbers and a long period of time for its validity.

I am sure that the vast majority of officials of stock companies believe that this 10 percent deduction is absolutely necessary to put them on a fair competitive basis with the large mutuals which in addition to a 7 percent actual surplus have the advantage of a yearly dividend cushion for possible price adjustment equaling more than 30 percent of such purplus. This fund is available to them for purposes of safety each year. Therefore the 10 percent figure in my opinion is the minimum compensating factor which will permit the average stock company to compete with their mutual rivals and still maintain comparable margins of safety for their policyholders.

This naturally brings up the question as to why stock companies on the average set up lower reserves than mutual companies do, particularly the large ones. It was once not so nearly universally true as it now is. Some of the very largest mutual companies formerly put up their reserves on a 3½ percent basis. However, during the war interest rates declined radically. The time came when many companies were not able to invest currently in securities of satisfactory quality which would yield the interest rate assumed in the reserve standard chosen by such companies. As a consequence, those companies financially able to do so strengthened their reserves by making a large contribution thereto from surplus in order to bring their interest requirements down to the yields readily available in the market.

At this time the large companies had most of their assets invested in market securities. Their older bonds purchased at a higher interest yield were selling at a substantial premium. Under the law then in force, life insurance companies were not subject to a capital gains tax. Therefore, as these bonds were called or sold at a profit, the gains went largely into reserve strengthening. Not all the reserve strengthening came from this source but a great proportion of it did.

The situation was much different with many of the smaller western and southern companies which invested largely in home mortgages. As interest rates fell, they had very few market securities upon which to take a profit. Their mortgages were not enhanced in value. On the contrary, as interest rates declined, they found it necessary to refinance a great many of their mortgages at a steadily diminishing return.

Even the smaller companies started writing their new business on a more conservative valuation basis. However, it takes a long time for reserves on new business to build up to large proportions. In the American Life Convention more than one-third of the companies still have more than half of their reserves on a 3½ percent basis and over one-half have 40 percent or more.

Also there are technical reasons why it is more difficult for stock companies than for mutuals to issue new business on exceedingly high reserve bases. High reserve valuation tends to increase premiums charged to the public. This is of little disadvantage to a mutual company which compensates for higher premiums by dividends. However, in the case of stock companies, if their stationary premiums become too high, they cannot compete with the estimated net cost of participating insurance after dividends. If companies reduce their premiums to the public below the theoretical net premium required by the reserve standard chosen, they must immediately put up additional reserves covering the full present value of such deficiency in the net premium over the entire life of the policy. This charge is a heavy one and results in a great strain on surplus in a growing company.

For this reason, a number of stock companies have found it necessary recently to reduce their reserve basis on new issues in order to write new policies on a competitive basis without setting up punishing deficiency reserves. So, as a generality, it is true that it is easier for strong mutual companies to put up high reserves which reduces the necessity for larger surplus funds. It is also true as a generality that mutual companies as a class do carry higher reserves and set up smaller surpluses than stock companies do.

The question has been raised from time to time as to whether there is not a margin of built-in profit in our mortality tables because mortality has been more favorable in the intervening years than it was when the table in current use was published in 1941 based on the experience of the thirties. The answer is that profit and loss on a long-term life insurance contract does no depend upon the reserve but on the premiums charged and interest earned in relation to loss experience, expense factors, and investment return.

In the case of most mutual companies, the current mortality table may be used for the calculation of premiums. In stock companies, this is not the case for a reason that is readily apparent.

It makes no real difference whether the mutual companies use a redundant mortality table for the calculation of premiums because if mortality experience, expense estimates, and investment returns are more favorable than those assumed in calculating the premiums, the difference is returned to policyholders in dividends and the net result is the same.

It follows that if stock companies, in issuing guaranteed low-priced nonparticipating policies, used the same premium structure they would immediately price themselves entirely out of the market. Therefore, although stock companies must put up reserves as required by the mortality table in use, their premiums are actually calculated on an analysis of their own modern mortality experience, an estimate of their own expenses, and their best guess as to the actual investment return which they expect to make for a long period in the future. In other words, the redundancy in the table is necessarily discounted in advance in the charge made for nonparticipating insurance. Otherwise stock companies would be utterly unable to compete with mutual companies operating at cost.

That they are able to compete against the large mutuals which nevertheless dominate the market is due to the fact that, as testified to by Mr. Richard C. Guest, vice president of the Massachusetts Mutual Life Insurance Co., the two types of insurance offer the same protection to the insuring public at prices which are remarkably similar. It follows that the somewhat natural assumption that the mortality table used for reserve purposes by stock companies gives them a built-in profit because of the redundancy of such tables is not true in practice. The only real effect of the mortality tables upon premiums charged is, as stated above, when nonparticipating rates are forced so low by competition that they dip under the actuarial net premium and deficiency reserves are required. When this happens it puts the stock companies at a great competitive disadvantage.

The need for surplus in a life insurance company above and beyond its legal reserve arises from several factors. There is always the possibility of epidemics. Fortunately in 1918 the onset of the influenza epidemic was in the late fall and ran its course the following spring. If by chance it had occurred all in 1 year, many life insurance companies would have become insolvent in spite of rather ample surpluses over and above their legal reserves. The fact that their heavy losses were spread over 2 calendar years permitted them to survive. There are those who think there will never be another epidemic. No life insurance man discounts the possibility. If the recent Asian flu had been the same sort of killer as the Spanish influenza in 1918, the companies would have had a similar experience and many of them would have needed all the surplus they had. We are afraid that such epidemics are still possible in spite of the development of wonder drugs. Epidemics may occur when germs develop tolerance for the type of medication in use and therefore diseases are unresponsive to available remedies.

In addition to the dangers of epidemic, no one can calculate the effect of atomic fallout even in the absence of war on the long-range mortality of the future.

However there are other factors. Life insurance reserves are a mathematical figure expressed in terms of dollars. The investments behind these reserves are of fluctuating value. Within the recent past, even such basic investments as Government bonds have plummeted in the market as much as 10 or 12 percent within the period of a year. The corporate bond market has oscillated in a similar fashion.

These gyrations of the market do not seriously affect the statements of life insurance companies currently because by the laws of the States their bonds are carried on an amortized basis which is independent of market price so long as they are not in default and stocks are held in small amounts. However, in any depression when cash surrender values are demanded in large proportions and it should become necessary for life insurance companies to liquidate assets in the market at a time of deflated prices, an adequate surplus over and above reserves would be absolutely essential to the ability of companies to perform their contracts. Life insurance companies have remained solvent over the years and, with some few tragic exceptions, have been able to perform their obligations to their policyholders without loss, not because life insurance officials are miracle men but because they have maintained and have been permitted to maintain large margins of safety against extraordinary hazards such as war, pestilence and panics, all of which have occurred within the lifetime of many of us. Twice in 40 years the surpluses of life insurance companies have been put to severe strain because of such emergencies.

Another serious issue is the treatment of tax-exempt interest and the intercorporate dividend credit. An argument which, on the surface at least, seems to have a great deal of merit is that a life insurance company is not entitled to a double deduction for reserve interest just because it owns tax-exempt bonds or stocks. Furthermore, because the capital and surplus of life insurance companies are relatively small in comparison to their reserve liabilities, permitting such companies to allocate their ownership of tax-exempt securities and stocks to their capital and surplus rather than to their reserve account might seriously affect the revenue from the investment income portion of the bill.

On the other hand, since life insurance companies under the overall provisions of this act are really taxed on their total income with deductions peculiarly necessary to their type of operation, just as manufacturing companies are properly permitted a deduction for depreciation and obsolescence and oil and mining companies are entitled to a deduction for depletion, it is a little difficult to understand how a distinction can be made legally in the case of tax-exempt securities or how a denial of the intercorporate dividend credit can be justified on philosophical grounds.

The reserves of life insurance companies must be improved at interest year by year as a matter of contract. The cash surrender values which are based on such reserves are policy obligations payable on demand. From this viewpoint, reserve interest partakes of the general nature of interest paid on bonds and debentures by other corporations, or perhaps by even closer analogy it is comparable to interest paid or credited to bank depositors. Many utility companies, for instance, have small capital compared to their total assets. They have large interest payments to bondholders which of course are allowable deductions. This deduction is not diminished because the same corporation invests some of its assets in tax exempt securities or the stock of other corporations. They still are accorded both a deduction for interest on tax exempt securities owned and the full intercorporate dividend credit on stocks held in their portfolios. Banks are not deprived of these deductions because they also receive a deduction for interest paid to depositors.

In the case of tax exempt interest, there is a real legal question involved. In the case of *National Life Insurance Company* v. *United States* (277 U.S. 508), the U.S. Supreme Court held in effect that any device through which a life insurance company is deprived of its deduction for tax exempt interest in full under a total income tax law and whereby the company owning such securities does not receive an additional exemption over and above that allowed to all companies whether they own tax exempt securities or not, constitutes a strategem to nullify such tax exemption on State and municipal bonds and therefore is unconstitutional.

It is certain there will be a number of lawsuits testing the legality of the device embodied in this law to circumvent an independent deduction for tax exempt interest. If such lawsuits are successful, they could seriously impair the effectiveness of the present bill if it becomes a law in its present form.

Under previous laws, when the tax was laid altogether on investment income, the issue was not so clear and was not so serious because the money involved was trifling. Under this law, it would be a matter of great moment to a substantial number, particularly of the smaller companies and I believe the question deserves very careful consideration.

Just one more point. Congress has oft been reminded that the States lay very heavy exactions upon life insurance. On the average, the State taxes take approximately 2 percent of all premiums of all policyholders. Because these taxes are laid upon premiums, it is obvious that they fall directly upon the policyholders. The exaction is a tax upon saving one's own money for the protection of one's own family. In no other area is the mere act of saving taxed as such. In my opinion, the Treasury has been quite callous in its attitude that these unusual and oppressive State taxes are no concern of the Federal Government and have no relationship whatever to the heavy taxes levied under this bill which to a considerable extent will fall upon the policyholders also.

In my opinion, Congress has a direct responsibility in this connection. After the South-Eastern Underwriters decision which held that insurance is commerce, Congress passed Public Law 15 in 1945 declaring it to be congressional policy that the regulation and taxation of insurance companies by the States should remain unimpaired. As a consequence, a number of tax laws in the various States which otherwise might have been invalid as an undue restraint upon interstate commerce were upheld by the Supreme Court because of Public Law 15. To a considerable extent therefore, Congress is responsible for the heavy load of State taxes borne by the policyholders of the Nation. They are levied by express consent of Congress.

I repeat that in my opinion the aggregate tax laid by both the State and Federal Governments upon life insurance is oppressive considering the nature of the institution and the social benefits that flow therefrom to the small savers of the Nation. Even the taxes under the 1955 law, when added to to the State levy, constituted a heavier burden than is levied upon life insurance in either Canada of Great Britain. Even under the 1955 law, taxes rose to the highest level ever levied in the history of this country. Personally I do not believe that it is sound economics or good social philosophy to tax this form of savings so heavily and in such a discriminatory manner that it may discourage the purchase of life insurance for family protection. I share the fears of many that this may happen. I do not think that would be in the public interest.

(See also pp. 125, 524.)

The CHAIRMAN. Our next witness is Mr. Albert L. Hall, of Berkshire Life Insurance Co.

## STATEMENT OF ALBERT L. HALL, VICE PRESIDENT AND GENERAL COUNSEL, BERKSHIRE LIFE INSURANCE CO., PITTSFIELD, MASS.

Mr. HALL. My name is Albert L. Hall. I am vice president and general counsel of the Berkshire Life Insurance Co., of Pittsfield, Mass., a mutual life insurance company chartered in 1851. At the end of 1957, the Berkshire ranked 62d in assets and 101st in insurance in force.

My remarks do not deal primarily to the problems occasioned by H.R. 4245 in its impact upon the mutual life insurance business as a whole, but will relate with particular pertinency to the operations of Berkshire Life Insurance Co. As one small mutual life insurance company, we concur with previous witnesses that the bill, with suitable amendments, will be acceptable. I will discuss briefly the impact of two amendments already proposed because they have marked relevancy to Berkshire Life.

H.R. 4245 provides that the "policy and other contract liability deduction" be at an artificial mean rate. As an individual company, we subscribe to the use of our own actual earned interest rate for the taxable year. If, however, this is not practicable because of its failure to provide the amount of revenue desired, we concur in the suggested use of the 5-year average of the actual investment rate of the individual company which would tend to eliminate marked fluctuations in the tax from year to year.

A second amendment has particular significance to the Berkshire Life. Here is where our special problem lies. Under the bill as drawn, while our gain from operations for 1958 amounted to a bit more than $1,250,000, we are required to use the larger taxable investment income of $1,600,000 as the tax base, for the reason that the bill does not permit a reduction in the gain from operations by the full amount of dividends paid to policyholders, but only down to the level of the taxable investment income where it is pegged. This has the effect of arbitrarily forcing us to a taxable level which is $350,000 in excess of the Berkshire's actual gain from operations. At a 52-percent rate this affects my company by an additional tax of $180,000. Simply expressed, this makes the rate of tax on gain from operations 66 percent, not 52 percent. We feel amendment is in order.

Premium rates established by mutual companies are set at a level believed to be sufficient to cover any adverse experience which may arise. Because of this, provision is made that any overcharge in the premiums will be returned to the policyholder. These returns, or so-called dividends, are recognized in tax laws as not being income to the individual policyholder. Such returns should not be taxed to the individuals through tax on the company. However, the individual is in effect taxed on these refunds under H.R. 4245 whenever taxable investment income exceeds gain from operations. For the Berkshire this would mean a 1958 tax of approximately $180,000 on dividends to policyholders.

Although a deduction of 100 percent of dividends could be justified in computing the tax base, we recognize that from a practical standpoint this might involve too great a decrease in revenue. Accordingly, Berkshire recommends that section 809(g) be amended to permit the deduction of 50 percent of the dividends now disallowed. This would incorporate the same 50-percent principle now used in H.R. 4245 for establishing the tax base when gain from operations exceeds taxable investment income.

It would appear appropriate at this point to clarify two assertions now on the record concerning (1) underwriting losses and (2) deductions of dividends to policyholders.

(1) When taxable investment income exceeds gain from operations, there is an "underwriting loss," as defined in the report of the Ways and Means Committee. It was pointed out in previous testimony that

H.R. 4245 provides recognition of underwriting losses because the underwriting loss may be subtracted in full from the phase 1 income base. It was also pointed out that this should be of particular importance to small new companies, which characteristically have underwriting losses in their early years.

We agree with the concern expressed for small new companies with underwriting losses. However, the bill in its present form, although providing relief in this area to small new companies which issue nonparticipating insurance, does not provide similar relief for companies which issue participating insurance. This is because of the limitation in section 809(g) on the deductibility of dividends to policyholders.

This bill, with its discrimination against participating insurance, could have the practical effect of forcing new companies to issue only nonparticipating insurance. The activities of new companies should not be thus limited.

There are also small old companies. These small companies should also have tax relief when their gain from operations is less than their taxable investment income.

Regardless of the age and the size of the company, an underwriting loss incurred through paying out dividends to policyholders is no different from, and no less real than, an underwriting loss incurred through collecting too small an amount of premiums from policyholders. Both underwriting losses should be treated alike in the tax bill. Nevertheless, as a practical solution, we are only requesting, as indicated above, that 50 percent of an underwriting loss incurred through paying out dividends should be taken into consideration.

(2) The president of a mutual company with assets of over three-quarters of a billion dollars—four times the size of my company—testified on March 4 about—

> the concern of many of us smaller mutual companies that such so-called dividends could injure us competitively.

He further stated that—

> There is a movement among some mutual companies to seek additional deductions for policyholder dividends. This we believe to be a most dangerous proposal and we oppose it most vigorously.

As a supporter of the temporary committee on the taxation of mutual life insurance companies, I was aware of 32 mutual companies—including my own—who favored such an additional deduction and 2 who did not. So it was natural to wonder to whom the "we" and "us" used by this particular witness referred. Accordingly, a telegram was sent to every one of the other 88 mutual companies reported on in Best's "Life Insurance Reports." Incidentally, each of these companies was in fact smaller than this particular witness' company. The telegram asked whether the company favored an increased deduction for dividends to policyholders along the lines proposed at the hearings by several representatives of mutual companies.

Replies have been received from 48 of these mutuals. I believe they provide the best available evidence of the attitude of the smaller mutual companies. Forty-one of these replies stated that they favored such an additional deduction. These 41 companies are located in 21 States throughout the country. Only 5 companies replied that they were opposed. There were 2 companies who did not take a definite position one way or the other on this question.

The positions stated in these replies and those of the companies whose position I already know are combined in the following summary:

*Position and number of mutual life insurance companies*

| | |
|---|---|
| Favor an increased deduction for dividends to policyholders | 73 |
| Do not favor this change | 7 |
| Do not take a definite position on this subject | 2 |

I believe, therefore, that the best evidence available supports the view that most mutual life insurance companies—small, medium, and large—are strongly in favor of amending the limitation in section 809(g) on the deduction of dividends to policyholders.

One witness proposed that companies be permitted—

to apply phase 2 negatives, to the extent they are not allowable to reduce phase 1 taxable income, to reduce phase 2 gains of other years. Such phase 2 negatives would be applied to phase 2 taxable income of other years under appropriate carryover and carryback provisions.

In the case of my company this would be most unlikely to provide any relief and I am sure that most mutual companies would be in this position. Such an amendment would help primarily those stock companies that write some participating policies because those are the companies that would be most likely in any years to be subject to a tax under phase 2. Any company whose total operating gains are regularly less than its taxable investment income would obtain no relief under such an amendment, yet these are the companies that are most in need of relief.

For the various considerations outlined above, Berkshire Life strongly recommends the adoption of H.R. 4245 after revision by incorporation of the two amendments discussed above.

Thank you.

The CHAIRMAN. Mr. Hall, do you have an estimate of the revenue loss that would occur by the adoption of these two amendments?

Mr. HALL. For the industry, Senator?

The CHAIRMAN. The revenue loss that would result by the adoption of your two amendments.

Mr. HALL. I have it in reference to my own particular company. I do not have the industry estimate, but I believe that was put in the record yesterday, if I am not mistaken.

The CHAIRMAN. Are there any questions?

Senator KERR. I would like to have it for your particular company.

Mr. HALL. I beg your pardon, sir?

Senator KERR. I would like to have the amount of reduction that would be in your tax liability for your company.

Mr. HALL. Yes, sir. Under H.R. 4245 as it currently stands, our tax would be approximately $827,000. Taking amendment No. 1 alone, our tax would be reduced to $717,000, or a reduction of approximately $110,000.

Taking amendment No. 2 alone, our tax would be $737,000 approximately, a reduction of about $90,000 below the H.R. 4245 base as it currently stands.

And taking the combination of amendments Nos. 1 and 2, as suggested on the original base, we would have a tax of $682,000, or a total reduction of about $145,000 in our total tax.

The CHAIRMAN. What tax did you pay last year?

Mr. HALL. That we paid last year?

The CHAIRMAN. How does this figure compare with the taxes you paid last year?

Mr. HALL. The tax that we paid on 1957 income was $492,000. On the basis of the stopgap law, our tax in 1958 income would have been approximately $540,000.

The CHAIRMAN. What would it be under the 1942 formula?

Mr. HALL. Under the 1942 basis, sir, approximately $910,000.

Senator KERR. Mr. Hall, you addressed a good deal of your statement to your position toward tax treatment on so-called policyholders' dividends. I mean that is just an introductory premise. What do you call those payments to policyholders, dividends or cash adjustment, what is the terminology that you use?

Mr. HALL. The usual terminology, and that used by my company, is the terminology of a dividend, which is treated as a refund of an excess premium collected at the beginning of the policy years.

Senator KERR. Now, is that currently regarded as taxable either in the hands of the company or in the hands of the policyholder after he receives it?

Mr. HALL. No, sir; and the Federal income tax law so recognizes.

Senator KERR. If H.R. 4245 as written becomes a law, would you say that one effect of it would be to establish the policy that that payment was in whole or in part income to the policyholder——

Mr. HALL. Yes, sir.

Senator KERR. Or to the insurance company?

Mr. HALL. Well, it would be a tax upon the insurance company, but certainly indirectly upon the policyholders because they are the only persons affected in a mutual company.

As I indicated before, we were disallowed the dividend payment under phase 1 to the extent of $350,000, and that thereby increased our tax by approximately $180,000.

Senator KERR. Here is the thought that comes to me.

If the Federal Government, by pasing a law, thus identifies certain moneys as taxable income, how could they be consistent without applying the tax to all of the income which is identical in character?

Mr. HALL. It probably could not maintain consistency unless so doing.

Senator KERR. You request amendment to the law that would, in effect, free half of this income from taxation.

Mr. HALL. That is correct, sir.

Senator KERR. It would seem to me that the correct approach would be if the Federal Government has discovered some income that should be taxable as income, it should apply to all of such income, no more and no less, and that the burden should be assumed by somebody of identifying what part, if any, even though it might be all of such income, as taxable income.

Mr. HALL. If I understand your question, Senator, it probably leads to a consideration of whether or not there was some interest element in the payment of a dividend. And if that be the fact, I think it is incumbent upon someone to ascertain what portion of that dividend payment is interest and therefore taxable.

Senator KERR. That is almost what I am trying to say. The thought that comes to me is this:

How long have these so-called dividends been paid by mutual companies to their policyholders?

Mr. HALL. Well, I think since about 1862 or 1863, as I recall.

Senator KERR. Somebody told me here that these mutual companies had been in operation for 200 years. Has it taken them that long to get a premium high enough and a position profitable enough to where they could make an adjustment of the redundant premium? That is another term that I have learned. [Laughter.]

Mr. HALL. I have heard that, too, but not being an actuary, I have not comprehended its full significance.

Senator KERR. It would seem to me that an income or a payment of money in a classification which for even a hundred years had been regarded as a refund of excess premiums, regardless of whether it is called a dividend or what it might be called, would be of such significance that if a change is to be made in tax policy with reference to it, it could consistently be done only on the basis that all or part of it is income taxable, taxable income similar to other taxable income, and that if that decision is made and that policy instituted, it should be done very carefully so as to include first all of that payment, which is taxable income, but certainly no more of it than the portion which would be so identified.

Mr. HALL. That is correct, sir. I think an illustration might be made as between the difference of taxes between a stock and a mutual company.

In a mutual company you have some extra margins in there that have been collected on the premiums, and with an earning rate, let's say, of 3.9, an actual earning rate in my company before taxes, that would be about 3.9 percent of the dividend which was paid out that year.

I think that is a relatively small amount, and we are only asking for a crediting of 50 percent of these dividends, which certainly leaves considerable margin for any other interest element that might be found under other less frequent circumstances to exist in a dividend payment.

Senator KERR. It would seem to me if there is a basis to tax part of that money in the hands of the insurance company, because of the fact that it is earnings instead of a rebate or a refund, there would be an equal basis to tax any part of it that would still be going into the hands of the policyholder that would be earned income rather than a rebate or a refund.

Mr. HALL. I suppose if the company is taxed we are in effect taxing the policyholder, and since dividends, as received by him are now recognized under the present income tax law as not being income to him, it would suffice to put the tax on a portion of the dividend payments upon the company rather than making him pay once directly and once indirectly.

Senator KERR. But if it is earned income, and for that reason should be taxed, and if a formula does not tax all of that money which is earned income in the hands of the corporation, it still has to some degree to be earned income when it gets to the policyholder, does it not?

Mr. HALL. On that premise; yes, sir.

Senator KERR. So that if the Treasury or the Congress has found some income which is earned income and not a refund, it would seem to me that it should not only be taxed in the hands of the corporation, but the residue which finds its way into the hands of the policyholder should likewise be taxed to him.

If the stock company has an earned income, it pays a corporate tax on it, or is presumed to do so, both under existing law and under this bill. Well, then, whatever residue it has left of earned income after taxes, it passes on to its stockholders, which to them is earned income, and is taxable in their hands.

Mr. HALL. To that I agree, Senator. I think that if the interest element or what we call taxable income is found in the hands of the company, that should be taxed, and as it is passed along to the policyholder——

Senator KERR. Whatever the residue might be, if you pass it on to your policyholders, if it is income in your hands, it looks to me like it would have to be income in his hands for whatever part of it was left.

Mr. HALL. That segment that is treated as income by the company should be treated as income to him.

Senator KERR. That is all.

The CHAIRMAN. Are there any further questions?

Senator CURTIS. I do have some questions.

A policyholder's dividend, what it amounts to is that the policyholder doesn't have to pay quite as much in his annual premium, is that true?

Mr. HALL. That is correct, sir.

Senator CURTIS. Now, if he doesn't have to pay, how could it be income to the company?

Mr. HALL. Only to the extent that a portion of the excess collected by a mutual company is retained at interest over the year, and at the end of the year the dividend is distributed to the policyholder.

I suppose you might consider there is interest on that excess collection which, in turn, is refunded.

Senator CURTIS. But if the premium is established at a certain figure, and the mutual company finds they can provide that protection by collecting less than that amount, how could the amount that they did not collect ever be income to the company?

Mr. HALL. It shouldn't be so treated, the excess as it is collected at the beginning of the year.

Senator CURTIS. If a stock company either because they have a high interest earnings or for any other reason collects a smaller premium than they otherwise might, it wouldn't be income, either, would it?

Mr. HALL. No, sir.

Senator CURTIS. If they would reduce their premium?

Mr. HALL. No, sir.

Senator CURTIS. I can see the basis for argument there on the interest element, but in the case of yout company, how much did you say that would be as applied to the dividend to the policyholder?

Mr. HALL. The disallowance was $350,000. The tax on that, therefore, was $180,000.

Senator CURTIS. My question was of a policyholder dividend paid by your company, what portion of it conceivably could be a result of interest earnings?

