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TREATMENT OF STATE AND LOCAL TAXES FOR PURPOSES OF COMPUTING THE FEDERAL EXCISE TAX ON CIGARS AND TAX TREATMENT OF MORTGAGE GUARANTY INSURANCE RESERVES

DECEMBER 11, 1967.—Ordered to be printed

Mr. LONG of Louisiana, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 6058]

The Committee on Finance, to which was referred the bill (H.R. 6058) to amend the Internal Revenue Code of 1954 to provide for rounding the amount of State and local taxes for purposes of computing tax on cigars, having considered the same, reports favorably thereon with amendments and recommends that the bill, as amended, do pass.

I. SUMMARY

The committee accepted the House-passed provision relating to cigars without change. However, it has added a provision relating to the tax treatment of mortgage guaranty insurance reserves. These provisions are briefly summarized below.

The House-passed provision specifies that in determining the ordinary retail price of a cigar in its principal market for the purpose of assessing the Federal excise tax on cigars (which is based on the ordinary retail price of a cigar in its principal market), the amount to be excluded from the retail price on account of a State or local tax which is not an even number of cents per cigar is to be rounded up to the next highest full cent. This rule is to be disregarded, however, if rounding would result in reducing the Federal excise tax to less than the tax which would be imposed in the absence of a State or local tax. This provision is to become effective with respect to removals of cigars made on or after the first day of the first calendar quarter which begins more than 30 days after the date of enactment of this bill.

The committee added an amendment to solve a problem faced by companies which provide mortgage guaranty insurance. They are subject to State regulation and are almost uniformly required to place

half of their earned premiums in contingency reserves for 15 years to provide protection to policyholders from losses which might result from adverse economic conditions. The committee amends the law to provide a special deduction for additions to an extraordinary loss reserve for amounts which State law or regulations require a mortgage guaranty insurance company to add to such a reserve, but not in excess of 50 percent of earned premiums. However, the special deduction is to be allowable only if the tax benefit obtained from the deduction of additions to the reserve is invested in a special issue of noninterest bearing Government bonds. The bonds may be used for payment of income taxes which will be due when the reserve is returned to income (no later than 10 years after the deduction) or may be redeemed in the event of extraordinary losses during the period of the reserve.

The Treasury Department has indicated that it favors the enactment of this bill, as amended.

II. TREATMENT OF STATE AND LOCAL TAXES IN DETERMINING TAX ON CIGARS

(*a*) *Present law.*—Under present law, the manufacturer's excise tax on large cigars (those weighing more than 3 pounds per thousand cigars) is imposed on the basis of a bracket system with the rate of tax dependent on the retail price of the cigar. The brackets are as follows:

Retail price per cigar		Tax per thousand
Over	Not over	
Cents	Cents	
0	2½	$2.50
2½	4	3.00
4	6	4.00
6	8	7.00
8	15	10.00
15	20	15.00
20	....	20.00

The retail price of a cigar is defined for Federal tax purposes as "the ordinary retail price of a single cigar in its principal market." The law provides that any State or local tax imposed on cigars as a commodity is to be excluded when determining the ordinary retail price for Federal excise tax purposes.

(*b*) *Reasons for the provision.*—This provision as passed by the House and as agreed to by your committee is addressed to a problem which arises under the present bracket system when State or local taxes which do not amount to an even number of cents per cigar are imposed. When a State tax, for example, amounts to one-half cent per cigar, retailers often round off the retail price of a single cigar to the next highest cent. It would obviously be impractical for them to try to sell individual cigars for prices which include a fraction of a cent and they are reluctant to absorb the tax by holding the price of the cigar at the pretax level. However, this upward rounding of the retail price when a fractional-cent State or local tax is imposed may cause a cigar to be subject to a higher Federal tax if the retail price of the cigar is normally at the top of one of the excise tax brackets and the State comprises the principal market for the sale of the cigar. For

example, a cigar which normally retails for 6 cents in its principal market is taxed at the rate of $4 per thousand. If a State were to impose a tax of one-half a cent per cigar, retailers would normally round this tax off to a full cent and sell the cigar for 7 cents rather than 6 cents. If the State imposing the tax were the principal market for the cigar, the Internal Revenue Service would have to conclude that the retail price of the cigar excluding the State tax was 6½ cents. Cigars priced at this level are taxed at the rate of $7 per thousand.