Mr. HALL. Well, the actual interest earnings of our own company before Federal taxes was 3.9, so I would say it was 3.9 or some part less than 4 percent.

Senator CURTIS. In other words, a policyholder dividend would be 96 percent price adjustment, is that what you mean?

Mr. HALL. In my own nontechnical terms, yes.

Senator CURTIS. That is what you contend?

Mr. HALL. That is what I mean.

Senator CURTIS. So your point is that regardless of just where you would fix the estimate of how much of it was price adjustment and how much of it was interest, that the fact that you are asking only for a 50-percent allowance for policyholder dividends in the offset against phase 1 income removes interest, from the controversy, does it not?

Mr. HALL. That is correct, once that factor has been ascertained.

Senator CURTIS. So on the basis of asking for a 50-percent offset, there is none of that that could be income to the company, is there, because you don't collect it?

Mr. HALL. That is correct.

Senator CURTIS. The policyholders' dividend, that is something that is ascertained on a long, long-term basis, is it not?

Mr. HALL. Generally it is ascertained and the reserves established, as explained to me, about a year in advance of its payment, and once the company has established a dividend level, unless there are certain economic factors of depression or bad economic times, the company is certainly very, very reluctant to cut its dividend scale.

Senator CURTIS. And while it isn't a contractual arrangement, it is established as a permanent thing and generally held there, isn't that so?

Mr. HALL. It certainly is a competitive arrangement.

Senator CURTIS. But your computation of your tax under phases 1 and 2 is on an annual basis, is it not?

Mr. HALL. That is correct, sir. And in declaring a dividend a year in advance, any new scale that might go in it would be rather difficult to anticipate, with too great precision, what our situation would be.

Senator CURTIS. If no negative is allowed, would it be possible for a company to owe a tax and have no profit?

Mr. HALL. And to have no profit, yes. Provided there was a part of that reduction that put it below, that was accountable by the fact that a dividend was paid.

Senator CURTIS. And the dividend paid—I realize it is a term that has been used; it is printed right on the policy receipts, and so on—in reality it is money that is not collected, isn't it?

Mr. HALL. That is true, I mean, if you follow the analysis through as between a mutual and a stock company.

Senator CURTIS. I am talking about a policyholder, it is money that he doesn't have to pay to the company, is it not?

Mr. HALL. That is right. It is an adjustment in price at the end of the year.

Senator CURTIS. I think you get in trouble when we artificially declare something income that isn't income.

Mr. HALL. That is true.
Senator CURTIS. If it is going to be an income tax.
Mr. HALL. That is true.
Senator CURTIS. And money that isn't collected certainly isn't income, and take any general business, speaking of other than the life insurance business, if one competitor determines his costs to the customer in one step, and another competitor takes two steps, and has a first price and then a final price that he sets also, it is the final price that determines what the taxpayer receives, isn't it?
Mr. HALL. That is correct, sir.
Senator CURTIS. That is all, Mr. Chairman.
Senator COTTON. Mr. Chairman, on that point, and this may be drawing too fine a distinction, I would like your reaction to this:
Suppose I have a policy with a mutual company. I believe that in most cases I can indicate when I purchase that policy, or at some subsequent time, whether I want any dividends that accrue to me under that policy to be used to reduce my future premiums or whether I want them used to accumulate and to purchase additional paid-up insurance, is that right?
Mr. HALL. That is right, sir.
Senator COTTON. Now, might there be a distinction taxwise in trying to determine whether the dividend paid to a policyholder by a mutual company is income or as a refunding of an overpaid premium? Might the tax situation be affected by whether the dividend was used to reduce future premiums or whether it was used to purchase additional insurance for the policyholder?
Mr. HALL. Well, to the extent of the price reduction, 100 percent of the price reduction, it looks as though it is simply a discounting and thereby lowering the price, and probably the policyholder looks forward to paying instead of a $60 premium, the premium minus the dividend, the net amount being, let's say, $55.
Senator COTTON. My point is just this, and perhaps I am drawing too fine a distinction:
I have a policy, and I am entitled to a dividend this year. While I do not actually receive it, I am informed that I paid more for my policy this year than was necessary to retain it. Therefore it will be necessary to reduce my premium next year. Certainly that is an adjustment, clearly an adjustment of premium. It couldn't be considered anything else, right?
Mr. HALL. That seems to be an adjustment of premium.
Senator COTTON. And it could not be income?
Mr. HALL. That is right.
Senator COTTON. But on the other hand, because of my election, I am notified that I am entitled to so much dividend this year. It is being used by me to purchase additional paid-up insurance. Looking at it taxwise, might that not be considered income?
Mr. HALL. That could not be considered income, not any portion of it, sir.
Senator CURTIS. Would the Senator yield at that point?
Senator COTTON. Certainly.
Senator CURTIS. Doesn't the liability of the company increase, then, to pay a greater sum for that additional insurance? If he takes money from any source and buys additional insurance, you have in-

creased the liability of the company to pay a greater sum to somebody.

Mr. HALL. That is true.

Senator KERR. Would the Senator yield?

Senator CURTIS. So what you are doing, you are taking your price adjustment to buy more goods. It doesn't change the nature of the price adjustment.

Senator COTTON. So Senator Curtis' point, as I understand it, is this: It may be income to the policyholder, but it still isn't income to the insurance company.

Senator CURTIS. That is not my position. My position is that the liability of the company becomes greater and you just purchase a bigger policy, is all. But the element of whether or not it is income or price adjustment doesn't change.

Mr. HALL. I think that is probably true, sir.

Senator KERR. Will the Senator yield?

Senator COTTON. Yes.

Senator KERR. If I understand these contracts, the insurance company isn't the one that determines what is done with that dividend after it has been found to be due to the policyholder, is it?

Mr. HALL. No; that is at the election of the policyholder, sir.

Senator KERR. So whatever he does with that money does not determine its character?

Mr. HALL. That is true.

Senator KERR. If it is his money, he has the right to elect to receive it either in cash or usually to apply it on the purchase of additional insurance, or to reduce current premium, or to leave it there for accumulation with interest.

Mr. HALL. Generally, those are the four options.

Senator KERR. But it is determined first to be his money.

Mr. HALL. That is right, and I mean——

Senator KERR. The manner in which he uses it would not fix its character, but merely be the result of his exercise of his option to determine what is done with it.

Mr. HALL. That is correct, sir. I think the disposition that he chooses to make under his option is available to him——

Senator KERR. And does not——

Mr. HALL. Would not alter the character.

Senator KERR. And does not change the character of the funds.

Mr. HALL. No, sir.

The CHAIRMAN. Are there any further questions?

Senator COTTON. No further questions. Thank you, Mr. Chairman.

Mr. HALL. Thank you.

The CHAIRMAN. The next witness is Dr. Roy Moor of Williams College, Williamstown, Mass.

## STATEMENT OF ROY E. MOOR, PROFESSOR OF ECONOMICS, WILLIAMS COLLEGE, WILLIAMSTOWN, MASS.

Mr. MOOR. Mr. Chairman and members of the committee, my name is Roy E. Moor and I am a professor of economics at Williams College. For several years, I have been interested in the subject of the Federal income taxation of life insurance companies, and thought it might be useful to you to have the comments of someone who is not associated with the life insurance industry.

Most of the witnesses who have appeared before you on H.R. 4245 have taken the position that this bill represents a significant improvement over prior law. I agree with that conclusion, although there are several modifications that might be made in the bill. A number of changes have been suggested by other witnesses, and I would like to address my remarks primarily to two of these proposed changes.

*A 5-year average earnings rate in computing reserve additions*

The most frequent suggestion has been for a reserve deduction based on the average rate of earnings obtained by each company during the 5 years up to the taxable year. In other words, instead of using for tax purposes the actual reserve rate employed by each company—typically 2½ percent for large mutual companies and 3 percent for small stock companies—it is proposed that the rate of return on investments, which varies considerably but is now probably about 4 percent on a per company average basis, be used in computing the reserve deduction.

To analyze the effects of this suggested change, it is necessary to examine the method used by the companies in establishing reserves. Life insurance reserves are built up from two sources: premiums and investment income. The additions to reserves from these two sources are interrelated. For example, if an individual has an ordinary life policy with a face value of $1,000, any company will gradually increase the aggregate reserve against this policy so that, if the policyholder lives to be 100, the reserve will be $1,000. However, a small stock company would probably compound its reserve at 3 percent and a large mutual company at 2½ percent. In this case, the stock company would add lesser amounts to reserves from premiums, its aggregate reserves would be lower, but they would be compounded more rapidly from investment income. Hence, when a policyholder is at age 100, the stock company would have the same $1,000 reserve as the mutual company which added more to reserves from premiums, had higher reserves, but compounded them by adding lesser amounts from investment income. The proposed change in H.R. 4245 relates only to the deduction for additions to reserves from investment income.

Under H.R. 4245 in its present form, the deduction for additions to reserves from investment income would be determined in the following way. There is a table on page 3, by the way, that you might follow as we go through this.

A company would normally compute the average of its own reserve rate, for example, 2½ percent or 3 percent, and its earnings rate, for example, 4 percent. Alternatively, in order to obtain a higher average rate, a company may substitute the average reserve rate in the industry, that is, between 2½ and 3 percent, for its own reserve rate. Since the earnings rate will almost invariably be above the reserve rate used, the effect under the bill is to permit a higher reserve rate for tax purposes than the companies actually use. It is recognized that the higher the reserve rate, the lower the accumulated reserve base to which the rate is applied. Therefore, the bill provides a general rule that the actual reserves of a company must be reduced 10 percent for every 1 percent increase in the reserve rate.

An example of the application of this rule is provided in table 1.

If I may interpolate for a minute, if you assume a company had an earnings rate of 4.5 percent and they use the actual rate as indicated in the table of 2.5 percent, then the difference between the two would be 3.5 percent, and you can see the effect on the reserves to which that rate would be applied and also the addition to reserves as a result of the bill as it is suggested.

If the earnings rate figure alone is adopted, you could add another line on that table which would show 4.5 percent, the reserves would be reduced to $800,000, and the addition to reserves would be $36,000 rather than $31,500.

TABLE 1

| | Reserve rate | Reserves | Addition to reserves |
|---|---|---|---|
| Actual | 2½ percent | $1,000,000 | $25,000 |
| For tax purposes | 3½ percent | 900,000 | 31,500 |

It is evident that, under this adjustment, reserves are never reduced proportionately as much as rates are increased. Hence, the tax deduction for additions to reserves from investment income will always be greater than the actual amount which a company adds to reserves. In effect, all companies will be able, under the bill as it now stands, to deduct as an investment expense more than they actually incur as an investment expense.

The new proposal would raise the reserve rate for tax purposes even further by ignoring a company's actual reserve rate and basing the reserve rate for tax purposes entirely on a company's earnings rate, either for the current year or for the 5 years up to the current year. The reserve base would be reduced somewhat more as a result of the futher increase in rate, but the net effect would be a greater inflation of the tax deduction. The suggested change has been justified on several grounds by the companies.

1. Conservative companies will be hurt relatively under the bill in its present form.

A conservative company is presumably one which assumes a lower interest rate, and therefore has higher present reserves against policy claims. Actually, under H.R. 4245 as it now stands, a conservative company will already obtain two net advantages by comparison to less conservative companies:

(*a*) Since its reserve rate is below the industry average rate, 2.5 percent instead of 2.75 percent, it can substitute the latter rate in determining its reserve rate for tax purposes. In effect, therefore, the conservative company does not use its own actual reserve rate at all and is able to inflate its reserve rate for tax purposes solely because less conservative companies exist which serve to raise the industry's average rate. Moreover, the conservative company will have, even after the 10 for 1 adjustment, a higher reserve base against which to apply this inflated rate than will the less conservative campany.

A second way that a less conservative company benefits is that under step 2 of the bill, companies will be able to deduct, in effect, all of their actual additions to reserves from premiums. The conservative company adds more to reserves from premiums than a less conservative company, and therefore gets a larger deduction.

The second justification for the proposal is that an actual rate should be used rather than an artificial one.

Yet the rate which is proposed is not an actual rate, but rather an average rate. More importantly, the earnings rate is completely unrelated to reserves. It will be determined by such factors as the investment returns on railroad bonds, A.T. & T. stock, and Government securities. Finally, the base to which the rate would be applied is wholly artificial, based on the 10 for 1 ratio, and hence the tax deduction would be artificial. For example, under the proposal, if the earnings rate of a company rises, this fact alone will mean an increase in the reserve deduction even though the company may have actually added less to reserves than in a previous year.

A third justification for the proposal is that management decisions should not be allowed to affect tax liabilities.

It is difficult to understand this reason, since management decisions do affect tax liabilities throughout four tax laws. Any businessman is derelict in his responsibilities if he does not consider tax consequences. If the insurance companies and the State insurance commissioners decide that certain additions to reserves are adequate, these should probably be considered adequate for tax purposes. However, it should also be noted that under H.R. 4245 in its present form, management decisions with respect to reserves will affect tax liabilities only partially at most and not at all in many cases. The reason for this is that management decisions are reflected only in the actual reserve rate. Yet this rate is averaged with the earnings rate and may be entirely replaced by the industry average rate.

The second proposal that has been advanced before you, is application of policyholder dividends against taxable investment income.

This concerns the treatment of dividend to policyholders.

Under the bill, taxable investment income is determined in the manner described above. Then, in effect, all profits from underwriting and other sources are determined by subtracting the taxable investment income from the total profits shown in the books of the companies. These total profits are before dividends to policyholders.

Incidentally, there is another table on the next page which is perhaps easier to follow in this respect. You take total investment income and subtract it from total profits before payment to policyholders.

Then a full deduction is allowed against underwriting profits for dividends to policyholders. Finally, the remaining underwriting profits are divided in half, and one-half is added to the tax base. An example of these computations is provided in table 2.

TABLE 2

| | | |
|---|---|---|
| 1. | Total profits, as shown in a company's books, before dividends to policyholders | $1,000,000 |
| 2. | Taxable investment income | 300,000 |
| 3. | Total profits from underwriting, before policy dividends | 700,000 |
| 4. | Dividends to policyholders | 500,000 |
| 5. | Total underwriting profits after policy dividends | 200,000 |
| 6. | Underwriting profits subject to tax (one-half of line 5) | 100,000 |
| 7. | Taxable investment income | 300,000 |
| 8. | Total tax base | 400,000 |

Several of the largest companies have indicated dissatisfaction with this treatment. The reason for their complaint is that they may wish to distribute dividends to policyholders in excess of the computed total profits from underwriting, for example, the $700,000 in table 2. To follow out the hypothetical case in table 2, a company might wish to distribute $800,000 in dividends. This would be $100,000 more than the computed underwriting profits. Under H.R. 4245 in its present form, the company could, in this case, deduct $700,000 in dividends but could not deduct the additional $100,000 against taxable investment income. The large mutual companies would like to amend the bill in order to deduct at least some portion of this $100,000.

Several reasons are given in support of this proposed change:

1. Dividends to policyholders are entirely price rebates. It should be noted initially that the bill in its present form assumes that dividends are price rebates up to the entire amount of net premium income, that is, all profits stemming from premiums can be distributed back to policyholders taxfree. Therefore, the only question is whether policyholders dividends drawn from investment income are price rebates. The answer seems to be clearly in the negative because the policyholders do not provide the income from which these dividends are drawn. The source of the dividends is income from third parties. In effect, the dividends are a return on an investment by the policyholders, exactly like a cash dividend to a stockholder in an investment trust. The policyholders are not taxed on these investment returns and, therefore, it seems reasonable that the investment income be taxed at the company level.

The second justification for the proposal is that the entire amount of dividends to policyholders are necessary expenses that the companies are required to return to policyholders undiminished by taxes.

No evidence has been presented before this committee that the companies are required by any law or contract to distribute certain dividends undiminished by taxes and it seems clear that there are no such requirements.

A third justification is that taxation of investment income without reduction for dividends to policyholders will discriminate against those companies issuing participating policies.

This statement would be true if it applied to dividends drawn from premiums, since premiums on participating policies are higher than on nonpar policies. But dividends related to premium income are fully deductible under the present bill. In other words, to the extent that premiums are inflated in anticipation of policy dividends, a dollar-for-dollar reduction in taxable income can be made as dividends are distributed. Also, under H.R. 4245, the net investment income of both companies on a participating and on a nonparticipating basis are taxed alike. Hence, there is no discrimination. The only circumstance under which discrimination could occur with the present bill is if investment income were consistently at a different level for participating companies than it is for nonparticipating companies. This circumstance does not exist. Moreover, the proposed change would create a discrimination in favor of a few large participating companies, because these companies could obtain a deduction against investment income not obtainable by other companies.

Mr. Chairman, I recognize that the questions involved in H.R. 4245 are extremely complex. I can only suggest in conclusion that, if the two proposals I have discussed are adopted, the bill will not prove to be permanent legislation and within a very short time the same questions will be back in this committee room to plague you again.

The CHAIRMAN. Thank you, Dr. Moor. Are there any questions?

Senator CURTIS. I have one question.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. On page 6 you say the large mutual companies would like to amend the bill.

Is it your contention that there are no small mutuals wanting this?

Mr. MOOR. No; the only reason I said that was because the testimony I had heard earlier, it was the larger companies that were presenting it. I frankly don't know what companies would support it.

Senator CURTIS. That is all.

Senator KERR. Dr. Moor, did you say where Williams College is located?

Mr. MOOR. Northwest corner of Massachusetts, right in the heart of the Berkshires.

Senator KERR. Northwest corner of Massachusetts. Is there a town there?

Mr. MOOR. Yes, sir; there is, although the college dominates it. But don't put that in the record. [Laughter.]

The CHAIRMAN. Dr. Lent, you may proceed.

## STATEMENT OF GEORGE E. LENT, PROFESSOR OF BUSINESS ECONOMICS, DARTMOUTH COLLEGE, HANOVER, N.H.

Mr. LENT. My name is George E. Lent, and I am professor of business economics at the Amos Tuck School of Business Administration, Dartmouth College.

I am glad to have this opportunity to present my views on the so-called permanent formula for the taxation of life insurance companies. I speak as a policyholder and taxpayer and represent only myself. I am also an economist and have had tax-analysis experience in the Treasury Department and elsewhere including work in life insurance taxation.

I should like to clarify, if possible, some of the principal issues raised by the life insurance tax bill:

### GENERAL

*Is the tax rise too steep?*

This bill would increase 1958 insurance company taxes 70 percent over the 1955 formula from $319 million to $545 million. Although the House bill makes a major breakthrough in taxing underwriting income for the first time since 1921, only $40 million of the tax increase is attributable to this source. The net increase in taxes on net investment income is, therefore, $186 million, an increase of 58 percent.

This is simply a measure of the expanding free investment income which has accompanied rising interest rates. Whereas free investment income averaged about 15 percent of net investment income when the 1955 formula was adopted, it is now estimated at about 25 percent—an increase of about two-thirds. The bill, therefore, calls for a tax increase in this respect that is consistent with the higher free investment income. Incidentally, the tax from this source would be approximately the same as under the 1942 formula.

The taxation of so-called underwriting income under phase 2 is, of course, long overdue.

*Is the $500 million revenue goal a reasonable objective?*

The Treasury objective of $500 million obviously is an arbitrary round figure used for budgetary purposes and should not dictate the formula used for tax liabilities in 1958 or any other year. The tax formula adopted should be guided by generally accepted tax principles that will require the insurance business to pay its fair share of the cost of government without impairing its own financial soundness.

*What should be the objectives of life insurance tax policy?*

I believe that equitable tax treatment of life insurance should be guided by the following objectives:

(*a*) Substantial parity of taxation with savings income from competing sources.

(*b*) Substantial equality with the tax treatment of income from competing lines of business.

(*c*) Preservation of competition between different forms of organization such as mutual and stock companies.

(*d*) Substantial equality of tax treatment of profits realized by life insurance companies and other businesses operated for a profit.

(*e*) Tax parity among insurance companies that follow different policies with respect to interest, reserves, and other matters.

PHASE 1—NET INVESTMENT INCOME

*Does the present bill discriminate against income from insurance savings?*

Proceeds of policies paid at death are specifically exempted from income tax. Therefore, under present law, the interest income earned by a policyholder on his life insurance savings would escape Federal taxation if the life insurance company itself were not taxed.

Net investment income is the only proper measure of policyholders' taxable income that is generated by life insurance companies. For 1958, the bill provides for the taxation at only 25 percent of this income at the corporate tax rate of 52 percent. The effective tax rate on net investment income, therefore, would average only 13 percent. This contrasts with Federal income tax rates of up to 91 percent on income from other forms of investment, including interest on deposits in mutual savings banks, savings and loan associations, Government bonds, and other investments.

Federal income taxes are properly levied independently of State taxes, but generally allow a deduction for them in calculating taxable income. This is the case of State taxes on insurance. Moreover, these State taxes are assessed on premiums as a form of excise tax and do not apply to interest income taxed by the Federal Government.

*Does the bill threaten the solvency of life insurance companies?*

A life insurance company's business is essentialy involved with the issuance of long-term contracts. Its liabilities consist of fixed monetary obligations under these contracts that are unaffected by price-level changes. The policyholder has a relatively fixed commitment to pay premiums or default on his insurance policy. Funds, therefore, flow into the insurance company with great regularity. Expenses tend to follow broad trends rather than fluctuating widely from year to year. In the words of Haughton Bell, vice president of the Mutual Life Insurance Co. of New York:

It is * * * fair to say that, from a financial standpoint, probably the outstanding characteristics of life insurance companies as a class are the long-term nature of the business and the regularity and evenness of the flow of funds in and out of the companies.

In the last 50 years, there have been only two periods of abnormal demands on insurance companies: the "flu" epidemic of 1918 and the wave of policy loans and surrenders that occurred during the great depression. But even in these two periods, the inflow of funds was more than sufficient to offset the outgo. For example, in the worst year, 1933, the cash receipts of 45 large companies were approximately double their cash disbursements for that year. It is possible, of course, that some smaller inadequately financed companies may find themselves in difficulties. But the greatly increased role of the Government in the Nation's economy since the 1930's virtually precludes the recurrence of another great depression.

It has also been claimed that adverse market conditions impair company surpluses. This is largely a bookkeeping matter. Since the life insurance business is involved with long-term contracts, temporary declines in the market value of their securities—reflected in a writedown of assets and surplus—do not affect their ability to meet liabilities. Although writedowns in the value of their corporate securities averaged as high as 5 percent during the great depression, actual losses were in the neighborhood of only 2 percent. Declines in the market value of Government securities are of significance only if a company is being liquidated.

*Does the bill give proper recognition to tax-exempt income?*

The bill completely excludes tax-exempt income from net investment income. However, in allowing a reduction from net investment income for interest on policyholders' reserves, it reduces this deduction by an appropriate amount of tax-exempt income already excluded. The net effect of this adjustment is to prevent a double deduction for tax-exempt income.

Since the interest deduction averages about 75 percent of net investment income, about 25 percent of all income is subject to tax as free investment income. Interest on State and local obligations is, therefore, exempt from the average 13 percent effective tax rate to which all other income is subject (25 percent times 52 percent).

This rate of 13 percent is almost double the 7.8 percent effective rate under the 1955 bill. Life insurance companies would, therefore, receive an increased premium on municipal securities already owned. Moreover, contrary to claims, they would be given an even greater incentive than they have had to buy tax-exempt securities in the future.

In time, a double deduction for tax-exempt interest would seriously undermine Federal income taxes from this source. A 52 percent corporate tax rate would give insurance companies a tremendous incentive to buy tax exempts and make it possible for companies to escape Federal taxes entirely. They now own about $2.7 billion out of about

$60 billion State and local obligations outstanding and could readily increase their holdings to the point where such income equals 25 percent or so of their net investment income. Some companies are already near this point.

Contrary to many statements, the Supreme Court has not ruled on the constitutionality of Federal taxation of State and local obligations since the income tax amendment was adopted in 1913. This was in the Pollock decision of 1894. (The National Life Insurance Co. case was not decided on this point.)

In recent years, the Supreme Court has shown a disposition to remove intergovernmental tax immunities, so long as no discrimination is involved. (See, for example, *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938).)

In fact the present treatment is consistent with the treatment of tax-exempt interest since 1942, and the companies have not challenged it.

Allowance of a double deduction would greatly disrupt the insurance company market for U.S. Government bonds, which has only recently been stabilized at around $7.8 billion. At a full 52-percent tax rate, the companies would shift out of Governments and corporate securities in favor of municipals. This was the experience following the National Life Insurance Co. decision and has been the recent experience of fire and casualty insurance companies.

*Does the tax on investment income preserve competition between mutual and stock companies?*

Both stock and mutual companies are taxed on all their free investment income. Here the basic question is whether investment income distributed by mutuals to policyholders as dividends should not properly be included in the tax base.

As indicated above, the inclusion of all free investment income, before reduction by dividends, is essential to reach fully interest that would otherwise escape tax in the hands of policyholders.

But the full inclusion of such investment income is also essential to the equalization of tax on stock and mutual companies. As shown in the report of the Ways and Means Committee, the treatment accorded policyholder dividends greatly influences the distribution of the total tax burden between mutuals and stock companies. If the tax were limited to gains from operations (including net investment income) after dividends, the stock companies would pay approximately 42 percent of the total tax. On the other hand, largely because of the bill's treatment of investment income and policyholder dividends, the stock companies will pay an estimated 28 percent of the total tax.

PHASE 2—UNDERWRITING GAINS

The second step is intended to reach underwriting gains with an estimated tax of $40 million for 1958.

*Is the tax on underwriting gains adequate?*

Since stock companies are estimated to pay a tax of only $28 million under this phase, it seems apparent that the new formula does not fully reach their underwriting income. This conclusion could be confirmed by a company-by-company comparison of tax liabilities in relationship to gains. Because of their dividend policies and the tax treatment of net investment income, mutual companies cannot be expected to pay much tax under this provision.

Two major weaknesses of this provision explain the inadequate tax on stock companies. One is the fact that only one-half of underwriting gains are subject to tax. The other is the special deduction equal to 10 percent of the annual increase in reserves on nonparticipating policies (other than group and annuity).

*Why should underwriting gains be taxed?*

Since 1921, underwriting profits of stock companies have been completely exempt from taxation. In this respect, they have been unique among all corporations operated for a profit.

Partly because of substantial increases in mortality gains, the owners of insurance companies have enjoyed a rise in the value of their stocks almost without parallel. For example, the stocks of 19 companies included in a recent survey showed an aggregate appreciation of more than 10 times since 1948, with most of the gain realized prior to 1956 (The First Boston Corp., Data on Selected Life Insurance Stocks (1958)).

Underwriting gains have come into increased prominence with the rapid development of short-term contracts involving little or no reserves. For example, group and credit life insurance in force has increased from about 13 percent of total insurance in force in 1940 to about 34 percent in 1957. Their relative freedom from taxation has undoubtedly stimulated the development of these low-reserve forms of insurance, and many specialty companies such as those selling credit life insurance have been formed to take advantage of their tax exemption.

*Does the taxation of underwriting gains penalize stock companies?*

Some stock companies maintain that taxation of their profits places them at a competitive disadvantage with respect to mutuals. This allegation cannot be supported in theory or practice.

The profits of the insurance business, as of any business, represent the excess of income over costs. If stock companies were not successfully competing with mutual companies, they would not be able to realize the substantial profits earned in the past. A tax on their profits (or gains) would impinge only on the excess of revenue over policy costs and not on the cost of insurance itself. The incidence of the tax on underwriting gains, therefore, would be on stockholders and not on policyholders.

Taxation of stock company gains would close an important tax gap and place investment in the insurance business on the same competitive level with banks and other competing types of business.

*What is the justification for taxing only one-half underwriting gains?*

A 50-percent reduction of underwriting gains is made because of the claim that it is difficult to establish the annual income of life insurance companies with certainty.

This view conflicts with the high degree of predictability that lies at the heart of life insurance. The fundamental basis for this certainty is well stated by Haughton Bell:

> There has been a vast amount of statistical material accumulated and tabulated on mortality and morbidity expectancy for every age, physical condition, and

occupation, and on other demands such as for loans and cash values. In actual experience, this material has proved so reliable that it fully supports the view that unless some major catastrophe not heretofore experienced in this country should befall * * * liabilities will be incurred only within very regular and predictable patterns (Taxation of Life Insurance Companies, Committee on Ways and Means, House of Representatives, 1954, p. 205).

Moreover, short-term contracts permit considerable flexibility in the adjustment of rates to changing operating costs, investment yields, and mortality experience. This is particularly true of specialty insurance companies, that have been realizing such substantial profits. It is significant in this connection that profits of casualty insurance companies are taxed in full. Since life insurance companies write more than 80 percent of all health and accident insurance in the United States, preferential treatment of their underwriting profits from this source would not appear to be justified.

Incidentally, in this connection I would suggest that the definition of a life insurance company be reexamined. It is now based on the percentage of reserves of a company devoted to life insurance, and not on the basis of premiums, as I think it probably should be.

Finally, the tax laws permit taxable earnings to be averaged over a period of 9 years, with a 3-year carryback and a 5-year carryforward of operating losses. This provision should give adequate recognition to possible adverse years.

*What is the justification for tax-free additions to surplus?*

In addition to the taxation of only half their underwriting gains, stock companies are given a special deduction equal to 10 percent of their annual increase in reserves on nonparticipating policies (other than annuities and group insurance). According to the House report, this allowance is intended to provide a cushion against the fixed premium margin on nonparticipating policies similar to that available to mutual companies.

The effect of this provision is to permit stock companies to build up, tax free, surplus equal to 10 percent of their policy reserves, and thereby enable some companies virtually to escape tax on their profits. The unusual tax savings thereby made possible are not warranted by the nature of life insurance. The margin realized on insurance operations—or profits—should itself provide adequate financial protection, as in the case of other businesses.

Life insurance companies, in fact, have a built-in protection in the mortality tables used. The margin for protection is evidenced by the progressive reduction that has taken place in the death rate among policyholders due to rising living standards and medical advances. In the 1930's, for example, the average death rate was 7.5 per 1,000 policyholders; by the 1950's through 1957 the average death rate declined to 6.1 per 1,000, a reduction of about 19 percent. Continued improvement in life expectancy should continue to improve the odds on the risks assumed by life insurance companies.

## PHASE 3—TAX UPON DISTRIBUTION

Phase 3 provides that any income distributed to stockholders in 1959 and later years out of the untaxed portion of income subject to tax in phase 2 shall be subject to income tax. This income is also taxed if the cumulative amount exceeds 25 percent of reserves or 60 percent of premiums, whichever is higher.

*Is this provision realistic?*

This tax on distributed earnings will give a powerful incentive to retain rather than distribute earnings. Even under present law, stock companies generally follow conservative dividend policies. For example, in 1957 only 4 of 21 stock companies studied distributed more than one-third of their operating gains, after tax, and none distributed as much as one-half. The average distribution was 24 percent (First Boston Corp., op. cit.).

The limits established by the bill to "trigger off" the tax on undue retentions are generously high. And only in exceptional cases are they likely to be effective.

In view of the above considerations, I urge you to strengthen H.R. 4245 so the life insurance industry will contribute its fair share of the Federal Government's pressing revenue needs.

The CHAIRMAN. Thank you, Doctor.

Are there any questions?

Senator KERR. Where is Dartmouth College, Doctor?

Mr. LENT. Dartmouth is located in a quiet little town 5 miles above Lebanon, N.H., where Senator Cotton resides.

Senator KERR. Did you say a quiet little town where Senator Cotton resides? [Laughter.]

Thank you.

The CHAIRMAN. Are there any questions?

Senator COTTON. Mr. Chairman, I would not ask this question except for the fact that my name was brought into it, although I am happy to welcome my neighbor here to this hearing.

Doctor, in your statement where you are enumerating the objectives of life insurance tax policy, under (*b*) you say:

> Substantial equality of treatment of profits realized by life insurance companies and other businesses operated for profit.

You do not limit the other businesses to other forms of savings, such as savings banks and building and loan associations? You mean, as a public policy, that life insurance should be treated the same as all profit corporations?

Mr. LENT. My position is that they should be fully taxable on their net operating gains or profits on a comparable basis with other business corporations operated for a profit; yes, sir.

Senator COTTON. That is, you do not feel that in a society where we are seeking to encourage savings, where society as a whole has a certain stake in people providing for their dependents and providing for their old age, that there is at least some slight element of public policy involved in dealing with and encouraging this form of saving?

Mr. LENT. I am not at all sure this has any relevance to savings. When I speak of the profits of life insurance business, I am thinking of the profits of a stock company, the tax on which, of course, is on the stockholder's profits and not on the policyholder's savings.

Senator COTTON. So that on (*b*) on page 2, the flat statement that you make about substantial equality of tax treatment of profits, you had reference to stock companies rather than to all insurance companies?

Mr. LENT. That is correct, sir.

Senator COTTON. Just one other thing. I was interested—and probably other members of the committee who have been here longer than I have would not feel the need to have this elaborated on—by your interpolation about reexamining the definition of "life insurance."

Senator KERR. Of a life insurance company.

Senator COTTON. Of a life insurance company.

Would you care to explain a little more fully to me your suggestion?

Mr. LENT. I am not certain of the correct phrasing in the law, but generally companies operating life insurance business——

Senator KERR. Here is the definition in the bill, Doctor, if you would like to have it.

Mr. LENT. Let me read you the definition as it is now stated in section 801:

Life insurance company defined: For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts, or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves, plus

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

comprise more than 50 per centum of its total reserves.

In other words, if 50 percent or more of the reserves of a company consist of life insurance reserves and unearned premiums or noncancellable policies, it is classified as a life insurance company and taxed as a life insurance company rather than as some other business.

If it crossed over that line, let us say, and its total life insurance reserves were only 49 percent, it would be subject to tax like other corporations on its entire taxable profits.

Senator COTTON. Your suggestion to substitute would be, as you said, on a basis of premiums.

Mr. LENT. My suggestion is that the committee reexamine this definition and give consideration particularly to the classification on the basis of premiums paid.

Senator COTTON. Why? Why would that be a more logical and just test?

Mr. LENT. Well, relatively little reserves are involved in the issuance of many types of nonlife insurance policies such as cancellable accident, casualty, health, and so forth.

Some life insurance companies have a substantial amount of this business, and if they were a stock company and classified as a casualty business, they would be fully taxable on their corporate profits.

Now, with the development of short-term life insurance such as term, group life, credit life, and similar types of policies involving little or no reserves, I think that a more realistic measure for the classification of a life insurance company should be premiums, rather than reserves.

Senator COTTON. Just one more question. Would not the substitution of the formula you suggest have a tendency to remove an incentive that is now present to keep insurance companies sound and solid with sufficient reserves? Is there any danger of that changing?

Mr. LENT. I have stated my position on the soundness and solvency of life insurance companies in my statement.

I think that many companies are, perhaps, cloaking their other nonlife insurance operations with life insurance business for which they get special tax treatment.

Perhaps, ideally, we should separate out other types of business and tax them separately from their life insurance operations, and I think that the accounting methods of insurance companies today would permit that separation.

Senator COTTON. You have anticipated my next question. I was going to ask you if that would not, perhaps, be a better approach.

Thank you, Doctor. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Doctor.

Any further questions?

Senator COTTON. No.

The CHAIRMAN. The next witness is Mr. Vester T. Hughes of the American Life Insurance Co. of Alabama.

Senator KERR. Mr. Chairman, at this point, I would like to put in the record a copy of a letter which I addressed to a previous witness, Mr. Manton Eddy, vice president and secretary of the Connecticut General Life Insurance Co. of Bloomfield, Conn., and his answer.

(For reference to testimony of Mr. Eddy see p. 476.)

The CHAIRMAN. Without objection it may be inserted.

(The document referred to follows:)

MARCH 17, 1959.

Subject: Taxation of insured pension plans.

Mr. MANTON EDDY,
*Vice President and Secretary,*
*Connecticut General Life Insurance Co., Bloomfield, Conn.*

DEAR MR. EDDY: With reference to your testimony before the Senate Finance Committee this morning, I would appreciate it if you would submit in writing answers to the following questions:

(1) What interest rate does Connecticut General need to earn on its reserves?

(2) What interest rate did Connecticut General earn in 1958?

(3) What becomes of the difference between the interest you earned and the interest you had committed yourself to earn on your reserves?

(4) Suppose your company earned a profit under a pension plan. Would this profit be exempt from taxation under the terms of H.R. 4245?

I feel that the answer to the above questions will help complete the record in connection with this important phase of the bill and I would appreciate a response at your earliest convenience.

Sincerely yours,

ROBERT S. KERR.

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CONNECTICUT GENERAL LIFE INSURANCE CO.,
*Bloomfield, Conn., March 18, 1959.*

Hon. ROBERT S. KERR,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR KERR: I am glad to submit answers to your questions outlined in your letter of March 17.

(1) What interest rate does Connecticut General need to earn on its reserves?

The average rate of interest which Connecticut General has assumed under its insurance and annuity reserves is 2.6 percent.

(2) What interest rate did Connecticut General earn in 1958?

The rate of interest which Connecticut General earned in 1958 on its assets was 3.89 percent. This is the rate of interest earned after deducting all investment expenses but before paying the Federal income tax. We estimate that if H.R. 4245 is applicable to 1958 operations, the rate of interest earned after expenses and after taxes will be 3.28 percent.

(3) What becomes of the difference between the interest you earned and the interest you had committed yourself to earn on your reserves?

The interest we assume on our reserves is the amount of interest which must be added to our reserves for solvency purposes. However, in handling group pension funds we credit to the funds an amount of interest which is approximately the earned interest rate after taxes.

In 1956, Connecticut General earned on its assets an interest rate of 3.59 percent before taxes. The rate after taxes was 3.27 percent. We credited to our group pension funds that year 3.26 percent. If there had been no tax on the investment income of these pension funds, we would have credited approximately the full rate of 3.59 percent.

In 1957 Connecticut General earned on its assets an interest rate of 3.50 percent. The rate after taxes was 3.32 percent. We credited to our group pension funds that year 3.39 percent. If there had been no tax on the investment income of these pension funds, we would have credited approximately the full rate of 3.59 percent.

While we do not know the precise figures for 1958 it is clear that if the pension relief, as provided eventually under H.R. 4245, is made effective on an immediate basis for 1958, we will be able to and will credit to our group pension funds for 1958 an amount of interest approximately one-half of 1 percent greater than would be the case if the tax relief had not been granted.

(4) Suppose your company earned a profit under a pension plan. Would this profit be exempt from taxation under the terms of H.R. 4245?

If our company earns a profit under a pension plan this profit is included in the net operating gains that are subject to taxation under the terms of phase 2 and phase 3 of H.R. 4245.

I am at your disposal if I can be of further service.

Sincerely yours,

MANTON EDDY,
*Vice President and Secretary.*

The CHAIRMAN. You may proceed, Mr. Hughes.

## STATEMENT OF VESTER T. HUGHES, JR., REPRESENTING AMERICAN LIFE INSURANCE CO., BIRMINGHAM, ALA.

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

I am here representing American Life Insurance Co. of Birmingham, Ala. A majority of the stock of this company is owned by residents of the State of Texas.

I ask your permission, Mr. Chairman, to file the written statement which has been prepared in this matter, but I would like to summarize this statement, in the interest of time.

The CHAIRMAN. Without objection the entire statement will be inserted in the record.

Mr. HUGHES. American Life Insurance Co. is a relatively small stock company with approximately 740 shareholders most of whom live in the South or Southwest.

The company has approximately $24 million in assets.

In the year 1958 this company entered into a transaction which is somewhat unusual in life insurance business. For many years it had written what is commonly known as industrial insurance, that is insurance on which the premiums are collected weekly by agents.

It had between $80 million and $90 million of this weekly premium insurance, and during the course of the years had spent what is estimated to be $22 million in generating this business—puting it on the books.

Over and above the $22 million estimated to have been expended directly, there was some $3,200,000 which represented the reserve liability on this insurance.

I would like to say at this point, Mr. Chairman, that these figures are estimated because we had no reason to know the exact figures until the time of this bill. It was only a business matter.

Over against this we had premium income from such business estimated at about $18 million.

The business was transferred in four separate transactions to other companies interested in acquiring industrial business for a total consideration of $3,400,000.

This means that the loss that American realized in 1958 upon the closing of this transaction was approximately $3,800,000.

My reason for being here today is the lack of clarity of H.R. 4245 with regard to the tax treatment to be accorded such a transaction.

I am of the opinion that this sale should and will be treated as a capital transaction. It was a sale of an entire department, which included the sale of all of the policies, almost $90 million in the face amount, the sale of furniture and fixtures, the transfer of the personnel who carried on the industrial business, and the transfer of all the records relating to the business. For this reason it seems to me the transaction has all the earmarks of a capital transaction.

If that is the case under the bill as presently written there is no tax. And there is no deduction for the loss incurred.

On the other hand, because of the new concepts relating to income and in particular to capital gains transactions, contained in various parts of the bill—I am referring particularly to section 802 and to subsections (a), (b), and (c) of 817—we think there is some possibility that this bill might be interpreted to give rise to an income tax.

Thus if the transaction were not treated as a capital transaction, the tax would come about as follows—there would be income to the extent that reserve requirements were decreased—we transferred our policies, and the reserves covering the policies were no longer required; there would be a corresponding and offsetting deduction to the extent of assets which were transferred—since assets equal to these reserves were in effect transferred, this would be an offset; but in addition to this, as I have stated before, we received $3,400,000.

Thus, if this transaction were taxable, it would generate a tax of roughly $884,000.

On the other hand, as I have stated before, we estimate our loss to be $3,800,000. We think that it is inconceivable that under the tax laws there should be some doubt that a transaction giving rise to a loss of almost $4 million would generate a tax of $884,000.

To show you how important that is to our particular company, a tax of that magnitude would be roughly, not quite, 4 percent of our total assets.

You gentlemen may be wondering what can be done about this matter or what caused it. If this possible interpretation of the statute were adopted, and the transaction did give rise to ordinary income, it would be the result of the whole approach of the bill in changing the accounting principles which relate to the taxation of life insurance companies.

As to the specific solution, we have set out five possibilities in the prepared statement which has been made part of the record, and suggest those for your consideration, depending upon how far the committee cares to go into this general subject of the transfer of an entire life department or of the transfer of the policy itself. Of course, this is a relatively rare type of transaction.

The first of the possible methods of treatment suggested is to make it clear in the bill that a 1958 transaction of this kind does not give rise to a tax. It would leave the matter open for future years.

As I say, in the future I think it probably will be interpreted to give rise to the treatment accorded a capital transaction.

The second possibility is to make it clear that any such transaction as this gives rise to capital gains treatment in the future, as well as for the year 1958.

The third possibility is to state that it gives rise to no tax, but to allow a capital loss carryover. We did actually realize a loss estimated to be $3,800,000.

The fourth possibility is to take the approach of operations income and give an operations deduction. This, of course, we would like, because it would give us a deduction or operations loss carryover, of some $3,800,000, but we realize the practical difficulties of going back into the records and reconstructing the expenses that were incurred in putting the business on the books.

The fifth alternative would be to treat it as an operations item but allow a deduction only up to the extent of any income which would be generated on the corresponding income side of the transaction.

Whichever of these possible approaches the committee might see fit to take, of course, depends, as I said before, on how much detail the committee wants to go into with respect to the matter of what happens, not when you reinsure in the sense of reinsurance ceding, not when you split risks, but when you dispose of entire policies or when you dispose of an entire department.

In this regard, I would like to suggest that the report, at least—perhaps the bill itself—clarify the definition of "reinsurance ceded", and of "assumption reinsurance."

The House report indicates that when the term "reinsurance ceded" is used, you are speaking only of risk splitting.

However, for certain life insurance purposes, a transaction of this kind might be called reinsurance ceding, although under the House report, the drafters of the bill would have called the sale of a life insurance contract—complete disposition of it—assumption reinsurance.

What I am asking of this committee on behalf of American Life is an amendment that will at least make it clear that a transaction like the one American entered into in 1958 does not cause a tax.

The sale of a life insurance department would not have caused the imposition of a tax under the 1942 act. It would not have resulted in a tax under the stopgap rules.

So far as we know, nothing had been proposed at that time of sale which would indicate that a sale of this kind would generate a tax.

It is indeed a bizarre result when a transaction that causes a loss of almost $4 million could cause a tax of almost $900,000.

We have in our prepared statement suggested additional language for one of the subsections of section 802 of H.R. 4245.

Our suggested addition would only make it clear that a sale of life insurance, whether a department or a policy, during the year 1958 does not give rise to a tax.

After all, this was a business decision that was entered into without reference to the tax consequences, because under the tax laws, at least the tax laws we knew of, there would have been no tax. With respect to future transactions, the proposed amendment would leave that open; it would leave the same doubt.

I believe that your staff will agree with me that the matter is not clear. As stated before, if H.R. 4245 is not changed and the assertion were made that we owe a tax as a result of this transaction—I believe I can win the matter if it is taken to court.

But we believe that the legislation should leave no possible doubt—we believe that it should be changed in whatever way may be necessary to make it abundantly clear that we do not have to litigate the matter—to make it clear that a transaction of this kind which gave rise to a loss does not at the same time generate an additional tax.

Thank you.

The CHAIRMAN. Thank you.

Are there any questions?

Senator KERR. Yes.

The CHAIRMAN. Senator Kerr.

Senator KERR. Can you tell the committee what your tax liability would be under existing law, which is the 1942 Act?

Mr. HUGHES. I have the company's actuary with me, and he can probably tell better than I. This is Mr. John Gilchrist.

It would be around $12,000 or $13,000, Mr. Gilchrist tells me.

Senator KERR. What would it be if the stopgap put into effect for 1957 were carried over and made effective for 1958?

Mr. HUGHES. It would be around $9,000, Mr. Gilchrist tells me.

Senator KERR. But if H.R. 4245 is enacted and interpreted as you fear it might be, it would create how much of a tax liability?

Mr. HUGHES. Approximately $884,000. As I said before, that is almost 4 percent of the company's assets.

Senator KERR. In other words, then your position is that because of the fact that you would not owe in excess of $12,000 or approximately $12,000 taxes under existing law, which is the 1942 act, was during the year and still is, and in view of the fact that you would have owed $9,000 or $10,000 in taxes had the Congress seen fit or if it does see fit to make the law applicable in 1952 applicable to 1958, and since there was no way that you could possibly have known when this transaction was made that legislation was contemplated that could result in a situation in which you fear might result if H.R. 4245 is enacted, it is your position that to bring such a situation about would be a retroactive taxation by the Congress of your company of $800,000 or $900,000 not on profit but by reason of a transaction which actually entailed a loss?

Mr. HUGHES. Yes, sir.

Our position is exactly the way you state it, that any time a loss transaction could give rise to a tax and thus make the loss not $3.8 million but make it $4.6 million, if you add the tax to it, any time that could happen the situation should be reexamined, but all the more so when you could not possibly predict such a possibility under anything that had been proposed, at least anything which we knew about.

Senator KERR. I think your position is sound that if existing law could bring about such a situation it should be reexamined; but to enact a law which retroactively would bring about such a situation would seem to be much less justified than the continuation of a law; although effective at the time, which would have produced such a result.

Mr. HUGHES. Yes, sir.

Senator Kerr, if we had known there was any possibility of this, undoubtedly we would have taken a different approach.

Senator KERR. You would not have made a deal.

Mr. HUGHES. We would not have made the same deal.

Senator KERR. If you knowed the road, you wouldn't have went. [Laughter.]

The CHAIRMAN. Mr. Hughes, the committee will ask the staff to make an investigation.

Senator CURTIS. Mr. Chairman, if I may ask a question, was the purchaser of this department related in any way to the American Life Insurance Co.?

Mr. HUGHES. No, sir. There were actually four purchasers. The business was from an area of several States, and the purchases bought the industrial business related to their geographical area. They wanted to fit it in with their business.

Senator CURTIS. They were clearly stranger purchasers?

Mr. HUGHES. Yes, sir.

Senator CURTIS. How long did that department run?

Mr. HUGHES. I do not know. Most of the losses had come about since 1952. The company was established, if my memory is correct, in 1931.

Senator CURTIS. You do not know what the average length of time the policies transferred had been in existence?

Mr. HUGHES. No, sir. But I would think that they had been in existence for a comparatively short time because otherwise there would have been the possibility of more premium income to have offset it. There are some well-known figures on what it takes to generate industrial business.

I think the industry generally takes some figure in the range of 50 to 100 times the weekly premium, which would indicate in this case quite a bit of this business had been put on the books in the last 3 to 5 years.

Senator CURTIS. Had you retained the department but if you would have written no more insurance, would you ultimately have sustained a loss?

Mr. HUGHES. That is hard to say. We thought that the possibility of making any money on the deal or that the possibilities of making any money on industrial insurance were sufficiently slim that we had to either keep on selling industrial insurance or get out of it altogether. I do not believe that the possibility of just letting it run out was considered; the possibility of just letting it run out is what you have in mind, I take it?

Senator CURTIS. Yes.

Mr. HUGHES. I do not believe that was considered, but whether or not we would have made money I do not know.

I take it that would depend in large measure on the number of cancellations, how many policies lapsed.

Senator CURTIS. But you took a loss on the sale because you had spent more money securing insurance than you had taken in in premiums?

Mr. HUGHES. Yes, sir. Now that is almost always true in the beginning of any insurance business. But it had been the situation here for a long enough period of time so that businesswise it seemed only appropriate to get out of the business, so to speak; in this department there was almost $90 million of life insurance in force, and it was the business judgment of our people that we should get out of the industrial business.

Senator CURTIS. That is all, Mr. Chairman.

(The prepared statement of Mr. Hughes follows:)

STATEMENT ON BEHALF OF AMERICAN LIFE INSURANCE CO. BY VESTER T. HUGHES, JR.

American Life Insurance Co. is a life insurance corporation organized under the insurance laws of the State of Alabama. It is a relatively small stock company with home offices in Birmingham, Ala. At the present time there are approximately 740 stockholders, most of whom live in the South or Southwest. As of the end of 1958, the company had $211,215,232 of life insurance in force. This includes $55,941,708 of new business put on the books during 1958, which shows that American is an active and growing company. The total assets of the company at the end of 1958 including policyholders' reserves, amount to $24,181,478.48. Of course, these figures show that this is one of the country's smaller life insurance companies.

During 1958 American Life disposed of its entire industrial department. Life insurance in this department consisted of policies of a face amount usually less than $1,000 and on which premiums are collected weekly by agents, together with other policies serviced by such agents. This business was operated as a separate department of American Life and because of extensive losses on this business, it was determined that the entire industrial department should be disposed of.

The industrial department consisted of nearly $90 million of life insurance in force, reserves applicable thereto, furniture and fixtures, and other miscellaneous tangible and intangible properties. Over the years American Life Insurance Co. and its predecessors incurred costs estimated to be $22 million (over and above reserves) in generating such business, whereas, the total premium income during that time from such business appears to have been around $18 million. The exact figures have not been ascertained since prior to the present time the only matter of importance to American Life has been the magnitude of the loss, which appears to be approximately $4 million. As stated before, it is this loss which caused the decision to dispose of the industrial business.