This problem has become more acute as the number of States levying a tax on cigars, particularly at the wholesale level, has increased. At the present time 17 States have excise taxes on cigars. These taxes rarely work out to an even number of cents per cigar. This is almost invariably true when the State tax is a percentage of the wholesale price. It is also often the case even when the tax is a specific tax. For example, a State tax of $15 per thousand is equivalent to a tax of 1½ cents on each cigar.

The present system at times results in undersirable interference in competitive relationships. The imposition of a State tax which works out to a fraction of a cent per cigar can result in the imposition of different Federal taxes on comparable cigars. If the cigars ordinarily retail at the top of one of the brackets, action by retailers who round off a fractional State tax to the next highest cent will increase the Federal excise tax only if the State imposing this tax happens to be the principal market for the cigar. Thus, the same tax on two comparable cigars may result in an increased Federal tax on the product of one manufacturer if the State imposing the tax is his principal market for that cigar but leave unchanged the Federal tax on the product of another manufacturer whose principal market for a comparable cigar happens to be elsewhere.

(c) *Effect of provision.*—This provision as passed by the House and as agreed to by your committee rectifies the situation just described by providing as a general rule that when the ordinary retail price of a cigar in its principal market is determined, the amount that may be excluded from the retail price on account of a State or local tax which ends in a fractional part of a cent is to be the next highest full cent.

An exception to this rule is provided, however, to prevent the enactment of this provision from reducing the Federal tax to less than the amount that would be imposed in the absence of a State or local tax. That is, if the rule above were followed strictly in all situations, cases could arise in which a cigar priced near the bottom of a bracket would have its retail price computed at the top of the next lower bracket as the result of the imposition of a State or local tax. For example, a cigar manufactured to sell at three for 25 cents (8⅓ cents per cigar) is now taxed at the rate of $10 per thousand. If a State tax of one-half cent per cigar were levied on the cigar in its principal market, retailers would round the ordinary retail price up to 9 cents. If the rule outlined above were followed, the Federal tax on the cigar would be determined on the basis of a cigar selling in its principal market for 8 cents and, therefore, the tax would be reduced to $7 per thousand. To prevent this result the provision specifies that a fractional-cent State or local tax, which is excluded in determining the price of the cigar for purposes of determining the applicable Federal excise tax, is not to be rounded to the next highest full cent for the purpose of exclusion if this

would result in a lower Federal excise tax than would be imposed in the absence of the State or local tax.

(*d*) *Effective date.*—This provision is to be effective with respect to removals of cigars made on or after the first day of the first calendar quarter which begins more than 30 days after the date of enactment of this bill.

III. MORTGAGE GUARANTY INSURANCE

(*a*) *Reasons for the provision.*—Mortgage guaranty insurance companies guarantee the holder of a real estate mortgage against loss on its mortgage loan, in a manner somewhat comparable to the mortgage insurance written by FHA. However, FHA insures the entire amount of the mortgage, while mortgage guaranty insurance companies have an option to pay 20 percent of the face of the mortgage in full satisfaction of the liability. While as a practical matter 20-percent coverage presently may be sufficient to cover any likely loss on a defaulted mortgage, nevertheless in the event of a serious depression, that option may be significant. Moreover, FHA insures mortgages representing as much as 97 percent of the appraised value of the property, while mortgage guaranty insurance is not written on loans for more than 90 percent of the appraised value of the property. Premiums on these policies are sometimes paid in a lump sum when the contract is written, but in most cases, perhaps 80 percent, annual premiums are paid over the period of risk.