The reserves applicable to American's industrial business were roughly $3,200,000. When the industrial department was transferred, American Life Insurance Co. also transferred assets of a value equal to the reserves carried by American Life with respect to such policies; that is to say, assets of a total value of $3,200,000 were transferred to the acquiring corporations with such acquiring corporations assuming all the incidents of the industrial business including assumption of life insurance policies in toto (including the right to collect premiums, the liabilities thereunder, and all other incidents of ownership), the taking over of personnel, the taking over of furniture and fixtures, the taking over of records, and the assumption of leases on properties used in connection with such business. American Life Insurance Co. received a total consideration of about $3,400,000, or a net amount of approximately $200,000 in excess of assets representing the reserves applicable to insurance policies transferred.

(There were four transactions in connection with the liquidation of such industrial business and in some instances instead of asset transfer, compensating book entries were made with the result that instead of making a payment to American, the acquiring company would increase its reserves by transferring other assets held by it to such reserve account and American would release assets committed to its own reserve liabilities to surplus—of course, the net effect was the same as if American had transferred asset to the acquiring corporation and the acquiring corporation had in turn tranferred cash or other assets to American.)

With regard to the overall economics of its industrial business, American realized a loss estimated at $4 million when it disposed of the industrial business. This loss came about because of the excess of costs over the premiums and other income related to such business.

Under H.R. 4245, it is not clear how a transaction such as that described above will be treated for tax purposes.

For example, under the bill it is not clear whether this transaction is a capital transaction. Of course, if the transaction described above is a capital transaction, under section 802 there will be no capital gains tax and under section 817(c) there will be no capital loss carryover. Life insurance appears to be a capital asset as defined in section 1221 unless one of the exceptions contained therein is applicable, and it seems to be clear that no such exception is applicable in the instant case.

Conceivably, however, it might be argued that section 817 throws doubt on the question of whether capital gain treatment would be given to such a transaction. In this connection, section 817(b) states that for purposes of that subsection life insurance and annuity contracts are not to be treated as property. By its terms, section 817(b) of the bill deals only with transactions occurring after December 31, 1958, and should not, therefore, apply to this transaction. Even with regard to transactions of this kind after 1958, it seems to be clear that the exclusion of life insurance and annuity contracts from the definition of "property" in 817(b) should have no implications with regard to the definition of capital assets contained in section 1221, since subsection (b) of 817 relates only to determination of the amount of gain realized on sale whereas section 1221 deals with the definition of a capital asset.

But (a) if the rule of 817(b) that life insurance and annuity contracts are not property is deemed to apply to the general definition of capital asset, or (b) if it were determined that life insurance and annuity contracts are property used in a trade or business (with the result that it would be excluded from 1231(a) treatment by reason of section 817(a)), then the disposition of one policy or of an entire department would not be viewed as a capital transaction.

Under either of these highly questionable interpretations, the bizarre result of an $884,000 tax being imposed on a transaction resulting in a $4 million loss might be reached. This would come about by reason of the concept of income in the new bill which could be interpreted to include the gross amount of decrease in reserves ($8,200,000 in our case) under section 809(c)(2) and further to include in income the $8,400,000 of consideration received by American under section 809(c)(4). On the other hand, apparently the only deduction relating to the transaction would be that provided for in section 809(d)(8), and that deduction would include the reserve figure ($8,200,000) which would appear to be the consideration transferred by American. (The foregoing is based on the assumption that section 809(d)(8) includes a transaction such as the one here in question; for certain insurance purposes, the complete transfer of policies, reserves, and liabilities incident thereto is called "reinsurance ceded." However, 809(d)(8) apparently uses reinsurance ceded to mean a partial reinsurance for risk splitting purposes rather than a total transfer, and the House report at page 27 indicates that transactions like the instant situation involve what the report terms "assumption reinsurance." To avoid a possible misunderstanding of terminology, one or both terms should be defined.) Under such an interpretation, there would be a net amount of $3,400,000 added to income, and the transaction would generate a tax of roughly $884,000 notwithstanding the fact that the net effect of the overall transaction would be an economic loss of approximately $4 million. A tax of $884,000 would amount to almost 4 percent of the assets of the company. Under such a construction of the act, this obviously unfair result would come about by reason of the provisions of the bill which allow current deduction of expenses in connection with generating business but deny deduction of expenses incurred prior to the date of the enactment of the bill.

There are various ways in which H.R. 4245 could be clarified in order to eliminate the possibility of the unfair treatment which would result from taxing American's sale of its industrial department. Among these are the following:

1. To spell out in the legislation that 1958 transactions involving sale of life insurance and annuity contracts will be treated as capital transactions (with the treatment to be accorded such transactions in the future to be the same as under the bill as presently written).

A specific provision in the law treating all 1958 transactions involving disposition of life insurance and annuity contracts (but not including reinsurance ceded) as capital transactions would make it clear that American's sale of its industrial department does not generate a tax. American would not have a capital loss carryover and the overall effect would be the same as under both the stopgap rules and the 1942 act. This approach seems to be inherently fair since the only treatment a taxpayer could have anticipated would have been no tax and no deduction.

On the other hand, H.R. 4245 would not be changed with regard to transactions taking place after December 31, 1958. Such transactions would result in a capital gain or loss, or in ordinary income or loss depending on the character of life insurance—whether it is property, whether it is held primarily for sale to customers, etc.

2. To insert a general provision providing that transactions involving the sale of life insurance and annuity contracts, both before and after January 1, 1959, will be treated as capital transactions.

The result with respect to American of giving capital transaction treatment to all sales of life insurance and annuity contracts would be exactly the same as in 1 above. But the rule would be of more general application since it would clarify future treatment of such transactions. If such an approach were adopted, the tax revenues relating to such a sale should be almost as great as if the item were operations income, since the effective rate on operations income as presently set forth in H.R. 4245 is 26 percent and on capital gains is 25 percent. Of course, this ignores the difference which such treatment might make with respect to taxable income as defined under section 802(b)(3), but it is not believed that this and other differences would ordinarily be significant.

The chief problem with regard to this treatment is a determination of whether or not life insurance contracts owned on December 31, 1958, have a tax basis, and, if so, whether this basis should be determined by the fair market value of such contracts on December 31, 1958, or whether it should be previous net costs for which no deduction had been taken (pre-1958 net costs). It should be noted that this problem is latent in the bill as presently written.

3. To treat a 1958 sale of life insurance and annuity contracts as a capital transaction with a proviso allowing for a capital loss carryover where net costs in producing such business exceed the total amount realized during the same period.

This treatment would result in no tax on the transaction, but there would be a capital loss carryover of some $4 million. Although this treatment would not be in accordance with the usual capital gain rules relating to 1958 transactions, it would certainly be compatible with (a) recognition of the economic realities of the loss and (b) allowing current deductions of costs incurred after December 31, 1957.

4. To treat the sale of life insurance and annuity contracts as an operations item with the allowance of all net costs incurred prior to 1958 as a deduction from operations income.

This approach would mean that all net costs relating to American's industrial business would be deducted in the year 1958, giving American a deduction of some $4 million in determining gain or loss from operations. If, in view of the approach of H.R. 4245 which makes operations taxable, it is thought to be necessary to treat transactions involving life insurance and annuity contracts as other than capital transactions, then there should be a deduction from operations income of nondeductible costs relating to generating such business at the time of the final disposition of such business. Premium income and expenses after 1957 would be ignored—such income and expenses were not directly or indirectly includible and deductible by insurance companies under prior revenue laws. It is believed that this approach would recognize the true economics of what happened. Of course, in a sense, this would be the mixing of accounting principles. But if such a transaction is to be considered an operations item, it would be the only fair approach inasmuch as income from operations will be taxable for the first time; it would relate previously nondeducted and nondeductible expenses to the transaction which in effect really caused the operation to become a "closed transaction."

The primary difficulty with this approach is, of course, the matter of (a) defining such costs and (b) going back into the records to determine the exact figures involved. Since such records were kept only for business purposes, many matters which might need to be substantiated, more fully described, or otherwise treated differently for tax purposes would probably be very difficult, if not impossible, to ascertain. But certainly where disposition of life insurance results in an overall economic loss, it is fair to give this loss to the taxpayer as a deduction from operations income if the same sale, when resulting in an overall economic gain, would give rise to operations income.

5. To treat the sale of life insurance and annuity contracts as an operations item with the allowance of all previous net costs as a deduction from operations income, but with the limitation that if such costs exceed income, that the loss cannot be used to offset other operations income nor as an operations loss carryover.

The result on American of the fifth alternative suggested would be no tax but no deduction against other operations income (and no increase in net operations loss carryover, if any, on account of this transaction). Of course, this approach is subject to the same difficulties with respect to ascertaining the amount of loss as are discussed in paragraph 4 above. However, it is the minimum which should be granted if a sale of insurance is to be treated as an operations item.

Which of these possible solutions should be adopted is open to question. But to tax a transaction which results in an economic loss (where costs have not been previously deducted) would be totally unreasonable and unconscionable. It is submitted that the present bill should be clarified so that a taxpayer will be certain that such a transaction resulting in a loss does not generate a tax. It may be that the matter should be corrected only with respect to 1958 transactions and more comprehensive legislation in this area should await further study. For the remainder of this year and in the future years, most companies would be able to handle any such transaction in a manner which would take into account whatever treatment is to be accorded. But where, as here, the transaction would not have resulted in a tax under the stopgap rules nor under the 1942 act, there i[s] all the more reason not to add a further penalty by taxing a loss transaction. There was no way American could have predicted that the disposition of its industrial business at a loss might possibly result in a tax. If such a possibility could have been anticipated, it would have undoubtedly affected the terms of the transaction. Thus, it is submitted that even if the rules relating to such a transaction impose a tax thereon in the case of transactions after 1958, the tax laws relating to life insurance companies should make it abundantly clear that a transaction such as that here involved which occurred in 1958 does not generate a tax.

A comparatively simple amendment to section 802 would make it clear that all 1958 sales of life insurance and annuity contracts are not taxable but would not change the treatment of such transactions for later years from the treatment accorded by H.R. 4245 and subchapter P. This change would be accomplished by adding to section 802(a)(2) the following two sentences:

"For taxable years ending before January 1, 1959, capital gains and losses shall not be recognized. The gain or loss resulting from the disposition prior to January 1, 1959 (other than reinsurance ceded) of insurance or annuity contracts shall be deemed to be gain or loss from the sale or exchange of a capital asset."

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

The next witness is Mr. George Harris of the Chicago Metropolitan Mutual Assurance Co.

## STATEMENT OF GEORGE S. HARRIS, ASSISTANT SECRETARY AND INVESTMENT OFFICER OF THE CHICAGO METROPOLITAN MUTUAL ASSURANCE CO.; ACCOMPANIED BY CARL TIFFANY, ACTUARY

Mr. HARRIS. Gentlemen, on behalf of my company I wish to thank your committee for the courtesy extended to me to appear before you. I would like to make the statement that this statement is made in support of the National Insurance Association, even though from a short-term selfish point of view, would require our company to pay more tax. In other words, we are substantiating the report of the National Insurance Association that has testified before this committee.

My name is George S. Harris, assistant secretary and investment officer, and member of the board of directors of Chicago Metropolitan Mutual Assurance Co. Our company is domiciled in Illinois.

I have here with me Mr. Carl Tiffany, our actuary, who has had a very broad experience in the life insurance field, to help me answer any questions you may wish to ask.

Our company is a small mutual company, but it is our aim and purpose to continue to build and grow on the basis of a sound and financially strong life insurance company. It is on this premise that I shall base my remarks and observations.

We in our company believe that a tax formula based solely on investment income is the only sound formula, theoretical as well as practical, under which a life insurance company can be taxed on its earnings. From the year 1921 to the year 1958 this fundamental truth was generally recognized by the life insurance industry as well as by our Federal legislative bodies; however, a departure from this approach has been made in H.R. 4245 which places a tax on so-called underwriting profits. It is our feeling that this new approach has arisen as a result of alleged unconscionable profits made by a very few so-called specialty companies representing an infinitesimal part of the total insurance volume of the industry. Such companies should be taxed under a specialty formula applicable to the peculiarities of their operations.

Much testimony has been given before this committee regarding H.R. 4245 and its advantages to a small and beginning company, in particular a company losing money. However, once a company moves out of the red column and over into the black, it then suffers under phases 1 and 2 in that a large part of its earnings are then subject to tax and the company's growth potential is badly impaired. It is a sad commentary on a tax formula that makes desirable an unprofitable operation.

As applied to the struggling company in its infancy, the virtues of the small business deduction are highly exaggerated. The 5-percent deduction on net investment income with a maximum of $25,000 is of dubious value to the small company and could perhaps more properly be called a middle-class company deduction, since a net investment income of one-half million dollars would be required to produce the maximum limit. We suggest an across-the-board deduction of $25,000 as a benefit which would not result in any significant loss of revenue to the Treasury, since many companies would enjoy the maximum provided under the bill as now drafted.

Phase 1 purports to tax companies on the excess interest earnings realized over and above those required to maintain policy reserves; however, in reality it makes use of a complicated formula which favors companies issuing policies under which the assumed interest rate on reserves is low. Inasmuch as young companies are forced to issue policies having a higher rate of interest, the advantage accrues to the larger companies, particularly the large mutuals. This is to the competitive disadvantage of the companies which assume a realistic rate of interest. The giant mutuals enjoy a highly favored position in this respect since their assumed rates of interest are among the lowest in the life insurance industry.

Phase 2 permits the deduction of dividends prior to calculation of tax, the theory being that dividends are simply refund of redundant premiums or, let us say, return of invested capital, and consequently compose no part of earnings. One has simply to refer to the basic actuarial textbooks or schedule M of the annual statement of a mutual company to learn that the standard formula for dividend calculation involves the factors of (1) interest, (2) loading, and (3) mortality. It would appear that only one factor, loading, can constitute the "redundant" part of the premium. In this connection I should like to direct your attention to the excellent illustration of W. W. Wilson, Jr., president of the Colorado Life Convention, given on page 5 of his testimony before this committee. The fallacy of the "redundant" premium is abundantly obvious.

Phase 3 is an insidious part of H.R. 4245 by which a tax lien is placed on 50 percent of the profit from operations. Moreover, it militates against the use of surplus for development and growth and locks up existing surplus. I recognize that this does not affect my company which is a mutual company.

The absence of comments herein regarding other discriminatory features of H.R. 4245 in no way constitutes an endorsement of such features. It has been my purpose here simply to point out the more flagrant violations of equity, and I thank you for the privilege of using your time to do so.

The CHAIRMAN. Thank you, Mr. Harris.

Are there any questions?

Senator CURTIS. Are you a mutual company?

Mr. HARRIS. Yes, sir.

Senator CURTIS. How could you be affected by part 2?

Mr. TIFFANY. I think Mr. Harris' opening statement is significant that that is a statement of support to the position taken by the National Insurance Association, and not a statement of the application of the bill or the proposed bill to his own company.

Senator CURTIS. Part 3 would have no effect on his company?

Mr. HARRIS. On our company, no, sir, and I made it in my opening statement because we are part of the association, and it was part of our understanding to support the resolution from the National Insurance Association that is before this committee.

The CHAIRMAN. Thank you, Mr. Harris.

The next witness is Mr. Daniel J. Lyons, of the Guardian Life Insurance Co. of America.

## STATEMENT OF DANIEL J. LYONS, VICE PRESIDENT, GUARDIAN LIFE INSURANCE CO. OF AMERICA, NEW YORK, N.Y.

Mr. LYONS. Mr. Chairman, my name is Daniel J. Lyons, and I am vice president of the Guardian Life Insurance Co. of America, a medium-size mutual company domiciled in New York and authorized to do business in all States and the District of Columbia. I am testifying on behalf of that company. The Guardian is a supporter of the

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temporary committee on the taxation of mutual life insurance companies.

The Guardian's Federal income tax for 1957 was $1,215,000, and on the same basis would have been $1,339,000 for 1958.

Senator KERR. Under which bill, now?

Mr. LYONS. On the same basis, that is the stopgap, in 1958 it would have been on the same basis as in 1957, it would have been $1,339,000.

Under H.R. 4245 the tax for 1958 would be $2,437,000. This amount is $246,000 greater than the tax under the 1942 law and is an increase of 82 percent in the level of tax in a single year. This tax would fall entirely on our policyholders and would, if continued, increase the cost of insurance.

We estimate that the amendments proposed by Mr. Slater, who spoke for the temporary committee, will still leave us with a 60 percent increase in our tax. Although we feel that the level of tax is too high, H.R. 4245 with these amendments is acceptable to my company. This conclusion has been reached principally in the hope that the amended bill will permanently eliminate the uncertainty of the stopgap legislation.

The first amendment would eliminate the arbitrary deduction rate in phase 1 of the bill and substitute an individual company 5-year average. This change would substantially improve the bill.

The second amendment would modify the limitation on the deduction of dividends to policyholders by allowing 50 percent of the amounts now disallowed. Dividends should be deducted for the following reasons:

(1) Dividends to policyholders in a mutual company are price adjustments and do not in any sense constitute taxable income to the company. In business, generally, return of part of the purchase price to the buyer is excluded from income.

(2) Failure to allow full deduction of premium refunds results in a tax for many companies of more than 52 percent of net gain from operations. In the Guardian, for example, the tax under H.R. 4245 for 1958 would be 61 percent of net gain from operations.

(3) A company should not be required to pay more taxes because of fluctuations in underwriting losses. However, this is just what can happen when full credit for premium refunds is not given. An example of this is shown in exhibit A, where it is demonstrated that two small companies with identical results over a 2-year period would incur taxes differing by over $50,000. The proposed amendment would eliminate only one-half of this inequity, except for the fact that only 50 percent of the excess of taxable investment income over gain from operations is taxed.

(4) Fear has been expressed by witnesses that stock companies will be unable to compete with mutuals if the latter get credit for the full amount of refunds made to policyholders. Actually H.R. 4245 gives a distinct competitive advantage to a company writing nonparticipating insurance. The premium less the dividend required of a mutual company policyholder is comparable to the nonparticipating premium of a stock company. To the extent that the dividend is taxed the mutual company is at a disadvantage.

(5) A mutual company should not be required to pay more taxes just because it collects extra premiums at the beginning of the year

and returns them at the end of the year. An example of this inequity is shown in exhibit B.

(6) When the gain from operations exceeds the taxable investment income the mean of the two becomes the tax base. It seems logical that the mean should also be the tax base when the gain from operations is less than the taxable investment income.

A reason given for the limitation on the deduction of dividends to policyholders is that investment income is income received from third parties which it would be inappropriate to exempt after allowance for interest required on policy and contract liabilities.

This argument overlooks the fact that a proper allowance for operating expenses is not made in determining taxable investment income. In computing such income, the only expenses which can be deducted are the expenses of handling the investments of the company. Other investing institutions also deduct expenses of obtaining the funds, of administering individual accounts and disbursing withdrawals. Life companies have similar expenses but they may not be deducted. The failure to allow these expenses as a deduction results in an artificially high investment income base in phase 1 of the bill.

In its present form, H.R. 4245 provides in effect that the gain from operations shall not be the tax base if, because of dividends to policyholders, it is less than the taxable investment income. In this case the investment income figure is the tax base. The use of an artificially high investment income figure makes it most important that the limitation on the deductibility of dividends to policyholders be modified.

Other businesses are taxed on the final result of the year's operations; that is, on the net balance of profits and losses on the various types of income received. Losses on one part of operations are deductions from gains on other parts. Mutual life insurance companies are being made an exception to this rule. Under H.R. 4245 they are not permitted to deduct from so-called investment gains the full amount of negatives or losses to which they are properly entitled in figuring their operating gains.

My company urges that the bill be amended to permit deduction of 50 percent of the negatives.

I wanted you to know that one, at least, of the smaller mutual companies wants this amendment, because there has been so much testimony here that this is something for the large companies. It is equally important for the small mutual companies.

Thank you.

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

Are there any questions?

Senator CURTIS. Mr. Chairman.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Mr. Lyons, the contention has been made here that the bill as written, as it passed the House of Representatives, gives more favorable treatment to stock companies than others, and it is contended it is more favorable to mutual companies.

What is your answer to that question, and why?

Mr. LYONS. Well, I have heard that, and I think that it is very much more favorable, as now written, to the stock companies than it is to the mutual companies.

In other words, I do not agree with those witnesses who testified to the contrary.

I would like to recall to you, if I may, some of the points. First of all, there is this one on the negatives that we have been talking about. The bill provides that stock companies get 100 percent of the negatives. There isn't any question about that. Those negatives result from underwriting losses, just as you notice we have in the little example I showed. They get 100 percent.

The mutual companies are asking for only 50 percent of theirs, and there is quite some opposition to that.

Secondly, there is an allowance for stock companies of 10 percent of the increase in reserves, which can flow through ultimately—and I realize this is contrary to some of the testimony that was given here—can flow ultimately to the stockholders without tax. That 10 percent is not paid into the policyholders' surplus fund, where one would expect it to be if it is there just from the standpoint of the policyholders, but it flows into other accounts.

There is also——

Senator CURTIS. Before you leave that, is that 10 percent allowance—does that figure out a sizable amount taxwise?

Mr. LYONS. In the large companies, it is a very sizable amount. You could have, Senator, an increase in not even the largest company, an increase in reserves of $50 million in a year, and 10 percent of that would be $5 million, and you have got a tax of 26 percent of $5 million.

Senator CURTIS. How could that reach the stockholders without the tax?

Mr. LYONS. It could reach them ultimately in a mutualization of the company, or it could reach them after the other funds have been paid out to the stockholders.

The logical approach that you would expect would be 10 percent if it is going to be allowed to be paid into the policyholders' surplus account, and from there into the shareholders' account whenever they wanted to disburse it, and then pay a tax, but it doesn't go that way.

Senator CURTIS. What was the way other than by way of mutualization of the company?

Mr. LYONS. By payment of the first two accounts, the shareholders' account and ultimately the depletion of the policyholders' account through paying that into the shareholders' and then to them, and then the balance of the accounts, the other accounts, the third part of phase 3.

Senator CURTIS. Go ahead.

Mr. LYONS. The other item in there which I will mention in passing is the 2 percent on group insurance which does not go through the policyholders' fund.

Senator CURTIS. How does that 2 percent affect the mutuals and affect the stocks?

Mr. LYONS. It affects them the same, and I think it is proper, just as the 10 percent would be. But it could well go through the policyholders' fund in the stock company so that in the event it is subsequently paid to shareholders there will be a tax on it. In the case of the mutual company, of course, everything is policyholders' fund, there is no difference. So it is in about the same position, I believe, as the 10 percent.

Another point is that there is a very high limit on the amount which can be held in the policyholders' surplus account, 25 percent of the reserves, which is very substantial, and I have never seen any demonstration of need for as much as 25 percent of the reserves as a special fund of this kind.

Actually, that creates some difficulties, too, in analyzing a stock company because it is called a policyholders' fund. It is a misnomer. There is a good bit of unpaid taxes to the Government which may be paid at a later date in there, so it creates a problem of knowing how to value the company, and of course, it is a fund which can be used for the benefit of the shareholders until such time as it is transferred out.

But at any rate, the point I am trying to make is 25 percent is very liberal for the stock companies.

Another point that occurs to me, Senator, is that the gain from operations of stock companies is about 42 percent of the total gain, and the tax is 32 percent on the stock companies. If the tax were prorated evenly between stock and mutual on the basis of how much they took out of the business, then it would be 42 for the stocks and 58 for the mutuals.

Senator CURTIS. On similar policies is the net premium charged in a nonparticipating policy actually about the same as the other premiums less the policy dividends?

Mr. LYONS. I think they are comparable. There may be a dollar or a dollar and a half difference over the year. Mr. Slitor submitted an exhibit which showed the difference.

Senator CURTIS. A dollar or a dollar and a half over a period of years, you mean per $1,000 of insurance annually?

Mr. LYONS. Yes.

Senator CURTIS. Which way would the dollar be?

Mr. LYONS. Well, in the figures Mr. Slitor gave it was in favor of the mutual companies.

Senator CURTIS. In favor, you mean they charged more?

Mr. LYONS. The mutuals charged less after the return of premium. But you can pick out stock companies who over a period of years would do better than some mutual companies, and vice versa. It depends on the company, by and large——

Senator CURTIS. From the policyholder's standpoint the cost of his insurance is the amount he ultimately pays after the whole transaction is completed?

Mr. LYONS. That is correct, Senator.

Senator CURTIS. So to arrive at what the premium income to a company was, you have to figure it after the whole transaction is completed?

Mr. LYONS. That is right. As a matter of fact, they set up their premiums, the mutuals, on a nonparticipating basis and add something to them for this return, and then they make the return each year.

Senator CURTIS. While a nonparticipating policy in a stock company is written on an actual—a fixed-level premium?

Mr. LYONS. That is correct, Senator.

Senator CURTIS. But in determining the ultimate financial position of a company you must take a figure after the payment of policy dividends, must you not?

Mr. LYONS. Yes, sir.

Senator CURTIS. Because if you took any other position you would be allowing for something you didn't have?

Mr. LYONS. That is correct, Senator.

Senator CURTIS. That is all, Mr. Chairman.

Senator KERR. I would like to ask a question.

The CHAIRMAN. Senator Kerr.

Senator KERR. I think this would be a good point to get into the record either from this witness or from the Treasury the answers to these questions.

Whether it is a stock company—and I would like for the Treasury to listen to the questions and if the witness answers them correctly, then let it go, and if not, speak up and let us be sure that the information we get into the record at this point is accurate—2 percent of collected premiums on group insurance, health or accident insurance, is exempt.

Mr. LYONS. That is correct, Senator.

Senator KERR. Whether mutual or stock?

Mr. LYONS. That is correct, Senator.

Senator KERR. For a stock company 10 percent, an amount equal to 10 percent of the increase of nonparticipating reserves other than group and annuity reserves is exempt?

Mr. LYONS. That is as I understand it, Senator.

Mr. SLITOR. I would point out, of course, that the 10 percent would be available to a mutual company if it sold nonparticipating business, and to the extent that it sold nonparticipating business.

Mr. LYONS. I think that is correct. This applies——

Senator KERR. I think that is correct, too.

Mr. LYONS. This applies to nonparticipating.

Senator KERR. Do mutuals sell nonparticipating?

Mr. LYONS. I couldn't name one right now, Senator, that does.

Senator KERR. Does the Treasury know of any that do?

Mr. SLITOR. I understand that a small amount of nonparticipating business is held by mutual companies.

Senator KERR. For the purpose of this bill it is negligible?

Mr. SLITOR. It is negligible.

Senator KERR. So that in reality that provision will be utilized and applicable to the nonparticipating business sold by stock companies.

Mr. SLITOR. Yes, sir.

Senator KERR. Then after total gains from operations have been reduced by those two amounts, the investment income included or referred to in phase 1 of the bill is deducted from taxable income?

Mr. LYONS. That is correct.

Senator KERR. Is that correct insofar as the stock companies are concerned?

Mr. SLITOR. Yes, sir.

Senator KERR. Then under the bill 50 percent of the balance is exempt from taxation?

Mr. LYONS. That is correct, Senator.

Mr. SLITOR. It is placed in a tax-deferred account.

Senator KERR. But insofar as current operations are concerned, it is exempt from taxation unless one of the eventualities written into the bill to trigger the implementation of taxation has occurred?

Mr. SLITOR. Yes, sir.

Senator KERR. That is correct?

Mr. SLITOR. Yes, sir.

Senator KERR. I just felt that while we were discussing this phase of the bill, that is, the taxation of stock companies, that this brief summation of the applicable features of the bill might well be put into the record at this point.

Mr. LYONS. Thank you, sir. The testimony hasn't been entirely clear on it up to now, so it is well to put it in.

The CHAIRMAN. Thank you, Mr. Lyons.

(Exhibits A and B to Mr. Lyons' testimony follow:)

EXHIBIT A[1]

| | Mutual company A | | | Mutual company B | | |
|---|---|---|---|---|---|---|
| | 1958 | 1959 | 1958 and 1959 combined | 1958 | 1959 | 1958 and 1959 combined |
| Taxable investment income | $600,000 | $600,000 | $1,200,000 | $600,000 | $600,000 | $1,200,000 |
| Gain from operations | 600,000 | 600,000 | 1,200,000 | 800,000 | 400,000 | 1,200,000 |
| Tax base under H.R. 4245 | 600,000 | 600,000 | 1,200,000 | 700,000 | 600,000 | 1,300,000 |
| Tax at 52 percent | 312,000 | 312,000 | 624,000 | 364,000 | 312,000 | 676,000 |

[1] For the 2 years combined, both companies have the same net investment income and the same gain from operations; both pay the same dividends to policyholders.

NOTE.—Dividends of $800,000 were paid to policyholders each year by each company. Fluctuations in experience cost company B an extra $52,000 in taxes.

EXHIBIT B

Assume we have two companies, X and Y. X is a stock company. Y is a mutual company. Both do exactly the same type and volume of business and have the same results except that Y collects $1 million more in premiums each year than does X and returns this amount with interest at 4 percent.

| | Company X stock | Company Y mutual |
|---|---|---|
| Taxable investment income | $2,000,000 | [1] 40,000<br>2,000,000 |
| Dividends to policyholders | | 1,040,000 |
| Gain from operations | 1,500,000 | 1,500,000 |
| Dividends not allowed | | 540,000 |
| Tax base | 1,500,000 | 2,040,000 |
| Tax at 52 percent | 780,000 | 1,060,800 |

[1] 4 percent interest on the $1,000,000 additional premiums collected.

NOTE.—The mutual company is taxed $280,800 more than the stock company although the only differences in operations were that it collected $1,000,000 more in premiums and $40,000 more in investment income and returned $1,040,000 in dividends.

The CHAIRMAN. The next witness is Mr. M. C. Reese, Jr., of the Association of Arizona Insurance Companies.

Senator KERR (presiding). All right, Mr. Reese, you may proceed.

## STATEMENT OF MELVIN C. REESE, JR., PRESIDENT, ASSOCIATION OF ARIZONA INSURANCE COMPANIES

Mr. REESE. My name is Melvin C. Reese, Jr. I am president of the Association of Arizona Insurance Companies, a trade association of Arizona life insurance companies, whose premium income, assets, and insurance in force make up the bulk of the life insurance business of Arizona insurance companies. All of the companies would be classified as small companies, assets ranging from a few hundred thousand to $5 million.

I am also president of the First National Life Insurance Co., a company incorporated in 1947. As of December 31, 1958, my company shows assets of $2.277 million and insurance in force of $30 million. We are one of the leading companies in Arizona, but still a very small company when compared with companies from all over the United States.

This appearance before the Senate Finance Committee comes after a study of the subject by the various member companies of our association. Our association appreciates the fact that to write a bill that would be satisfactory to everyone, produce a certain amount of revenue for the Government and embody a formula that could be used year after year, presents a most difficult problem.

We also appreciate the fact that the Treasury Department and the Committee on Ways and Means of the House of Representatives have spent a great deal of time on this problem before the writing of H.R. 4245. We do feel, however, that this bill in its present form is unfair to small- and medium-sized companies.

This bill has three parts and also a separate part dealing with capital gains.

Regarding part 1 of the bill, which is the tax on investment income, we still believe that this is the best approach for the Federal Government to tax life insurance companies. We agree with the part of H.R. 4245 that says if a company's gains from operations are smaller compared with its taxable investment income, the tax should be on the smaller of the two as this investment income is needed to offset underwriting losses, if any. However, we believe that the deduction of 5 percent of net investment income which is designed to help the small companies, can be improved upon. If a small company shows a net investment income of $10,000, they receive a $500 credit, a small item. At the same time, the bill is granting a 5 percent deduction to all companies on their first $500,000 of net investment income, with a maximum deduction of $25,000. If this is really meant to be an assistance to small companies the credit should be either a much higher percent for the very small companies or a flat amount for all companies, such as the $25,000 figure.

Now regarding that part of the investment income needed to meet the interest requirements of our life insurance reserves—one of the unknowns in the past is still found in H.R. 4245 and that is the changing rate of interest to be determined by the Treasury Department each year. The insurance industry does not know how this will be arrived at, and, therefore, cannot know what its taxes will be until the Treasury's "rate of interest" is announced. Also, I believe most small companies are reserving on a 3 percent basis. The bill as it is now drawn says, in effect, that the large companies can use the industry average which might be approximately 3 percent, instead of their own assumed 2.25 or 2.5 percent. This would give the large companies a tax deduction that would not be available to the small companies.

Rather than attempt to determine a fair way to tie in assumed interest rates and earned interest rates, we would suggest using some sort of a gradual increasing tax rate on investment income. Of all of the suggestions made, we believe that the fairest approach to date is that made by the National Association of Life Companies, who are suggesting a tax on 10 percent of the first $250,000, on 15 percent of the next $1.250 million, and on 20 percent on all income beyond that.

Regarding parts 2 and 33 of the bill, which have to do with taxation on the gains from operations, a young company might go through several years of losses or small gains and then might start to show sizable gains on operations as the result of several years' work. It is now being suggested, with some allowance for carrying losses forward, that the company be heavily taxed, even though the stockholders' original investment may not have been replaced. If a company were to go from a negligible gain in operations up to a $100,000 gain in operations, the tax would go from a small figure to probably $20,000 or $25,000. This is too heavy a tax on a small company; this money is needed to finance further growth of the company, and is needed to build up the company surplus. All financial institutions such as banks and insurance companies must build up a surplus. In an insurance company it is for additional protection for its policyholders, and it is wrong to tax these gains in surplus. An exception to this is the specialty company with the large underwriting gain and the small investment income. A special tax is needed to cover this situation.

Further the proposed bill, in parts 2 and 3, would permit the mutual companies to deduct policyholder dividends from their gains before determining the tax. This particular part of the bill would give the mutual companies an immediate competitive advantage. The 10 percent deduction on reserves of nonparticipating contracts, in our opinion, will not offset the tax break being given the mutual companies at this point. No legislation should be written which will in any way hamper the growth of the small stock life insurance companies in the United States, and no legislation should be writen which will benefit the large insurance companies at the expense of the small life insurance companies.

In conclusion, we should keep in mind that when we increase the taxes on life insurance companies, we are really increasing the penalty on those people who choose to save money through life insurance. We should also remember that the States, through a premium tax, are already collecting a sizable tax from these policyholders.

On behalf of the Association of Arizona Insurance Companies, I wish to thank the committee for granting me this time. We believe that the position of the small insurance companies in Arizona is similar to the position of small insurance companies all over the United States and respectfully request consideration be given the small company.

Senator KERR. Thank you, Mr. Reese.

Are there questions?

Mr. Charles A. Siegfried, Metropolitan Life Insurance Co.

## STATEMENT OF CHARLES A. SIEGFRIED, SECOND VICE PRESIDENT, METROPOLITAN LIFE INSURANCE CO.

Mr. SIEGFRIED. Senator Kerr, Senator Curtis, my name is Charles A. Siegfried. I am a second vice president of the Metropolitan Life Insurance Co.

My comments will be directed to the provisions of the bill affecting insured pension plans.

I might explain that insured pension plans and employee benefit plans of other kinds are my particular area of responsibility at the Metropolitan Life Insurance Co.

Insured pension plans is a branch of the insurance business of vital interest to older persons particularly since it deals with arrangements for providing income during the years of retirement.

This branch of our business had a period of vigorous growth but in recent years has been adversely affected by the impact of the tax laws which have favored noninsured plans. During the last 10 years more insured plans have been discontinued than new plans have been issued.

Senator KERR. At that point, Mr. Siegfried, is that a situation common to the insurance industry, or is your company's experience an exception?

Mr. SIEGFRIED. I understand that our experience is fairly typical of the experience of other companies.

Senator KERR. In reference to this line of business?

Mr. SIEGFRIED. That is right.

Senator KERR. All right.

Mr. SIEGFRIED. More employees were covered under these discontinued plans than were covered under new plans.

Such figures are, however, not a complete index of the seriousness of the situation. Many employers who basically favor an insured plan have not been convinced that the existing tax inequity could long continue and consequently they have withheld decision to change to a noninsured basis. However, if the current legislation does not establish a high measure of equality of treatment between insured and trusteed noninsured plans it is likely that a substantial volume of existing plans will be discontinued.

Perhaps it is not clear why this tax element is so important to employers dealing with pension plan questions. The difference may be described briefly as follows. Under a noninsured trusteed pension plan of the customarily qualified kind there is no Federal income tax on the investment income. On the other hand, if the same pension benefits are insured, the corresponding investment income is subject to substantial Federal income taxes.

If you will permit me, sir, I think it will be helpful if I interpolated a brief illustration at this point that would make clear this difference in tax treatment between the insured plan, on the one hand, and the trusteed noninsurer plan, on the other.

Senator KERR. I will say to you, for my part I will be glad to have you do it, because this is a question on which we have had a vast abundance of testimony, and while it embarrasses me somewhat to do so, I must admit that it has not been followed by a proportionate increase in my understanding.

[Laughter.]

Mr. SIEGFRIED. That is a challenge, sir, and I will try to meet it.

Senator KERR. If you can make a contribution to that, it may not be reflected in the legislation that comes out of this committee, because that will be determined by the committee, but I want to say to you it would be reflected in the improved quality of my morale.

Mr. SIEGFRIED. Well, here goes; I will try.

Let us assume that we have two plans. On the one hand, we have an insured plan, and side by side, everything else is the same, a noninsured trusteed plan.

Let us further assume that $1 million is paid into each plan.

Senator KERR. Each year?

Mr. SIEGFRIED. Well, just let us take, for simplicity, 1 year and just look at the operations of 1 year.

Senator KERR. All right.

Mr. SIEGFRIED. Let us assume further that the only operation of the year has to do with the investing feature.

Let us assume further that the quality of the investment skills of both plans are the same, and they both earn, an investment income of $40,000 for that year. There is $1 million in each fund; each one receives $40,000 in investment income.

Now, in the case of the insured pension plan, the way these tax laws are proposed, a part of the investment income would be excluded from tax, and so, for simplicity, I have to make an assumption as to what part that will be, and for a round figure I will assume the law permits an exclusion of three-quarters of that $40,000 of investment income, leaving $10,000 of that investment income subject to tax.

So, if the tax rate is 52 percent, the insured plan is subject to an income tax of $5,200; whereas, on the other hand, the trusteed plan has no such tax, and so the trusteed plan, at the end of the year, has the $1 million it put in plus the $40,000 of investment income unimpaired, whereas, on the other hand, the insured plan has the $1 million, but has $5,200 less of the investment income left.

Senator KERR. Well, now, while you are discussing that, I would like for you to make it clear as to who will bear the burden of whatever tax there is on the investment income of this plan.

It has been evident here that there has been thought on the part of some that if the tax now on or now proposed on the investment income from the insured pension plan handled by the insurance company is either repealed or not levied, that the insurance company will be the beneficiary of the amount saved.

If I understand the statement you have made, your thesis is that the plan will be the beneficiary of any tax saving brought about by repeal or nonimposition of this tax.

Mr. SIEGFRIED. That is my view, sir; yes, sir.

Senator KERR. What is the correct situation now?

Mr. SIEGFRIED. Well, the plan is the beneficiary of the tax saving, or is the person or the party who is hurt by the imposition of the tax.

Senator KERR. Then if the tax remains on the earnings of this program, what you are telling this committee is that it is a tax on the funds available for payment to the beneficiaries of the plan or I would presume to the employer furnishing the funds?

Mr. SIEGFRIED. That is correct, sir. I deal with that later in my testimony.

Senator KERR. I know, but since you have mentioned this particular illustration here, I wanted to get it into the record, and in my own mind, as to who would be the ultimate payor of that $5,200 tax.

Mr. SIEGFRIED. The policyholder, the employer who was putting up the money for the pension plan, sir.

Senator KERR. The employer or the ones, the beneficiaries, for whom the funds are provided?

Mr. SIEGFRIED. Yes, sir.

Senator KERR. Proceed.

Senator CURTIS. This is a little bit irrelevant, but in both instances, if the employer put up the $1 million, he put it up before taxes, did he not?

Mr. SIEGFRIED. That is right; that is the illustration I gave.

Senator CURTIS. Yes, but the $1 million would be put up before taxes on the part of the employer.

Mr. SIEGFRIED. Well, the employer would get a tax deduction; we will assume this is a qualified plan.

Senator CURTIS. Yes.

Mr. SIEGFRIED. The employer gets a tax deduction on the amount that he has contributed to the plan.

Senator CURTIS. Full amount?

Mr. SIEGFRIED. Full amount; yes, sir.

Senator CURTIS. The individual does not.

Mr. SIEGFRIED. That is right, sir.

Senator KERR. The employer has a deduction for the amount he puts into a qualified plan, whether he does it with an insurance company or with a trust company?

Mr. SIEGFRIED. That is correct, sir.

Senator CURTIS. That is correct.

Senator KERR. If he puts it with a trust company, the earnings on it are tax-free insofar as the trust is concerned, and the benefits accruing to the beneficiary——

Mr. SIEGFRIED. They are fully available to provide benefits under the plan.

Senator KERR. But if it is in the hands of an insurance company, the earnings on it are subject to a tax which, by reason of the method of operation by the insurance company, has to result in an impairment or reduction of the amount of money going into the trust fund for the beneficiary, and really not in money out of pocket of the insurance company.

Mr. SIEGFRIED. That is correct, sir.

Senator KERR. All right.

Mr. SIEGFRIED. I tried at this point to draw attention to the sharp difference in treatment, and then I proceed to say, the effect of these taxes has been to increase the costs of insured pension plans from about 6 percent to 8 percent above the levels that would apply if the tax situation were the same as under a noninsured plan.

Differences of cost of this magnitude are significant to employers and will exert a powerful influence in determining whether employers will establish insured pension plans or noninsured trusteed plans.

It may be helpful to comment on the rather special risks and adverse influences that affect pension plans. These have been beset by powerful hazards. I have been associated with this activity for nearly 30 years. During this time many upward adjustments have had to be be made in pension plan costs (annuity rates). To illustrate, the price for an annuity of $10 a month for a man age 35 with benefits to commence at age 65 has ranged as follows: Back in 1928 the purchase price of such annuity was only $234.

By 1938 it had jumped to $427.90; and currently for the same benefit the price is $617.

These increases have been due to the fact the interest rates fell sharply below the 1928 level and while they have risen recently are still generally below that level. Likewise mortality rates have tended downward which has the effect of increasing the cost of annuities.

A major problem of insurance companies providing pension contracts has been to alertly follow these rapidly changing influences so as to avoid severe losses.

With improved interest earnings in recent years there have been apparent surplus earnings measured against our statutory reserve assumptions. However, under many contracts these surplus earnings are not true surplus since the measure of liabilities should be adjusted in many cases to reflect improvements in mortality rates.

Senator KERR. That means that any improvement in mortality rate results in a greater liability under any given commitment?

Mr. SIEGFRIED. That is correct, sir.

Senator KERR. All right.

Mr. SIEGFRIED. These adjustments are not made on a year to year basis but at intervals as experience is developing. Meanwhile surplus must be built up from which the necessary adjustments can be made. If experience should indicate that any part of the surplus is not needed it will be reflected in dividends to policyholders of insured pension plans.

There is no basis in fact for the view that the pension branch of the business does, or can be expected to, subsidize other lines of business.

There likewise is no basis for the view that any tax relief granted insured pension plans would or could be used to subsidize other lines of business or other classes of contract holders.

Senator KERR. You used the illustration there of the $1 million in the hands of either the trust company or the insurance company. Is there any possibility that a part of that goes into—that the income from any part of that goes to different funds like to your surplus or other category which remains the asset of the insurance company as diassociated from the trust fund?

Mr. SIEGFRIED. Well, we keep a strict accounting of all these pension moneys on a case by case basis, and any surplus that is derived as the result of experience in a particular plan is credited to that particular account, and so in the aggregate also the surplus is accruing to this whole line of insured pension business, and is allocated, credited and held——

Senator KERR. Credited to the trust itself?

Mr. SIEGFRIED. That is right, sir.

Senator CURTIS. Is it a variable contract?

Mr. SIEGFRIED. This is a fixed benefit contract that I am speaking of.

Senator CURTIS. Fixed premium?

Mr. SIEGFRIED. Fixed premiums for a fixed benefit; yes, sir.

Senator KERR. Is the fixed benefit a minimum or is it possible through additional earnings that that be increased or does the experience as you go along, if favorable, results in a reduction of the premium to gain the fixed benefit?

Mr. SIEGFRIED. Well, in a typical case, the employer sets up a plan that anticipates a certain level of pension benefits, and there is a certain price attached to the volume of benefits that must be purchased year by years.

If the experience is favorable and dividends are paid, either of two things can happen: The dividends can reduce his year-by-year cost of that particular plan or it might be used to purchase higher benefits for the employees.

Senator KERR. But it would do one or the other?

Mr. SIEGFRIED. It would do one or the other, yes, sir.

Senator KERR. If the experience was favorable, and the earnings in excess of the cost, that would be reflected either in what we have been talking about, a dividend, or refund of premiums to the employer or an increased benefit to the employee.

Mr. SIEGFRIED. That is correct, sir.

Senator KERR. All right.

Mr. SIEGFRIED. Apart from the fact that the operation of State insurance laws and regulations would preclude any such moves, particularly in the case of a mutual insurance company, the practical considerations against any such attempt would be compelling. Not only is the business highly competitive but employers generally follow very closely the insurers performance and elaborate reports are frequently called for analyzing the financial aspects of the administration of group plans. It is partly on this account that employers are so keenly aware of the unfavorable aspects of the present tax situation. Employers are looking for and hoping for a substantial reduction in these taxes. They are following the development of this legislation very closely. It is inconceivable that a company could hold back or divert from insured pension plan contract holders any relief which may be granted.

H.R. 4245, without the special treatment provided for insured pension plans, would very substantially increase the tax discrepancy between such plans and noninsured trustee plans. With the special treatment provided in this bill, the discrepancy is ultimately reduced. However, for the first year it is substantially increased and then reduced over a 3-year period. Even then, at the end of a 3-year period, it is not eliminated and we believe further relief is needed to remove the tax inequalities between insured pension plans and noninsured trustee plans.

Senator KERR. Any questions, Senator?

Senator CURTIS. No, I think not.

Senator KERR. Mr. Siegfried, I want to thank you for this statement.

I cannot tell whether my mind has been sufficiently disciplined and bettered to where I can understand or whether it would have been in a more lucid condition during these weeks had I heard this statement, to begin with. But it either has left me now reinforced in my misunderstanding or has enlightened me no end. [Laughter.]

Mr. James H. Horn. All right, Mr. Horn.

## STATEMENT OF JAMES H. HORN, VICE PRESIDENT, SOUTHERN UNITED LIFE INSURANCE CO., MONTGOMERY, ALA.

Mr. HORN. My name is James H. Horn. I am vice president of Southern Life Insurance Co. of Montgomery, Ala. My company is a capital stock legal reserve company. I have served as superintendent of Insurance of Alabama, and have some 9 years' State administrative experience in insurance. I have observed my company and many other new and growing companies in the South Atlantic region, and feel that my remarks will be repetitious to and supplemental to their position on this bill, H.R. 4245. I, and my company belong to professional insurance associations and trade groups; and along with them wish to further the orderly growth and progress of the business of insurance.

A summary of my testimony is simply stated as follows:

A. Delete from H.R. 4245, section 802, the provisions which impose the capital gains tax.

B. Delete from H.R. 4245, section 802, the provisions which include the gains from operations as taxable income regardless of taxable investment income.

C. Delete from H.R. 4245, section 805, the provisions which impose the limitations of deduction from investment income for reserves liability; and prescribes an industry average percentage application by the Treasury.

D. Delete from H.R. 4245, section 805, the provisions which grant an additional deduction for investment yield on reserves of insured pension plans.

E. Delete from H.R. 4245, section 815, the entire section and subject of taxation.

An analysis of these points of objection readily projects the recommendation of my company. And that is to revise this bill to the end that it reflect the use of an excess investment income formula as the measure of the actual profit of the company. We also recommend that provisions be made for taxing "windfall income" and "specialty-line" companies through the use of a limited formula which relates investment income to demonstrated excess gain from operations.

Is it possible to depart from my testimony at this point?

Senator KERR. Yes.

Mr. HORN. I had hoped Mr. Cade would be ahead of me because of his earlier testimony in the House on the specialty-line companies, so perhaps I will be getting into his bailiwick with these remarks; but we would certainly like to make them anyhow, and that is, to develop the demonstrated excess gain from operation, to have a modification period of that accounting, and in a 3-year formula.

Senator KERR. With reference to phase 2 or phase——

Mr. HORN. Phase 2; so that the excess, and the windfall income, the increase in your ledger assets from such thing as mergers and acquisitions and sell-off of the properties, such as were discussed by the American Life of Birmingham——

Senator KERR. They were not talking about the gains from a sale?

Mr. HORN. No, sir. Their loss would—they would have a represented increase in ledger assets by reason of the release of their reserves by reason of the business reinsured.

My company bought a large volume of that business, and that is why otherwise, with noncommitted assets that came with that business we purchased from them, it would have represented a gain on an annual statement formula.

So we need a smoothing out period for it. We need to provide, we feel, an orderly process for the specialty-line companies to expand

and to develop and encourage them to go into the ordinary and orthodox lines of insurance under which a true and legal reserve will be readily apparent; will be evident; and that the shock of an excess taxload in any one year would not be an absolutely prohibitive thing, or a deterrent.

Senator CURTIS. What is windfall income in the life insurance industry?

Mr. HORN. Perhaps the best way to answer it, Senator, is by saying "nonrecurring;" and that would be from an exceptional release of reserves, increased value of assets from book value to market value or disposable value which we acquired, not as a result of underwriting profits and true investments, but as a result of merger or acquisition of a company. Ours is a case in point.

I would really like to confine my remarks to our company, because we have that situation.

Much has been said on the subject of capital gains as it relates to a life insurance company and its investment portfolio. Suffice it to say, that stocks constitute a negligible portion of the investment portfolio; and through the use of amortization techniques and valuation procedures of the National Association of Insurance Commissioners, stock transactions do not represent an adequate source of tax revenue, nor do they indicate the existence of a tax loophole. Further, stocks are not considered by the companies to be economically appropriate or suitable investments in view of considerable legislation governing investments of reserves and capital.

Gain from operation, as reported on the convention blank of companies to the insurance departments is but an accrual basis statement of the distribution of the total dollars and admitted assets received. The overage is not the profit. The overage is the amount by which past losses may be recouped, and future losses or deficiencies be shored up. Each company has its own experience, and its own future. The gain or loss in operations for any given year is not the absolute mandate of the course to follow next year. The nature of its liabilities preclude the company's making short-range accounting, or determining a profit for the year, based solely on that year's operation results. Premium income accounting cannot stand apart from investment income to the company, when assessing or defining a profit for taxation. We believe that excess investment income is the fair and equitable source of taxable profits of a financial and savings institution.

The application of an industry average percentage for limitation of deduction from investment income for reserves liability is not considered compatable with our free-enterprise growth and development philosophy. Our company is as individualistic in character and scope as is the community and product we serve. We desire and request the privilege of development of new plans and modes of insurance—to be unfettered in our ability to contract for future liability—and to make certain that we are able to manage our fiscal affairs independently; and to the end that we fulfill our obligations completely and at the same time have the opportunity of making a profit. The competitive forces presently operative in the industry encourages us to undertake these innovations. Now, to press upon the management the need for designing policies and contracts whose interest reserve commitments would be responsive to the industry-average limitation would be a significant deterrent to us in that our chance for profit or service would be subordinated to the prevailing excess tax load imposed thereon. A case in point would be the limitation of reserves commitment for an individual variable annuity, and possibly a group variable annuity based upon the yet unproven reserve table adopted by the National Association of Insurance Commissioners in 1958. This table is presently operative in several States, and awaits legislation in Alabama.

Our company does not presently insure trusteed funds or pension plans. We simply feel that it is unfair and discriminatory to build into law a guaranteed and tax-free withdrawal procedure of a portion of an investment yield that otherwise would be an eligible source of taxable profit. This procedure bespeaks an invitation to shift administrative costs and unencumbered funds to generate profits which are not a result of basic competitive effort.

We consider the matter of separation of unencumbered funds as to policyholder's equity and stockholder's equity to be completely foreign to the business of determining taxable income. The productivity of the surplus of a stock company will be measured and assessed for taxes each year under the investment income approach.

My company feels that investment contributions to capital and surplus should be identified as stockholder equity, to share in the rewards or losses of prudent management. The policyholder equity is essentially represented in the reserves liability apportionment of resources of the corporation. To infer an additional equity of the capital structure to the benefit of policyholders could be interpreted as an indictment of the profit motives of management, and reflect unfavorably upon the proven actuarial principles upon which policy reserves are calculated.

An additional hazard to this separation of funds is the possible interpretations to be given these funds by the several State insurance departments. Life insurance rates are not presently regulated by the States. Certain statistical data on costs and loss ratios on specialty-lines are filed in justification of rate structures to many departments at present. It is possible that this proposed procedure of separation of surplus for tax purposes might open the door for further efforts to regulate basic rates by some departments of insurance. We feel and recommend that the present procedure and acceptable method of calculation and distribution of surplus should remain unchanged.

Again, if I may depart, Senator, to suggest that at this period, at this moment of testimony, that it also being in the 1942 act and in the 1955 stopgap Miller-Curtis Act; that we insert in H.R. 4245 section 818, which is the 10-year spread for the small company.

There may be some redundancy for the small business deduction in it, but we will, for the moment withhold comment on that.

In conclusion, let me state that my company is completely competitive in rates and coverages. We compete with mutual, fraternal, mutual aid, and benefit associations in the States in which we operate. We do not have a domestic mutual life insurance company in Alabama. We seek the prevention of possible advantages in competitive or investment practices, and earnestly request of this committee that it revise the bill before it. We urge the enactment of a permanent tax bill that will be conducive to the capital growth of all segments of the industry, and yet be immediately responsive to economic trends of our national economy. We feel that a permanent tax act along the lines of the law under which we have paid taxes since 1955 will provide this growth opportunity and produce appropriate revenue to the Treasury.

Thank you very much for this opportunity to be heard. If you have inquiries, I shall do my best to oblige.

Senator KERR. Any questions?

Senator CURTIS. No.

Senator KERR. Thank you very much, Mr. Horn.

According to the information before me that completes the list of witnesses who have been scheduled to appear, with the exception of one who, as I understand it, filed a statement and announced that he would not be here.

Thus it brings the hearings on this bill to a conclusion. However, the record will be kept open until Tuesday morning for the filing of any additional statements pertinent to this question by parties or companies to be affected by it or the filing of the retraction of any statements heretofore entered and made a part of the record.

Senator CURTIS. Does that apply to questions asked, too?

Senator KERR. Yes. [Laughter.]

For myself and the committee, I want to express appreciation for the unbounded patience and great effort made by all of the witnesses to enlighten the committee on this bill with reference to which, so far as I have been able to discover, the only unanimous opinion is that it is difficult and complicated, therefore one with reference to which all possible information has been and is needed.

With those remarks, the committee will recess subject to the call of the chairman.

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

STATEMENT FILED BY RICHARD C. GUEST, VICE PRESIDENT, MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY OF SPRINGFIELD, MASS.

Throughout the hearing great and repeated emphasis has been placed upon a contention that H.R. 4245 would place a discriminatory and unbearable burden upon stock companies, particularly small ones. The testimony being placed in the record at one time became so misleading that Chairman Byrd felt it necessary to read into the record the huge tax increases contemplated in a few of the large mutuals. In spite of this clarification, there may still remain some doubt as to whether the tax load under H.R. 4245 would in fact favor one type of operation at the expense of the other.

In my testimony before the Ways and Means Committee in November 1958, I studied relative tax impact among the companies who were members of the American Life Convention. I wish now to place in the record a similar study this time related to 168 company members of the A.L.C., 121 stock and 47 mutuals. They are representative of the business and represent a very large proportion thereof.

Life insurance company receipts are almost completely made up of premiums diminished by policyholder dividends, if any, and earned interest. I call the total of these "adjusted gross receipts". Adjusted gross receipts, although inappropriate for use as a tax base, bear the same relation to company operations in all companies regardless of the nature of the business and regardless of whether the companies are stock or mutual. Taxes proposed under H.R. 4245 have been compared company by company per thousand dollars of adjusted gross receipts. These results have been summarized.

Among the 121 stock companies as a whole, the taxload is $27.10 per thousand of receipts. Among the 47 mutuals as a whole the corresponding load is $32.50 per thousand, 20 percent higher than among the stocks. It may be contended that this difference in result is due to the deduction of policyholder dividends. In my testimony I made it quite clear that we consider that dividends should be fully deductible in any corporate tax approach. Without in any way implying that dividends should not be deducted, and merely as a test of the most extreme assumption, the figures were recalculated with no dividends deducted. Result: $20.30 for stocks and $28.30 for mutuals. Hence, regardless of the impact of dividends, the taxload under H.R. 4245 is undoubtedly heavier on mutuals than on stocks. This is to be expected because of (1) the deduction from taxable income in phase 2 of 10 percent of the increase in nonparticipating reserves and (2) the 50 percent postponement of tax on taxable gains calculated under phase 2 which applies to nearly all stock companies but seldom applies to mutuals since quite generally mutuals show no taxable gains except from interest. Any deferred tax payable in the event that the limit on the policyholder fund is reached, is definitely a stockholder tax and should not enter any comparison of the taxload from the standpoint of the policyholders.

Stock and mutual companies are equally characteristic of our great free enterprise system. Although on the one hand a strong case can be made for a lower taxload on free enterprise operating at cost on a mutual basis, on the other hand there is no valid reason why the taxload on mutual insurance should be heavier than on nonparticipating insurance offered by stock companies.

The recommended amendment to substitute the 5-year average earned rate for the mean of two interest rates in H.R. 4245 tends, to a small extent, to even the taxload.

The recommended amendment to allow deduction of 50 percent of negatives, revealed through phase 2 by the deduction of policyholder dividends, would likewise tend to result in a fairer distribution of the taxload. In fact this feature, although of great merit, seems to have been discarded in drafting H.R. 4245, not because it was unfair but because it was feared that in extreme circumstances an undesirable competitive condition might result and because it would seem to depress the revenue below the predetermined acceptable level. The bill should be amended in some way so as to (*a*) minimize the possibility of the development of such an undesirable competitive condition and (*b*) preserve the deductibility of extraordinary losses characteristic of all corporate tax law.

(See also p. 149.)

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MURRAY W. LATIMER

INDUSTRIAL RELATIONS CONSULTANTS

*Washington, D.C., March 20, 1959.*

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

DEAR SENATOR BYRD: The Senate Committee on Finance has under consideration H.R. 4245 relating to the taxation of the income of life insurance companies. I earnestly request your support for amendments to H.R. 4245 which would treat the income allocable to the highly important pension and group insurance business of the life companies on a more equitable basis than is done by the House version of the bill.

I am, and for many years have been, a consultant on pensions and other employee benefits to unions, corporations, and joint labor-management administrative groups. Among those for whom I have served in the recent past are the American Federation of Labor and Congress of Industrial Organizations, the Brotherhood of Railway and Steamship Clerks, Health Insurance Board of the State of New York, the Kaiser Motors-UAW-CIO pension fund, the Kaiser Metal Products-UAW-CIO pension fund, the Montgomery County Board of Education, the Pacific Telephone & Telegraph Co., and the United Steelworkers of America. For nearly 12 years I was Chairman of the Railroad Retirement Board; I served also on the Technical Board (and as Chairman of the Board's old-age security committee) of the Commitee on Economic Security, which was instrumental in the preparation of the Social Security Act; and I was the first Director of what is now the Bureau of Old-Age and Survivors Insurance of the Social Security Administration. What I have to say in this letter is based on my experience as a consultant in the pension and employee benefit field and as Government administrator of old-age insurance; the opinions expressed are my own and are not necessarily those of any whom I serve as consultant.

Under existing law, the investment income of a pension trust which has been approved by the Director of Internal Revenue pursuant to the provisions of section 401(a) of the Internal Revenue Code (sec. 165(a) before the 1954 code) is not taxed. But income from pension investments implementing insurance company underwriting of a plan with identical approval has no such exemption.

Group life and accident and sickness insurance underwritten by commercial insurers has always been subject to tax. Section 501(c) of the Internal Revenue Code exempts from taxation the income of many organizations engaged in underwriting life, sickness, accident and related benefits; fraternal beneficiary societies, orders or associations; certain voluntary employees' beneficiary associations; benevolent life insurance associations of a purely local character; and certain small mutual insurance companies. Blue Cross and Blue Shield organizations are also exempt from income taxation.

The bill H.R. 4245 contains provisions which will roughly double taxes on insured pension business for 1958 as compared with 1957 and multiply group life insurance taxes by three or more. The taxes on the pension business will be reduced over a 3-year period; and by 1962 the total tax bill since 1958 may be slightly less than if the 1955 law had been continued without change. Substantial discriminatory taxation, in relation to self-administered trusteed plans, will remain. The increased level of taxes on the group life insurance will, under H.R. 4245, be permanent.

This increase in the level of taxes on the pension and group insurance business, already discriminatory, seems to me not in the public interest.

It has been the policy of our Government—and I hope it always will be—to encourage employers to adopt pension plans to augment the benefits provided under the Social Security and Railroad Retirement Acts. This policy has a number of facets: maintenance of benefits provided through governmental arrangements at a minimal level; the offer of tax savings to employers who maintain pension plans meeting certain statutory standards; capital gains treatment for certain lump-sum distributions from pension trusts; and, for approved pension trusts, exemption of income from tax.

The stimulus of these encouragements, coupled with a high level of corporate and personal income taxation, has produced a phenomenal growth in industrial pension plans. There are now over 40,000 in operation covering perhaps 15 million employees; the pace of establishment of new plans remains rapid.

Governmental encouragement of employee benefit plans other than for pensions has occurred primarily in war and other emergency periods when wage control agencies denied cash wage increases in favor of employer expenditures on insurance plans. The growth of such plans has been rapid in part because contributions by employees have been more popular than has been true for pensions. In any event, I believe it desirable that the spread of these plans continue.

To meet the needs of American industry, a very wide range of types of pension and insurance plans is need. Many agencies have contributions to make toward the maintenance of these plans. Life insurance companies, through group insurance, annuity, and deposit administration contracts, are in position to render and in fact are rendering a great service to the maintenance of sound industrial pension and insurance plans. In my judgment, the service which insurance companies can perform has been artificially and undesirably restricted by tax discriminations embodied in the Internal Revenue Code, discriminations which would continue in substantial degree or be increased by enactment of H.R. 4245 in its present form.

Insurance company pension and insurance services are most needed by the smaller companies; large companies may find such service advantageous but they have feasible alternatives. With the small companies, insurance of risks is essential for safety. The tax discrimination against the insurance companies has been a factor in leading companies toward unwise decisions not to insure or, in certain cases, to join in with other small employers, particularly in connection with plans agreed upon in collective bargaining, in operating self-administered plans. My observation of the latter is that in many cases they are likely to prove an inadequate substitute for insured plans; already, despite the handicap of the tax inequity, there has been some movement of the groups of small employers with pooled funds toward insurance. That movement ought not to be handicapped.

This is particularly true for pensions. As an example, take the case of the steel industry. The United Steelworkers of America has collective bargaining agreements with over 2,000 employers in the basic steel and steel fabricating industries; of these agreements, about 63 affect 2,000 or more employees. In all of the group of 68 employers there is an agreed-upon pension plan. Some 220 agreements cover between 500 and 2,000 employees; the great majority, but not all, of the employers in this group have pension agreements, with insurance company underwriting in perhaps 10 to 15 percent of the cases. The union agreements with about half of the employers having between 100 and 500 employees provide for pension plans. There are few pension plans maintained either by agreement with the union or otherwise by most of the remaining 1,800 employers having fewer than 100 employees. The steel industry is typical of many. Any substantial expansion of pension plans, where small employers will be primarily affected, will require that pooling of risk which insurance companies are unusually qualified to provide.

There have recently been several investigations of the operation of "union health, welfare and pension funds." So far as I know, the overwhelming majority of the pension and insurance funds which have been investigated have been honestly managed. It seems likely, however, that one result of these investigations, directly or indirectly, will be to make almost universal the practice of selecting pension and insurance plan underwriters through competitive bids. In competitive bidding the immediate price rather than long-range cost tends to be the predominant factor in placing insurance business. Under these circumstances the consequence, for healthy further spread of private pension and insurance plans, of continuation of the discriminatory tax will be most harmful.

It would be too much to say that no other way could be found to extend sound pension plans to small companies. Pools of small employers can be organized, and perhaps common trust funds may have a use in this connection greater than now seems probable. But without private insurance carries there will be no feasible method of any kind for a not insignificant number, and for most the alternatives may well be less satisfactory than insurance. For most life insurance and sickness benefit plans there is no satisfactory alternative to insurance company underwriting.

To put the group annuity plans underwritten by insurance companies on a par with pension trusts these changes in the provisions of H.R. 4245 would be needed: (1) Exclude from taxable income all investment income and operating and capital gains attributable to the pension business; and (2) eliminate, for years after 1958, the staggered application of the exclusions. So far as other group insurance is concerned, complete exclusion of investment income and underwriting gains is probably not necessary. It would suffice to permit the full exclusion from taxable income of (2) the 2 percent of group life and group accident and sickness premiums, but only to the extent actually set aside as a contingency reserve for the benefit of policyholders, and (b) all dividends to group life and group accident and sickness policyholders, even though such exclusion in step 2 brings the taxable income below the amount determined under step 1.

Clearly the tax law ought to encourage rather than discourage the accumulation of contingency reserves which, in group term insurance particularly, are essential for policyholder protection. Dividends are to a considerable degree a form of pricing which, in group life insurance, is made necessary by the minimum premium law for all companies doing business in New York.

I understand that some witnesses testifying before your committee have alleged that the removal of the discriminatory pension tax will not benefit the pension funds, but rather will be used to reduce the net premiums to policyholders in other departments, to the competitive disadvantage of companies not in the pension business. Under State insurance laws such diversion would not be possible for a mutual company. Gains from pension and group insurance business must, in a mutual company, be allocated for the benefit of pension and group insurance policyholders. And while stock companies pay dividends, they must also compete with mutuals for business. On the basis of my long experience as an insurance and pension consultant and dealings with many insurance companies over many years, I am certain that, even without legal compulsion, reductions in pension and group insurance taxes will therefore directly benefit policyholders in these lines.

I should make it clear that I have a personal interest in this matter. I have pension and insurance plans for my employees. Because my staff is small, and because there are no pools of any sort in which I could participate if I were so inclined, lack of private insurance underwriting would mean that I could have no pension plan. I would be willing to pay more for my plan than I now do if that were necessary to keep it in operation. But I can think of no good reason for my being charged several thousands of dollars over the next several years because of a tax which I could escape entirely if trust fund operation of my pension plan were practicable. Nor do I think my employee life insurance plan should be taxed more heavily than if my employees were to organize a mutual benefit association.

I hope that this letter will be placed in the records of the current hearings.

Very truly yours,

MURRAY W. LATIMER.

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STATEMENT OF T. O. McCULLOUGH, PRESIDENT, UNION NATIONAL LIFE INSURANCE CO.

I am Ted McCullough, president of the Union National Life Insurance Co. domiciled in Baton Rouge, La. In addition to speaking for my own company, I believe that I am representing the views of all the companies domiciled in Louisiana. We have held statewide meetings concerning H.R. 4245. While we did not have 100 percent attendance, all companies attending expressed support of the points I will mention; and to my knowledge, none of the companies in this State are opposed to these points.

First, I would like to say that the companies of Louisiana desire to be placed on record as favoring Federal taxation based upon investment income alone. We feel this is the fairest way of taxation among the stock and mutual companies alike, and we urge you to develop a bill based upon this method.

Should it be impossible to tax us on investment income only, we solicit your consideration of the suggestions below. In reference to H.R. 4245, we would like to say that we support the testimonies already given in behalf of—

(1) The 5 year moving interest average.

(2) Tax exempt bonds.

(3) A transition period from the 1942 law to the new act.

(4) Liberalization of the small company deduction either by increasing the percentage to a maximum deduction of $25,000 or a flat $25,000 deduction and increasing the loss carryback to 15 years.

I would like to mention two other points for your consideration. Section 815 of H.R. 4245 requires the establishment of a shareholders surplus account and a policyholders surplus account and the amount in such account on January 1, 1958, shall be zero. We would like to have that last sentence read, the amount in such account shall be zero on either January 1, 1958, or on January 1, 1959, at the option of each company. The tax is retroactive to January 1, 1958; therefore, a company should be able to use January 1, 1958, if it so chooses to establish its shareholders and policyholders account. I have talked with the Treasury concerning this alternative and believe that they will concur with me that this alternative should be placed in the bill.

The final suggestion we would like to make concerns an alternate deduction to the 10 percent increase in reserves given stock companies in phase 2.

Several witnesses have testified that a stock company needs a larger safety margin in the form of surplus than is needed by a mutual company.

The House bill recognizes the need for a stock company safety margin provision to equalize competition. The deduction for certain nonparticipating contracts, provided by section 809(d)(6), is based on that principle. We endorse the principle, but we respectfully urge that in its present form the goal of equalizing competition is imperfectly achieved.

The need for the safety margin arises because of the long-term risk involved in principal types of insurance written by life insurance companies, and the nonpar deduction ought to reflect the degree of long-term risk. The long-term risk is not necessarily proportionate to the reserve on long-term policies. The bills' current deduction, equal to 10 percent of increase in reserve on certain nonparticipating policies, may provide a reasonable deduction on the average, but there are many companies—especially small companies—which are exposed to a high degree of long-term risk on policies with lower-than-average reserves. Such companies need a higher nonpar deduction than companies with higher average reserves, but the present provision gives them a lower deduction. Thus, if the safety margin is determined by increase in reserves, those companies with the greatest need get the smallest deduction.

To illustrate, let us take a term-to-age 65 policy and an endowment-at-age 65 policy. The endowment policy builds up reserves rapidly, in order to pay back the savings at age 65, and the higher the reserves grow, the lower is the remaining degree of long-term risk. The term-to-age 65 policy, on the other hand, doesn't involve any savings account like the endowment policy—it provides pure protection, and the reserve stays relatively low and the degree of risk stays high. Under the present provision, based on increase in reserves, the policy with the highest degree of risk gets the lower deduction.

To overcome that inequality in the safety margin provision, we urge that the bill be amended, retaining the present deduction based on increase in reserves but adding, as an alternative, a deduction based on 5 percent of premiums received.

We believe that, on the average, a deduction equal to 5 percent of such nonparticipating premiums is equivalent to the present deduction based on 10 percent of increase in nonpar reserves. Individual companies that differ from the average by writing a larger proportion of high-reserve types of insurance would use the deduction based on increase in reserves, and companies which write a larger-than-average proportion of high-protection, low-reserve types of long-term insurance would use the alternative deduction based on premiums. Both types of deductions are needed to provide an equitable result.

We urge that you add to the provision that gives the deduction of 10 percent of increase in nonparticipating reserves an alternate deduction of 5 percent of premiums collected on nonpar business.

Thank you very much.

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TAX FREE INTEREST AND H.R. 4245

Statement of Stanford Z. Rothschild Sr., President Sun Life Insurance Company of America of Baltimore, Md. Speaking in behalf of over 120 Life Insurance Companies from all parts of the United States on H.R. 4245, Life Insurance Company Income Tax Act of 1959, Before the Senate Finance Committee.

The purpose of this statement is to show that H.R. 4245 can be amended to give life insurance companies the same exemption for tax-free interest as is accorded all other investors without any appreciable net loss in revenue to the Treasury.

It has been stated that if the life insurance companies were allowed to retain tax-free status on interest from tax-exempt securities, the revenue to the Treasury anticipated under H.R. 4245, would be reduced by about $32½ million.

We believe this is in error and that any loss that could occur would be substantially if not completely offset for two reasons:

First, such income is not taxable now, therefore produces no revenue to the Government.

It is true that if H.R. 4245 is not amended, it could produce about $32½ million, less the offsets herein stated, by taxing the life insurance companies on from 70 to 75 percent of their tax-free interest on any securities issued by the States and their subdivisions; a result which we believe the Congress would sincerely wish to avoid.

If so taxed, the life companies, instead of venturing more freely into tax-exempt securities with their lower rate of return, may go largely to taxables with greater return. The same tax-free securities would then become available to others in high tax brackets, who would receive the very same income tax free. This again would produce no revenue for the Treasury. But—

If H.R. 4245 were amended as requested, the life companies, being encouraged to buy more tax-exempts, could to some degree replace investors in the higher tax brackets, making it necessary for the latter to move into taxable securities. The increased taxes which such investors would then pay on taxable income would partially offset the possible loss of revenue that is claimed. It is all a question of the rate of tax which applies to the individual owner of tax-free securities. And if the Treasury is to suffer any loss at all, it must be because the life insurance companies would be paying a tax on tax-exempt interest.

Second, if the life companies are allowed the full exemption already accorded all other investors, their increased activity in the tax-exempt field would push prices up, force yields down, and so make it easier for the States and their subdivisions to handle their own financing. This, in turn, would lower the pressure on the Federal Government for aid, and reduce the drain on the Treasury. It is commonly known that individual investors hesitate at going too freely into tax-exempts because of limited marketability. But marketability is of no great concern to life insurance companies, who seek security first, then try to invest for the long term.

The above views are shared by several economists of national reputation in the field of tax-exempt finance, among them—

Walter A. Morton:
- Professor of economics, University of Wisconsin.
- Ph. D. University of Wisconsin.
- Former president, Midwest Economics Association.
- Consultant in financial matters to a large number of industrial and utility firms.
- Author of numerous articles on taxation and finances including a book "Housing Taxation."

Harry L. Severson:
- B.S., University of Minnesota.
- M.S., University of Chicago, School of Business.
- Additional graduate word, Department of Economics, University of Chicago.
- Presently, financial consultant, New York City.
- Author of "Municipal Credit Analysis," published in "Municipals."
- Frequent contributor to various journals, periodicals.
- Formerly head of Investment Research Section, Federal Deposit Insurance Corporation.

Arthur R. Upgren:
- B.A., University of Wisconsin.
- Ph. D., University of Minnesota.
- Economic consultant, First National Bank of Minneapolis and St. Paul.
- Contributor, editorial pages, Minneapolis Star.
- Director, Green Giant Co., LeSueur, Minn.
- Formerly dean and director of research, Amos Tuck School of Business Administration, Dartmouth College. Vice president and economist, Federal Reserve Bank of Minneapolis. Chief National Economist, Division, Department of Commerce. Economic analyst, Department of State.

And several others of like stature who have expressed general agreement, and who are now[1] preparing a written statement.

Dr. Walter A. Morton's penetrating analysis of the tax-exempt aspect of H.R. 4245 follows:

MADISON, WIS., *March 18, 1959.*

Mr. HAROLD J. CUMMINGS,
*President, Minnesota Mutual Life Insurance Co. of St. Paul,*
*Washington, D.C.*

DEAR MR. CUMMINGS: Pursuant to my conversation with your Mr. J. S. Hill, I have studied the effect on total Federal income tax revenues should the present H.R. 4245 be amended as you propose to provide for full tax exemption of the income from State and municipal securities.

After considering the pertinent facts and the relevant economic theory, it is my opinion that such treatment will not diminish, in any except perhaps in some insignificant and incidental manner, the total revenues of the Federal Government as compared to what they would be if H.R. 4245 were enacted in its present form.

Briefly, the effect on total Federal revenue will be nil or negligible.

This is true because the total loss of revenue from tax-exempt securities is determined by the total income from such securities multiplied by the rate and not by who happens to hold these securities. If A buys a tax-exempt security from B, he gains tax exemption and B loses it. The only possible differences in the revenue will depend upon whether A or B would pay a higher rate. In the instant case, the rate applied to insurance companies is the same as that paid by other corporations and most likely is lower than the rate which would be paid by private holders in the higher income brackets.

In any event, the Federal revenue loss from tax-exempts is determined chiefly by the total volume of tax-exempt securities outstanding and not whether they are held by insurance companies or by others.

Let me now state the general economic analysis and facts upon which this opinion is based.

[1] Mar. 19, 1959.

1. By and large, those who purchase tax-exempt securities do so for the purpose of diminishing their tax liability. This liability is decreased in proportion to the height of the marginal rates of taxation. Hence the greatest benefit from tax-exempts accrues to the higher income groups.

2. Corporations, chiefly financial, subject to the 52 percent corporate income tax rate, also have an incentive to buy these securities.

3. This combined demand drives the yields down to a level lower than that on taxable corporate bonds of equal quality which, to that extent, offsets the tax savings. The net advantage to the holder, accordingly, is less than the tax-exempt income multiplied by the marginal rate.

4. Insurance companies under the proposed legislation will have the same incentives as other corporations to diminish their income tax liabilities. They will, however, not be able to compete for those securities with individuals whose marginal tax brackets are above 52 percent.

5. But insofar as the insurance companies acquire municipal securities that would otherwise go to banks or other corporations, the tax effect cancels out exactly. The income tax savings made by the insurance companies are lost to the banks and others, and total Federal revenues are unaffected.

Insofar as the insurance companies purchase municipals that would otherwise go to individuals, the effect on revenues would depend upon the differential rates of taxation. Inasmuch as I do not know the holdings of tax-exempts by income groups, I cannot calculate the tax gain or loss, but I believe it to be a reasonable assumption that tax-exempts are held chiefly by those paying higher than the corporate rate. However, insofar as they are held by those paying less than 52 percent marginal rate, there would be some loss of revenue if those holders sold to insurance companies. But this would also happen if they sold to higher bracket individuals, to banks, or to other purchasers of municipals, and since this is not a phenomenon peculiar to the insurance companies it hardly constitutes a ground for differential treatment.

6. At the end of 1957, total State and municipal tax-exempt securities outstanding in round numbers was $52 billion. The ownership was distributed as follows, according to the U.S. Treasury Department:

| | *Billion* |
|---|---|
| Individuals, partnerships and personal trusts | $22.0 |
| Commercial banks | 13.4 |
| Mutual savings banks | .7 |
| Insurance companies | [1]7.4 |
| Other corporations | 1.5 |
| Miscellaneous | 1.0 |
| Sinking, trust and insurance funds of State and local governments | 5.8 |
| Total | 52.0 |

[1] "The Life Insurance Company Fact Book for 1958" shows the holdings of life companies to be $3,163 million or only 2.1 percent of total assets.

7. The question arises whether enactment of the proposed provision that insurance company tax-exempt income be fully credited would lead to complete avoidance of taxation by insurance companies through the acquisition of tax-exempt securities.

Even if this were to happen, as I already pointed out, it would automatically increase the taxes paid by others and would not affect total tax revenues.

But I do not believe that it will happen for the reasons stated in paragraph 8.

8. According to the information furnished me by you, about 30 percent of the income of insurance companies now comes from funds other than reserves and hence would be subject to the 52 percent rate. To completely avoid taxation, 30 percent of total income would have to be derived from tax-exempt securities. Now even if the yield on municipals would be equal to the yield on other taxable securities (which it is not), it would require insurance company holdings of municipals to be increased 10 times, that is, from 3 percent to 30 percent of total assets, or from $3 billion to $30 billion. And since the yield on tax-exempts is lower than on other assets, complete tax avoidance would theoretically require municipals to be about 40 percent of total assets, or about $40 billion or 13 times present holdings.

This means that the insurance companies would have to bid these securities away from other holders shown in paragraph 6.

9. To attempt to bid away those securities would drive yields down to the place where the yield differential between municipals and corporates would make this procedure undesirable and would, of course, subject the other holders to taxation which presumably the insurance companies were avoiding.

10. Nor could the life companies get exemption through purchase of new issues. New issues of municipals are about $3 to $4 billion per year. At this rate it would take 10 years for the insurance companies to acquire $30 to $40 billion of those securities if they bought all new issues and no one else bought any at all.

11. Insofar as it has any effect at all, the probable increased competition for these securities from insurance companies, assuming they remain completely tax-free, will drive down the rate further, and the beneficiaries of such interest rate reductions will be the municipalities and the property tax payers who will find their taxes decreased.

12. I do not believe, however, that such lower yields on municipals will have any appreciable effect on the total volume of municipal securities issued because that will be determined by need of money for schools, roads, municipal construction and other purposes. These are, within existing levels, quite independent of interest rates.

13. Any reduction in the rate of interest on municipal securities reduces by so much the total tax payments for property or sales taxes and thereby decreases the amount of tax deductions of individuals and corporations for Federal tax purposes. This, of course, would actually increase Federal tax revenue.

14. We may now consider what will probably happen to holdings of municipals based on the experience of others. I have shown that complete tax avoidance would require that tax-exempts constitute about 40 percent of total assets of life companies instead of the present 3 percent.

The experience of banks should throw some light on actual practice in this respect. The commercial banks are subject to a tax rate of 52 percent and now have the same incentive as insurance companies will have to avoid taxation of their income. Yet they have not carried municipal holdings to any extreme, partly for reasons of income and partly for considerations of liquidity. The insurance companies, however, would not be affected to a similar degree by the liquidity factor.

Page 124 of the "Annual Report of the FDIC for the year ending December 31, 1957" shows that the insured commercial banks received only 5.12 percent of their current operating earnings (gross income) from "other securities" which are mostly municipals. Their net profits before income taxes were 1.10 percent of their gross, and after income taxes 0.64 percent.

If the 1.10 percent had been subject to the full 52 percent rate, it would have left a net of 0.528 percent rather than the 0.64 percent. This shows that the largest corporate holders of municipals receive only a minor reduction in taxes from their holdings and do not carry this policy to attempt complete tax avoidance. The reason is that it would be impractical as well as unprofitable to do so.

In 1957 the insured commercial banks paid $998 millions of income taxes compared to $275 millions in 1948 (Ibid., p. 40). There is, moreover, no substantial change in the proportions of municipal securities held.

15. I doubt very much, therefore, whether the insurance companies are likely to move into municipals by 30 percent or more of their assets. But if they should do so, other institutions and individuals will by so much lose the tax-exempt income gained by the insurance companies.

16. I conclude that the feared loss of revenues to the Treasury from the proposal to allow full credit for tax-exempt income to insurance companies is without any foundation in fact. The real source of revenue loss is the very existence of tax-exempt securities.

Sincerely yours,

WALTER A. MORTON.

Harry L. Severson, a consulting economist from New York, comments upon the tax loss involved in granting full tax exemption to life insurance companies as follows:

"The wide ramification of a fundamental change in the application of the income tax makes extremely difficult the task of estimating the net loss of revenue to the Treasury which would result from an amendment to H.R. 4245 giving life insurance companies the full benefit of tax-exemption. But it seems apparent that the loss, if any, would be negligible when all aspects of the situation are considered.

"The loss in revenue to the Federal Treasury results from the very issuance of tax-exempt bonds. The principal appeal of these bonds has always been to investors in the higher tax brackets, and there is no reason to think this will not continue to be the case. To be sure at today's prices investors in the middle income brackets could well afford to buy these bonds, but the fact remains that there has been no rush by this group to do so. Consequently, when life insurance companies buy additional quantities of tax-exempt bonds, they will, for the most part, be bidding them away from corporations who are also in the 52 percent bracket and from individuals who are in higher tax brackets, some even in the highest bracket.

"Furthermore there are certain indirect benefits which would accrue to the Federal Treasury from a more active participation of life insurance companies in the tax exempt bond market. These offsets should be considered in evaluating the effect of any policy upon the Federal Treasury.

"By holding down the interest cost on new offerings a policy which extends the market for State and local bonds would:

"1. Reduce the amount of tax exempt interest on each bond.

"2. Reduce debt service which, in turn, would reduce local taxes, and which in its turn would reduce deductions in computing net revenue subject to tax.

"3. The lower interest rate on new issues would tend to reduce the pressure for additional Federal aid.

"There are many imponderables but it seems unlikely to this writer that, with so many new issues coming to the market, a tax policy which has the effect of broadening the market for these bonds will result in a net loss of revenue to the Treasury."

Arthur R. Upgren, an economist of national reputation, writes as follows:

"In H.R. 4245 is found a failure to exempt from taxation the interest on securities which in the present interpretation of the Supreme Court of the United States shall remain tax exempt. Correction of the method of treating tax-exempt interest in its effects upon the proposed earnings base for life insurance companies is both required and desirable. In addition, *this correction will produce gain for the Treasury.* [Emphasis supplied.]

"The change contemplated in the rate of taxation of the life insurance industry and the needed correction in the treatment of tax-exempt interest, will pronouncedly shift tax-free securities into more favorable position as investments for the life insurance companies.

"Inasmuch as it will certainly be the will of Congress that tax-exempt securities will remain equally tax exempt when owned by life insurance companies, a greater flow of these securities into life insurance portfolios will result. The life insurance companies, being entitled to the same privileges granted other groups, will be receiving what they are entitled to. But there will be a diversion resulting thereby. This will tend to shift other groups relatively away from tax-free securities. To the extent then that these other investment groups purchase taxable securities, their income to that greater extent will become taxable. That will enlarge the flow of revenue to the Treasury accordingly. To the extent that these groups purchase *common stocks*, tax revenues will increase as substantially as the dividends are taxed, and by the amount of the capital gains tax upon such stocks as are bought for a long run capital gain or profit. These taxes are substantially better, obviously, than the complete absence of tax revenues from the tax-exempt securities which these other groups will have formerly held. Municipal or tax-exempt securities are flowing into the capital markets in large amounts. Granted the continued tax-exempt status for the life insurance industry and assuming the passage of H.R. 4245 with this needed correction, the life insurance companies will acquire a larger, much larger, portion of fresh issues of these securities. Other investor groups whose relative appetite for the tax-exempt issues is not similarly changed will acquire more of the taxable issues, and more of their other alternative, namely, common stocks. This will, given their non-tax-exempt status, improve the tax yield to the Treasury from the income of these investments and from such capital gains as may be made." [Emphasis supplied.]

Testimony submitted to the Senate Finance Committee states that approximately the same treatment was accorded tax-exempt interest in the 1942 law as is proposed in H.R. 4245.

The 1942 law and the stopgap laws were completely different in concept from the proposed legislation. They were, basically, industry-wide excise taxes, having no relation to a particular company's individual profits. In using an arbitrary industrywide percentage to determine taxable investment income, tax-exempt income was excluded.

But it is claimed that in determining the industrywide percentage the Secretary of the Treasury in effect taxed on an industrywide basis part of the tax-exempt interest. The proposed law H.R. 4245 abandons the industrywide approach and taxes each company on its own earnings.

This points up the fundamental distinction between all previous methods of treating tax-exempt income and H.R. 4245 except for the 1921 law which was changed by litigation.

The 1942 law did not penalize a life insurance company for its individual amount of tax exempts by reducing its deduction to the extent that it held tax-exempt securities.

There was no such thing as an individual company receiving a smaller deduction to the extent that it held a larger amount of tax-exempt securities.

H.R. 4245 is the first actual law attempting to determine an individual company's taxable income from investment results and from operation. As such, it should not be the first law to increase an individual company's taxable base by the partial inclusion of its tax exempt income.

In a word, since any loss of revenue that may be claimed must result from what would be a tax on 70 to 75 percent of the tax-exempt interest of the life insurance companies, and since such loss as may be claimed would be largely offset anyway for the two reasons stated, is it not fair and reasonable to ask:

1. Why discriminate unfairly between the life insurance companies and all other investors in tax-exempt securities?
2. Why threaten by precedent the very existence of tax-exempt securities?
3. Why risk litigation of what may at least be a constitutional question, and still end up with no additional revenues?

Obviously, if the life insurance companies can be taxed on tax-free interest, directly or indirectly, any and all other such investors can and probably would be taxed later in the same way.

Indeed, has the Congress ever before drafted a tax pattern for any group of taxpayers by first fixing the amount of revenue desired, then, in fixing the formulas for raising the funds needed, attempted to make up part of any deficit by taxing the tax-exempts owned by that particular group?

Should not all the taxes needed be raised by taxing taxable income only?

The 1959-60 fiscal year budgets $500 million in tax receipts from the life insurance industry.

However, estimates for revenue produced by H.R. 4245 approximate $545 million for 1958 and $600 million for the calendar year 1959.

Therefore, there seems to be no need for taxing State and local bonds, in part, even from the pragmatic aspect of tax revenue requirements.

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Question. Could the life insurance industry then eliminate all, or substantially all of its remaining tax liability of $516,500,000 by the purchase of additional tax-free bonds?

Answer. No.

As long as State and municipal bonds are tax-exempt, their purchase and ownership serves to eliminate tax liability. This escape is open to all investors, corporate and individual, but it is purely theoretical, and does not happen in practice.

Assuming tax avoidance was an objective in itself, commercial banks, casualty and fire insurance companies could invest all their funds in tax-exempt securities, and so could life insurance companies—but in practice they would not because—

1. This would be physically impossible (reference B).
2. This would be impractical (reference C).
3. This would be self-defeating (reference D).
4. If life insurance companies were to make such an effort, the Treasury would not lose tax revenue in an overall sense, but would actually gain (reference D).

REFERENCE B

If tax-free bonds were fully excludable from taxable income, the net tax bill remaining under H.R. 4245 for the life insurance industry would amount to $516,500,000.

The tax-free income needed to eliminate this tax would be $1,061 million.

| | | |
|---|---|---|
| Tax under phase I | $480,000,000 | |
| Tax-free income needed at 52 percent rate | | $922,000,000 |
| Tax under phase II | 36,260,000 | |
| Tax-free income needed at 26 percent rate | | 139,000,000 |
| Total | | 1,061,000,000 |

Capitalized at 3.68 percent (current Moody average yield for A rated 20-year tax-exempt bonds) this would require more than $28 billion, in principal value of bonds.

To show why this is a physical impossibility:

| | Billion |
|---|---|
| 1957 U.S. Bureau of Census State and local bonds, 1970 or longer, total outstanding | $23 |
| 1956 Census Bureau showed 11.6 percent of total State and local bonds held by sinking, trust and investment funds of such governmental units (latest figures available) | 2.66 |
| (Serial bonds are retired in order; longer bonds are usually held in such funds; therefore this 11.6 percent is probably low as a percent of long bonds.) Leaves | 20.34 |
| Already owned by insurance companies (Census Bureau) (1956 actual figures, plus life insurance increase for 1957 only; probably low) | −6.8 |
| Total | 14.54 |
| Therefore, of the 1957 total outstanding supply of State and local bonds of $50.7 billion outstanding, only $14.54 billion, or 28.5 percent were physically available, even in theory, for life insurance company purchase. The 1958 increase in total outstanding as estimated by the Daily Bond Buyer was $4.7 billion (net of retirements) ×28.5 percent | +1.34 |
| Total | 15.88 |

The physical supply of tax-exempt bonds in existence today is only slightly over one-half of the supply needed to wipe out the tax liability of the life insurance industry.

REFERENCE C

The outstanding supply that could be theoretically purchased must be further reduced because of bonds that are too low in quality for institutional investors, such as untried, marginal facilities of a revenue type. In addition, bonds that are of very high market quality such as AAA bonds, yield so little that they would not compare economically with yield available from taxable investments, even after a 52 percent tax rate.

It is entirely impractical for the life insurance companies to acquire tax-exempt bonds in large quantities from investors who presently own them.

These bonds are already owned by other taxpayers who save the full 52-percent tax rate in the case of corporate holders. Individuals, and trust accounts who are owners of such bonds, are substantial owners only if their surtax brackets tend to be 50 percent or higher.

The industry would have to bid against people whose tax advantage in owing such bonds would be equally great, or greater, since the life industry's effective tax bracket lies somewhat between 52 and 26 percent.

The only practical source for the industry to increase its holdings of tax-exempt bonds would be from the floating supply in dealers hands (usually between $200 million and $300 million) and the net annual increase in State and local bonds issued.

After deducting short bond purchases by commercial banks, of $1 billion, Salomon Bros. & Hutzler estimates that 1959 will bring an increase of $3.5 billion in State and local debt outstanding.

Therefore, the only practical means of tax-free bond purchase to the industry is from the new supply which is growing less than the industry's net increase in assets.

REFERENCE D

If life insurance companies began placing any significant portion of their new assets in tax-free bonds, in competition with investors such as other insurance companies, trust funds and individuals, the yield on such bonds would decline, and buying less corporate obligations would depress corporate bond prices and thus increase corporate bond yields. Therefore, supply and demand would act to reduce tax-free yields to a point where tax advantage to a life insurance company becomes smaller than loss of yield. For example: Taxable investments yielding 5¼ percent will give a greater net return after taxes than a tax free bond yielding only 3 percent.

In other words, a taxpayer would rather receive $55 of taxable income and keep $35, than receive $30 of tax-free income on which no tax is due.

As long as the constitutional privilege of tax-exemption for State and municipal bond interest is respected, the Treasury will lose the income tax on such interest, no matter who owns these bonds. The amount of such income tax lost through tax exemption varies according to the tax bracket of the respective taxpayer. This has a twofold result:

1. Taxpayers subject to a higher effective tax rate than life insurance companies (such as many individual buyers of tax-exempt securities and some institutional investors) can afford to pay higher prices for the same tax-free bond and yet realize a better net return.

2. The Treasury loses a larger amount of tax whenever a tax-exempt bond is held by an investor subject to a higher effective tax rate than the life insurance industry.

While it may be true that State and municipal authorities may be able to sell more bonds whenever the demand in the bond market is favorable to the floating of new issues, the total supply of tax-exempt securities over a long period of time will not be affected by market conditions. The amount of tax-exempt bonds outstanding will be determined by State and municipal needs.

In conclusion, if life insurance companies had full exclusion from taxable income as part of their tax legislation, simply putting them on a parity with other corporate taxpayers, they would have no more incentive than any other corporation to own tax-exempts, and the Treasury can only lose the tax receipts on such income but once.

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(The following supplemental statement by Stanford Z. Rothschild, president, Sun Life Insurance Co. of America of Baltimore, Md., is placed in the record at the request of Senator John Marshall Butler.)

COMMENTS ON THE TREASURY MEMORANDUM CONCERNING "THE TREATMENT OF TAX-EXEMPT INTEREST RECEIVED BY LIFE INSURANCE COMPANIES UNDER PRESENT LAW AND H.R. 4245"

I

The Treasury states (p. 1, par. 1): "H.R. 4245 provides for the exclusion from taxable income of interest on wholly tax-exempt securities. This exclusion or deduction applies in all phases of the computation of the proposed tax base for life insurance companies." This is not a complete statement of all facts. While it is true that tax-exempt interest is excluded at first in calculating net income, a large portion of the "excluded" tax-free interest is added back subsequently, with the effect that it partially nullifies the prior exclusion. As a result, taxable income is increased because tax-exempt interest was received.

II

The Treasury states (p. 3, par. 3): "The adjustment to prevent double deductions under H.R. 4245 is virtually the same in effect as built-in adjustments for the same purpose under present law (the 1942 formula), the 1955 stopgap, the 1950 formula, and the flat rate tax of 6½ percent applicable in the period 1951–54." This statement is incorrect. Under the 1942 law and the subsequent formulas, a flat percentage deduction was allowed for reserve and other policy liabilities. In other words, each company reported its net investment income, after excluding tax-exempt interest. The flat percentage ratio was then applied to this net income. There was no further adjustments because of tax-exempt interest. All life insurance companies reporting the same net investment income, would be allowed the same reserve deduction, even though one or the other company might have received tax-exempt interest. Under H.R. 4245, if two companies reported the same net investment income, the company receiving tax-exempt interest would be allowed a lower deduction than the other company which received no tax free interest. This is indeed a novel feature in life insurance tax legislation; it breaks with the established rule that tax-exempt interest must be ignored in income tax calculations.

The following examples, using the same figures as the Treasury memorandum will highlight the difference between the older laws and the bill:

| | Company A (owns tax-exempts) | Company B (no tax-exempts) |
|---|---|---|
| | 1942 law | |
| Net investment income | $100.00 | $90.00 |
| Less tax-exempt interest | 10.00 | ............ |
| Taxable net income | 90.00 | 90.00 |
| Reserve liability deduction | [1] 67.50 | [1] 67.50 |
| Adjusted taxable income | 22.50 | 22.50 |
| | H.R. 4245 | |
| Net investment income | $100.00 | $90.00 |
| Less tax-exempt interest | 10.00 | ............ |
| Taxable net income | 90.00 | 90.00 |
| Deduction for investment yield on reserves | 75.00 | 75.00 |
| Less adjustment for tax-exempt income | 7.50 | None |
| Net reserve deduction | 67.50 | 75.00 |
| Net income | 90.00 | 90.00 |
| Net reserve deduction | 67.50 | 75.00 |
| Adjusted taxable income | 22.50 | 15.00 |

[1] Secretary's ratio, 75 percent.

In the example above, the 1942 law levies the same tax on both companies. H.R. 4245 imposes a higher tax on the company receiving tax exempt interest. This underlines the fact that the treatment of tax free interest in the 1942 law is by no means "virtually the same" as in the proposed bill.

## III

The Treasury states (p. 4, par. 2) that the 1942 law eliminated the double allowance of tax-exempt interest and that the method of making the adjustment under H.R. 4245 differs only in superficial respects. This statement is not correct. Under the 1942 law; a uniform percentage ratio was used to calculate the deduction for policy reserves for all companies. The dollar amount of the deduction varied between companies only in exact proportion to their net taxable income.

The percentage ratio was determined by the Secretary of the Treasury on the basis of industrywise statistics supplied by all tax-paying life insurance companies. The formula included aggregate deductions for reserve earnings, interest, paid and deferred dividends; it also provided an adjustment for tax-exempt interest received by all life insurance companies. There was no change in the ratio because an individual company had larger than average holdings of tax-exempt securities. The same ratio was used for companies holding above-average portfolios of tax-exempt bonds, as was applied to companies holding no tax-exempt securities at all.

Inasmuch as the 1942 formula was constructed on the basis of—among many other ingredients—the average tax-exempt bond interest received by all companies, any company receiving above average amounts of tax-free interest was in fact favored. Companies enjoying no tax free interest or a less than average amount of tax-exempt income, were actually placed at a disadvantage. This is just the opposite effect from the method proposed in H.R. 4245 for the treatment of tax-free interest. No wonder, the Treasury found (p. 6, par. 1) that "the constitutionality of the method used in the 1942 formula and other subsequent formula to prevent a double deduction has not been challenged," certainly not by companies holding substantial amounts of tax-free securities. Actually, the ingredients used in determining excise tax formulas are always arbitrary, and no constitutional complaint should be raised against the type of ingredients used. The 1942 law did not consider the individual situation of the company in determining its reserve liability deduction. This was pure excise tax legislation.

H.R. 4245 however attempts to establish the reserve liability deduction on the basis of each individual company, giving due consideration to its contractual requirements and to its actual investment results. This is not an excise tax, and practices permissible under deliberately arbitrary excise tax procedures, are not at all acceptable within a regular income tax system.

The radical difference between the two tax methods has best been illustrated by the results shown in our sample comparisons above. Under the 1942 law, the final tax base remained the same after the deduction for policy reserve liabilities, whenever the same amount of taxable net income had been reported before applying the flat percentage rate deduction. Under H.R. 4245, even companies reporting the same net investment income will end up with different tax bases whenever the reserve liability deduction is reduced because of tax-exempt interest.

The Treasury has suggested (p. 4, par. 2) that H.R. 4245 might be rewritten by incorporating the same mechanical procedure for eliminating a double deduction used under the 1942 formula. If this were to be done, the Treasury should keep in mind that the 1942 law allowed the same deduction to all companies reporting the same net income, that there was no additional burden to the tax base because of tax-exempt interest. At the same time, any new tax formula must preserve the solvency of all life insurance companies by not impairing taxwise their ability to set aside the interest required to fulfill their contractual obligations.

The 1942 law intended to eliminate a "double deduction of tax exempt interest" by applying the flat percentage credit to net income after deducting tax-exempt interest (report to Congress, Internal Revenue Bulletin for 1942, p. 610). This was illustrated by the following example taken from the report:

| | |
|---|---|
| Gross income | $4,000,000 |
| Less: | |
| Tax free interest | 700,000 |
| Investment expenses | 100,000 |
| Real estate expenses | 80,000 |
| Depreciation | 20,000 |
| Net income | 3,100,000 |
| Reserve liability deduction at 93 percent | 2,883,000 |
| Adjusted taxable income | 217,000 |

## IV

The 1942 law intended to eliminate the "double deduction of tax exempt income" by applying the flat percentage rate to net income only. There was no further adjustment by scrutinizing the items excluded from gross income. Neither the type nor the size of these excluded items, such as expenses, depreciation or tax exempt interest was subsequently considered in arriving at the tax base. H.R. 4245 singles out tax exempt interest whenever it has been excluded from gross income. It manipulates the deduction by throwing back part of tax free interest, but ignores the other types of excludable items. H.R. 4245 thereby discriminates against holders of tax exempt securities among the life insurance companies.

## V

Life insurance companies have two kinds of gross investment income: On the one hand, there is the income which has to be set aside to cover actual expenses and the liabilities to the policyholders. On the other hand, there is free investment income, not needed for the operation of the company; this excess income is fully taxable.

All tax laws dealing with life insurance companies have allowed deductions from income for required interest. Even the excise tax formulas have provided for such deductions. The basic reason for this deduction is that required interest cannot be construed to be true income or profit, just as the cost of goods sold by a merchant must be eliminated from his gross income.

Tax exemption of interest from State or municipal bonds, is not connected with the business requirements of the taxpayer. The exemption springs from the nature of the bond instrument. Therefore, tax exemption of State or municipal bond interest is not in any way related to the deductions allowed for business or other reasons, such as depreciation, business expenses, charitable contributions, medical payments, etc. None of these deductions are reduced when a taxpayer also receives tax-exempt interest.

The Treasury however refers to section 265 of the code, which provides that no deduction shall be allowed for interest relating to tax-free interest (memorandum, p. 1, par. 2). Under this provision, interest paid on loans to carry tax-exempt bnods, cannot be deducted from taxable income. But, the law prohibits only the deduction of interest paid in connection with specific loans incurred for the purpose of carrying tax-exempt bonds. Most emphatically, the law does not automatically reduce all interest deductions of a taxpayer because somehow he also received tax-free income. For instance, a homeowner paying interest on his mortgage, does not forfeit all or part of his deduction for the mortgage interest, simply because he also received interest from tax-exempt bonds.

H.R. 4245 automatically reduces the deduction for required interest, whenever and to the extent that a life insurance company enjoys tax-free interest. Consequently, the provisions of H.R. 4245 are not at all consistent with the general treatment established in section 265 for a quite exceptional situation.

## VI

The Treasury claims that the treatment of tax-free interest in H.R. 4245 prevents double deductions of such interest. As we have seen, however, the deduction for required interest is basically unrelated to tax-exemption on State or municipal bond interest. The two deductions are independent; they should lead to separate allowances. Why should they not be granted together?

The deduction for required interest stands on its own feet; it has no connection with tax exemption of certain privileged bond interest. It is noteworthy that H.R. 4245 allows the fullest possible deduction for required interest to the life insurance company receiving no tax-free interest whatsoever.

The exclusion or deduction of tax-exempt interest is rooted in the constitutional privilege inherent in State and municipal bonds—no matter for what purposes they may be held and by whom. The exemption of this interest does not spill over into other taxable income. For instance, when tax-exempt interest exceeds taxable income, it cannot be used to offset profits or other gains from operations. There is no negative effect beyond the strict category of tax-exempt interest. Conversely, no other deduction should impinge upon tax free interest, thus reducing the privilege flowing from the ownership of State or municipal bonds.

As long as both allowances are independent of each other, the granting of one should not interfere with granting the other. Where both allowances are justified on their own grounds, there is no "double" allowance.

## VII

The Treasury states (p. 3, par. 3) that the proposal to eliminate the "adjustment for double deductions" would in effect apportion taxable investments to policy reserves and the tax-exempt investments to surplus funds. This analysis is correct. It actually confirms our findings that no "double allowance of deduction" exists as long as the deduction for required interest concerns only the interest on policy reserves, while tax-exemption is confined to free excess interest. The Treasury claims that such treatment would be "unrealistic" and would result in an unusual tax advantage for life insurance companies by virtue of their unique taxing formula (p. 5, par. 3). This is a strange statement. Far from being "unusual treatment," such treatment is in fact accorded to all other investors in tax-exempt securities. Casualty, fire, and any other insurance companies as well as commercial banks are permitted undiluted and full exclusion for tax-exempt income. As yet, no other group of investors has been compelled by any other tax law to modify their regular deductions because of tax-free income.

The Treasury admits that the effect of full tax exemption would be limited to interest on surplus funds. It recognizes thereby that interest on policy reserves and interest on surplus funds are quite distinct. How could there be an objectionable double allowance when each deduction is confined to a separate part of total income?

Under the 1942 law and the other excise tax formulas, each life insurance company was presumed to have an identical percentage of free income. In 1942, for instance, 93 percent of net income was presumed to be required for reserves, while the other 7 percent was presumed to be free or excess income. H.R. 4245 no longer presumes the existence of any free income; it seeks to establish the true situation. Under this bill it would be possible that a life insurance company might report no free or excess investment income. Such a company would pay no tax under phase 1 of the proposed law. To use a somewhat extreme situation for illustration: A life insurance company might conduct its investment operations in such a manner that it covers only required investment income. In the language of the Treasury, this company would have kept its capital and surplus funds uninvested—most likely in cash. Under H. R. 4245, this company would be allowed its full deduction for required interest but this deduction would exhaust all taxable income from investment. Yet, under the same bill, another life insurance company choosing to invest its capital and surplus funds in tax-exempt bonds—instead of in cash—would have its deduction for required interest reduced in proportion to the tax-free income received. This company would pay a tax.

This example illustrates how H.R. 4245 penalizes the ownership of tax-exempt bonds by life companies.

H.R. 4245, though purporting to be a true income-tax law, actually introduces a mandatory presumption, that each life insurance company which owns any tax-exempts, has, in fact, invested policy reserves in part of these tax exempt securities.

This is not a true income approach because it denies life insurance companies the freedom to invest their capital and surplus funds at their own discretion.

This mandatory presumption was a characteristic of former excise tax formulae, where it was acceptable in line with the arbitrary imposition of flat rate taxation.

Such a feature has no place in a tax levied on true income.

## VIII

As long as tax exemption is an acceptable feature in our political system, taxpayers will have an opportunity to reduce their tax liability by investing in tax-exempt bonds. This result should be objectionable only to those who disapprove of the concept of tax-exemption as such.

Even under the 1942 law, a life insurance company could have wiped out all tax liability by holding a sufficiently large amount of tax-exempt bonds. Under present laws, all taxpayers have the privilege of avoiding tax on their investment income by placing their assets in tax-exempt securities. In practice, no single group of investors is known to have resorted to this arrangement as a matter of general policy. The reason lies in the fact that the yield differential between tax-exempt and taxable bonds is greater than the tax benefit to the average corporate investor. Any attempt by a group of investors to place large funds into tax-exempt securities, would further increase the yield differential. The loss of net return would exceed the tax saving.

## IX

The more taxes are increased on any group of investors, the greater becomes their incentive to invest in tax-exempt securities. This natural function of an economic law can be obstructed by legislation, only if the normal advantages from tax exemption are denied to the investors in question. This would be discriminatory legislation; it would also remain useless and ineffective unless and until all other potential investors in tax-exempt bonds are placed under the same restrictions.

The Treasury concludes its memorandum by warning that the tax take projected under H.R. 4245 would be jeopardized if life insurance companies were granted full benefits of tax exemption. In other words, the Treasury admits that H.R. 4245 is a legislative attempt to deprive life insurance companies of full tax-exemption in order to increase the tax bite. This then is clearly an attempt to discriminate against life insurance companies as far as the treatment of their tax-free interest is concerned. At the same time, it is an attempt to sabotage the principle of tax exemption in its application to individual taxpayers. Is this the will of Congress?

STATEMENT OF PATRICK HEALY, JR., EXECUTIVE DIRECTOR OF THE AMERICAN MUNICIPAL ASSOCIATION, BEFORE THE FINANCE COMMITTEE OF THE U.S. SENATE RELATING TO THE TAXATION OF THAT PORTION OF INCOME OF LIFE INSURANCE COMPANIES DERIVED FROM INTEREST ON STATE AND MUNICIPAL BONDS UNDER H.R. 4245

This statement is submitted in behalf of the American Municipal Association which represents approximately 13,000 municipal governments in 49 States and territories, both directly and through State leagues of municipalities. These municipal governments are dedicated to the preservation of the constitutional immunity of State and municipal bond interest from Federal income taxation.

Our national municipal policy on this subject reads in part as follows:

"The constitutional immunity of State and local activities from Federal taxation must continue intact without exception. Therefore, we call upon the Congress to retain the statutory exemption of all State and local obligations and activities."

Our first interpretation of the tax treatment of municipal bond interest received by life insurance companies under H.R. 4245 was erroneous. We were under the impression that such interest had been allowed as a deduction or exclusion twice and that in order to prevent such double deduction some of it was added back. This was on the mistaken assumption by us that life insurance companies, like all other taxpayers, did not need to report tax-free interest in their gross income.

We are now informed that life insurance companies even under existing law must report tax-free interest in gross income. While other taxpayers under section 103 of the Internal Revenue Code of 1954 exclude exempt interest from their gross income, section 11(d)(2) of existing law specifically excepts insurance companies from the imposition of the usual corporate tax and provides specifically for their taxation under section 801 and subsequent sections.

Therefore, while section 804(c)5 of H.R. 4245 allows tax-exempt interest as a deduction from gross income, this is not a double deduction. It is the first such deduction, because tax-free interest is included in the gross under section 804(b)1(A) of the bill.

Having deducted such tax-free interest (rather than having excluded it in the first place), the bill then proposes to add back a portion of it and make such bonds taxable. It is misleading for the Treasury Department to explain this as an adjustment to prevent a double deduction.

It is, in fact, a tax on the interest from State and municipal bonds. As such it violates the immunity of such bonds from Federal income taxation. Therefore, we call upon the Congress to retain the statutory exemption of all State and local obligations by amending H.R. 4245 to remove such taxation.

For any income from State and municipal bonds to be made taxable in this bill would be the opening wedge to apply the same principle to all other taxpayers. This would be the "foot in the door" approach to eliminating entirely the tax-exempt feature of State and municipal bonds. Aside from the unconstitutionality of this attempt to tax part of the income derived by one class of taxpayers from municipal bond interest, there are numerous social and economic arguments justifying tax exemption of such securities. Not the least of these is the higher interest rates which State and local governments would have to pay if such a Federal tax were imposed on all their bonds in the future. This higher cost of financing State and local government would inevitably result in ever-increasing demands for more and bigger Federal aid or even subsidies.

We, therefore, respectfully request your committee to amend H.R. 4245 in subsection 805(e), 809(f) and such others as are necessary to eliminate their taxation of tax-free interest.

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NATIONAL ASSOCIATION OF COUNTY OFFICIALS,
*Washington, D.C., March 23, 1959.*

Senator HARRY FLOOD BYRD,
*Chairman, Senate Finance Committee,*
*Senate Office Building, Washington, D.C.*

DEAR SENATOR: This will constitute the statement of the National Association of County Officials on those aspects of H.R. 4245, the proposed Life Insurance Company Income Tax Act of 1959, relating to the tax treatment of the income of life insurance companies from State and municipal bond interest. We respectfully request that this statement be received and printed as part of the record of the hearings of the Senate Finance Committee on H.R. 4245.

The National Association of County Officials, composed of 6,000 elected and appointed county officials, supports and endorses the statement of the American Municipal Association, filed by its executive director, Patrick Healy, Jr., in these hearings. The position of the American Municipal Association, we feel, is in the best interests of a sound local bond market and is in keeping with section 1-9 of the American county platform, which reads:

"Any attempt by the Federal Government to tax the interest on county or local government bonds would endanger the fiscal affairs of local government, and would, if exercised on a selective basis, put the Federal Government in a position of passing judgment on local problems by the exercise of its right to tax specific issues. The National Association of County Officials vigorously disapproves and opposes any move to tax the interest on any type of county bonds."

Sincerely yours,

BERNARD F. HILLENBRAND,
*Executive Director.*

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STATEMENT BY SENATOR JOHN MARSHALL BUTLER RELATING TO PROVISIONS OF H.R. 4245 WHICH PARTIALLY TAX THE INTEREST INCOME FROM STATE AND MUNICIPAL BONDS HELD BY LIFE INSURANCE COMPANIES

Adoption of the Treasury Department's recommendations calling for the taxation of interest derived from State and Municipal bonds held by life insurance companies as provided in H.R. 4245, the proposed Life Insurance Tax Act of 1959, would directly contribute to the destruction of the States of this Union as separate political and economic entities as envisaged by the Constitution. I condemn the Treasury's stand in principle. I challenge it in fact and law.

Despite the testimony of Treasury witnesses and the statements contained in the memorandum forwarded me on March 15 by Mr. David Lindsay of the Treasury Department, four basic conclusions not subject to serious challenge are apparent.[1]

(1) H.R. 4245 as approved by the House of Representatives partially taxes interest from State and municipal bonds owned by life insurance companies.

(2) The Supreme Court of the United States has specifically held on at least two occasions in cases involving identical questions that formulas as contained in H.R. 4245 relating to the treatment of interest income from tax-exempt bonds were unconstitutional.

(3) The formula relating to tax-exempt income as contained in H.R. 4245 is discriminatory in that other classes of taxpayers owning such securities are not similarly taxed.

(4) Permanent provisions of statute taxing the interest on State and local bonds held by life insurance companies would have a serious depressant effect upon the State and municipal bond market at a time when many communities of our Nation are finding it difficult, if not impossible, to sell such securities to meet the cost of much-needed capital improvements. Deterioration of this bond market will inevitably result in greater pressure on Congress from ultraliberal quarters to approve even larger direct subsidy programs to States and municipalities at a cost far beyond the revenue here involved.

Discussing these points one a a time:

I, of course, am aware of the Treasury's arguments that H.R. 4245 does not tax interest from tax-exempt bonds. In the memorandum outlining Treasury's position, it is stated, and I quote: "H.R. 4245 provides for the exclusion from taxable income of interest on wholly tax-exempt bonds." However, the memorandum then continues: "Like present law and previous formulas, H.R. 4245 provides adjustments in the deduction (for reserves) to prevent a double deduction."

To the uninitiated, this argument reflects certain logic. However, it would not stand up under close scrutiny. The basic difficulty is that the Treasury has attempted to apply a logical development to a problem where a dominant premise involved, while reasonable in purpose, is arbitrary in effect. The premise is that State and municipal bonds will not be taxed. Once this arbitrary type premise becomes involved in your tax base computation, pure logic thereafter will not necessarily result in an overall consistent answer.

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[1] The Treasury memorandum appears at p. 48 of these hearings.

As logic cannot be utilized, how can we determine practically and conclusively whether H.R. 4245 taxes or does not tax interest from State and municipal bonds? There is one simple and reliable method.

Compare the tax base of a company having tax-exempt interest income with the tax base of an identical "phantom" company without such income. The Treasury's method of "compromising" the so-called exclusion of tax-exempt income by apportioning the reserve deduction on the basis of the ratio between the total deduction and the amount of tax-free income has the direct effect of partially taxing interest from tax-exempt bonds. What the Treasury gives with one hand, in the form of a so-called exclusion, it takes back with the other by reducing a generally allowable deduction. As under provision of H.R. 4245 a taxpayer with an additional increment of income from tax-exempt bonds will pay more tax than an identical company with no such tax-exempt income, there can be no argument to rebut the conclusion that the former pays tax on tax-exempt income.

Second question: Is this constitutional? To contend the formula contained in H.R. 4245 is constitutional requires one to ignore the specific holdings of the U.S. Supreme Court in at least two cases directly on point. We need not cast about for collateral cases nor resort to conjecture as to what the Supreme Court might decide in the future on this question. In *National Life Insurance Company* v. *United States* (277 U.S. 508 (1928)) and in *Missouri* v. *Gehner* (281 U.S. 313 (1930)) the Court in the plainest and most emphatic language has characterized formulas as contained in H.R. 4245 as unconstitutional. Despite more recent decisions on collateral questions, these decisions remain unmodified and unchallenged. As such, they are the only appropriate guideposts in considering this vital question of constitutionality.

This leads to the third point I wish to stress. Should the Treasury's recommendations be adopted, the result would discriminate against life insurance companies holding State and municipal bonds as compared to other general classes of taxpayers who would not be subject to tax on income from such securities. I would be the last to suggest that the Treasury Department might not be able to give the Finance Committee some variety of examples gleaned from the vast complexity of our tax code which may have come into being without notoriety and because of their obscurity obtained the sanction of Congress. However, I do challenge the inference noted throughout the Treasury's memorandum that there is general precedent in our tax laws for such a tax formula.

Thus, we are left with another grave reservation concerning the Treasury's recommendations—that is, this formula would tax income from tax-exempt bonds owned by insurance companies and not extend similar treatment to other classes of taxpayers. This proposal is thus discriminatory.

Lastly, there is the question of the impact such legislation would have on the State and municipal bond market. I need not go into detail on this question. The difficulty the Treasury is now having in marketing Federal bonds should in itself be persuasive. Yet, at this time, when the Federal Government is being asked to expand grants-in-aid programs and to approve new legislation aimed at directly assisting State and municipalities to finance capital improvements at a cost which may run into billions of dollars, the Treasury seeks to add a further burden to the already desperately hard-pressed State and municipal bond market. This factor alone is sufficient basis for characterizing the Treasury's recommendations as not only unsound, shortsighted and unrealistic, but actually dangerous to our economy. On this point, I suggest you note the many statements the Finance Committee has received from municipal groups warning of the grave danger this proposal holds in store for them.

Why, then, does the Treasury fight for adoption of a formula which taxes tax-exempt interest, is unconstitutional, discriminatory, and would have a serious and adverse effect on the State and municipal bond market? One possible explanation is suggested by the Treasury's memorandum. It is feared that complete exclusion of this income from the tax base would permit life insurance companies to "wash out" all tax liability under the proposed Life Insurance Act. This argument is based upon the fact that a large segment of company income, about 75 percent, is subject to the reserve deduction to meet eventual policy liabilities. The Treasury fears that if the complete exclusion is given, all that a company need do is place the remaining 25 percent of its investments in State and municipal bonds so as to attain a tax-free status. This possibility, of course, is generally true on an individual basis with regard to most taxpayers. Many corporations or individuals with only investment income could avoid Federal taxes by the same means. However, on a life insurance company industry level, this could not occur. Why? Simply because there are not enough State and municipal bonds available.

Life insurance companies now own approximately $2½ billion worth of tax exempts out of approximately $60 billion of such bonds presently outstanding. To achieve the goal set by the Treasury, these holdings by insurance companies would have to be increased to approximately $30 billion to $40 billion. This is not within the realm of practical possibility.

What, then, is the Treasury Department's real purpose in proposing this formula? The answer is readily apparent. Stated simply, the Treasury wants to "buy" a lawsuit. If Congress can be persuaded to approve this formula, then hopefully some insurance company will then be tempted to contest the levy on constitutional grounds. The Treasury has been waiting for this opportunity for years. The arguments are prepared. All that is needed is the legal controversy which will lead to Supreme Court review of the *National Life* and *Missouri* v. *Gehner* cases.

The Treasury seems convinced that the Supreme Court in such a case would not only uphold this partial tax on tax-exempt bonds held by life insurance companies, but more particularly, would strike down the whole tax-exempt doctrine by reversing these previous decisions. I view in the gravest terms the Treasury Department's resort to this circuitous route to achieve what, in effect, amounts to a constitutional amendment, especially in a matter so important to our Nation's basic structure. Certainly, in a matter of this kind, the consent of Congress on the direct issue involved and ratification by the States would appear essential.

Perhaps Mr. Justice Sutherland best expressed the issue involved, in *Carter* v. *Carter Cole Company* (298 U.S. 238, 295), when he said:

"The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States. Every journey to a forbidden end begins with the first step; and the danger of such a step by the Federal Government in the direction of taking over the powers of the States is that the end of the journey may find the States so despoiled of their powers, or—what may amount to the same thing—so relieved of the responsibilities which possession of the powers necessarily enjoins, as to reduce them to little more than geographical subdivisions of the national domain. It is safe to say that if, when the Constitution was under consideration, it had been thought that any such danger lurked behind its plain words, it would never have been ratified."

Admittedly, many steps have been taken since Justice Sutherland wrote these words. Some have been giant steps known and recognized for what they were by all concerned. Others have been small and imperceptible and have slipped by unrecognized and unchallenged. Yet, be they large or small, they have moved the States of our Nation closer to absolute subjugation politically and economically by an overcentralized government. I, for one, abhor and condemn any proposal, such as the one now at issue, which will, if adopted, constitute a further step in that direction.

(See also p. 16.)

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SUGGESTED AMENDMENT OF H.R. 4245 TO PERMIT SMALL LIFE INSURANCE COMPANIES TO BUILD UP THEIR SURPLUS AND CAPITAL FOR THE PROTECTION OF THEIR POLICYHOLDERS AND EXPLANATORY STATEMENT SUBMITTED BY UNIVERSAL LIFE ACCIDENT INSURANCE CO., BLOOMINGTON, IND.

The Universal Life & Accident Insurance Co., a small stock life insurance company of Bloomington, Ind., submits the suggested amendment to H.R. 4245 set out below:

Amend section 802 of H.R. 4245 by adding at the end of the section a new subsection to be identified as subsection (c) to read as follows:

"(c) EXCEPTION.—No tax is imposed on the gain from operations in excess of the taxable investment income of any life insurance company unless the capital and surplus funds of such company exceeds the greater of—

(a) 25 per centum of the life insurance reserves or

(b) 60 per centum of the sum of the net premiums for such taxable year as determined under section 809(c)(1).

This exception shall not be applicable to any company the capital and surplus of which is in excess of $5,000,000."

If this amendment is adopted, it will be necessary also to amend paragraph 2 of subsection (c) of section 815 to conform by adding thereto the following:

"(2) ADDITIONS TO ACCOUNT.—If the gain from operations for any taxable year beginning after December 31, 1958, exceeds the taxable investment income, there shall be added to the policyholders surplus account an amount equal to 50 per centum of such excess: *Provided, however*, That if a company is exempt from taxation on the gain from operations in excess of its taxable net investment income as provided in section 802(c), then and in that event 100 per centum of such excess shall be added to the policyholders surplus account."

The effect of this suggested amendment is to exempt these small companies from the payment of the tax imposed on the gain from operations unless the capital and surplus of the company exceeds 25 percent of its life insurance reserves, or 60 percent of the sum of its net premiums, whichever is the greater. But in no event would this exemption apply if the capital and surplus were in excess of $5 million. Neither would it apply if such earnings are paid out in cash dividends to stockholders because such distribution will still be taxable under section 815 of the bill. Neither will this amendment serve to exempt from taxation the so-called specialty companies because in most instances the capital and surplus of such companies will exceed 25 percent of their insurance reserves or 60 percent of their premiums for such taxable year and, therefore, the proposed suggested amendment would not be applicable to them.

It has been the history of most orthodox life insurance companies that during their initial years of growth the ratio of their capital and surplus to policyholder liabilities has steadily decreased to where after this initial growth period it is a matter of sound company practice to increase this ratio as rapidly as possible. Sufficient capital and surplus funds are in the best interests of policyholders, the industry, and the general public.

During a period of depression it is a historic facts that assets of a life insurance company decrease in value and there should be sufficient surplus funds to protect the policyholders against such shrinkage; in recent years the need of such surplus has been even more accentuated with the advent of possible atomic warfare and the resulting excessive mortality. It is, therefore, not only fitting but in the public interest that small companies be permitted to defer a tax on any operating gains to assist them in creating this surplus protection to policyholders. It is felt that the proposed amendment accomplishes this objective.

There are a large number of small companies in the country that need the protection of this amendment. These companies, though large in number, represent only a small portion of the business and assets of the industry as a whole. The adoption of this amendment, therefore, would not materially reduce the amount of revenue to be derived from the bill, if enacted.

Respectfully submitted.

UNIVERSAL LIFE & ACCIDENT INSURANCE CO.,
BLOOMINGTON, IND.
By H. C. EVANS, *President*.

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STATE SECURITY LIFE INSURANCE CO.,
*Anderson, Ind., March 18, 1959.*

HON. HOMER CAPEHART,
*U.S. Senate, Washington, D.C.*

DEAR SENATOR CAPEHART: We greatly appreciate the interest and encouragement given our company by your able legislative assistant, Mr. Stephen Leonard.

Mr. Leonard asked that we keep in touch with your office relative to legislation pertaining to the taxation of life insurance company income, and we would like for you to consider the merits of the following suggested amendment to H.R. 4245:

Amend section 802 of H.R. 4245 by adding at the end of the section a new subsection to be identified as subsection (c) to read as follows:

"(c) EXCEPTION.—No tax is imposed on the gain from operations in excess of the taxable investment income of any life insurance company unless the capital and surplus funds of such company exceeds the greater of—

(a) 25 per centum of the life insurance reserves, or

(b) 60 per centum of the sum of the net premiums for such taxable year as determined under section 809(c)(1).

This exception shall not be applicable to any company the capital and surplus of which is in excess of $5,000,000."

If this amendment is adopted, it will be necessary also to amend paragraph 2 of subsection (c) of section 815 to conform by adding thereto the following:

"(2) ADDITIONS TO ACCOUNT.—If the gain from operations for any taxable year beginning after December 31, 1958 exceeds the taxable investment income, there shall be added to the policyholders surplus account an amount equal to 50 per centum of such excess: *Provided, however*, That if a company is exempt from taxation on the gain from operations in excess of its taxable net investment income as provided in section 802(c), then and in that event 100 per centum of such excess shall be added to the policyholders surplus account."

The effect of this suggested amendment is to exempt these small companies from the payment of the tax imposed on the gain from operations unless the capital and surplus of the company exceeds 25 percent of its life insurance reserves, or 60 percent of the sum of its net premiums, whichever is the greater. But in no event would this exemption apply if the capital and surplus were in excess of $5 million. Neither would it apply if such earnings are paid out in cash dividends to stockholders because such distribution will still be taxable under section 815 of the bill.

Neither will this amendment serve to exempt from taxation the so-called specialty companies because in most instances the capital and surplus of such companies will exceed 25 percent of their insurance reserves or 60 percent of their premiums for such taxable year and, therefore, the proposed suggested amendment would not be applicable to them.

It has been the history of most orthodox life insurance companies that during their initial years of growth the ratio of their capital and surplus to policyholder liabilities has steadily decreased to where after this initial growth period it is a matter of sound company practice to increase this ratio as rapidly as possible. Sufficient capital and surplus funds are in the best interests of policyholders, the industry, and the general public.

During a period of depression it is a histroic fact that assets of a life insurance company decrease in value and there should be sufficient surplus funds to protect the policyholders against such shrinkage; in recent years the need of such surplus has been even more accentuated with the advent of possible atomic warfare and the resulting excessive mortality. It is, therefore, not only fitting but in the public interest that small companies be permitted to defer a tax on any operating gains to assist them in creating this surplus protection to policyholders. It is felt that the proposed amendment accomplishes this objective.

There are a large number of small companies in the country that need the protection of this amendment. These companies, though large in number, represent only a small portion of the business and assets of the industry as a whole. The adoption of this amendment, therefore, would not materially reduce the amount of revenue to be derived from the bill if enacted.

This is the matter concerning which I telegraphed to you this morning and I understand that such a proposed amendment is now before the Senate Finance Committee for study. Will you kindly keep us informed as to the status of this matter.

With kindest personal regards, I am

Yours very truly,

GEORGE W. E. SMITH,
*Secretary-Treasurer.*

(Whereupon, at 1:30 p.m. the committee recessed subject to call.)

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