These private insurers are regulated by State insurance commissions. On the possibility that extraordinary losses may occur from mortgage defaults, for example in a depression, State insurance commissions regulating this industry generally require the company's establishment of a contingency loss reserve to protect against extraordinary losses. For example, under the regulations of one State commission, a guaranty company is required to add up to 50 percent of earned premiums to its contingency loss reserves.[1] These reserve additions are not related to loss experience and remain in the reserve for 15 years, in the absence of authorization from the State commission for prior restoration to income. Normal losses are charged to income currently, rather than to the reserve. The regulations of this particular State commission indicate that reserve invasions may be authorized when losses exceed, by more than 10 percent of premiums, the expected losses set forth in the rate formula. Unless losses exceed 40 percent of premiums (30 percent in the rate formula plus the 10 percent margin) the reserve may not be invaded to meet current losses under the existing regulations of this State commission.

The typical life of a real estate mortgage is about 8 years, even though the mortgage may have been written for a 20-year life or longer (as a consequence of property transfers, mortgage loans on the average are paid off somewhat earlier than the original period of the loan). Even though there has been earlier payment in full of mortgage loans, and consequent termination of the need for the reserve, the State commission's regulations do not restore the reserve to income until after the entire 15-year period is passed.

[1] On loans for 80 percent or more of the appraised value of the property, 50 percent of earned premiums must be added to the reserve. On loans of less than 80 percent, 30 percent of earned premiums is added to the reserve. The likelihood is that most loans covered by this insurance are for 80 percent or more of appraised value.

Under section 832(b)(4) of the code a deduction is now allowed for contributions to a reserve for "unearned premiums." The Internal Revenue Service has defined unearned premiums as "that portion which the company has not yet had time to earn, or more precisely, that portion paid by the policyholder which must be returned on cancellation of the policy, and which is in direct proportion to the unexpired time which the policy is to run." In 1960 the Internal Revenue Service issued a ruling to a company writing mortgage guaranty insurance stating that its contingency loss reserve required by the State commission was a reserve for unearned premiums within the meaning of section 832(b)(4). A similar ruling was subsequently issued to another company. Since that time requests for similar rulings from other companies have been submitted to the Internal Revenue Service, but the Service has not ruled on the requests.

The Service has now decided that its original rulings of 1960 also should be changed, although it has not yet revoked them. The tax returns of 10 or more other companies which did not receive favorable rulings, however, are being held in suspense. These other companies contend that they are competitively handicapped, and their ability to obtain equity capital is prejudiced because they have not received a ruling similar to those issued in 1960. The Treasury Department believes that a legislative solution of the problem is desirable. Your committee agrees. Your committee has been informed that the Treasury Department will revoke the rulings when this provision is enacted.

It is clear, where State law requires 50 percent of the earned premiums to be placed in a reserve for extraordinary losses, that it would be extremely difficult for any company to operate without continuing additions to working capital. Their current losses and other expenses amount to more than half of their earned premiums. If half of those premiums must be placed in reserve, some of the current expenses will have to be paid from working capital. A current tax on the earned premiums dedicated to the reserve will necessitate an even greater depletion of the working capital. Your committee's amendment is designed to solve this unique problem created by unusual State requirements, and to afford uniform treatment to all companies engaged in writing mortgage guaranty insurance.

While it is recognized that State law in these cases requires the set-aside of large amounts to cover these possible future losses, nevertheless, deductions of anything like 50 percent would be providing these companies deductions substantially in excess of what they presently can show is their actual loss experience. Should this present loss experience prove to be correct in the long run, deductions of these large reserves required by State law would permit substantial amounts to remain free of tax for a period of up to 15 years. This would provide substantially more favorable treatment for these companies than is available for other businesses.

Because of the considerations set forth above, the committee has concluded that it is appropriate to permit these mortgage guaranty insurance companies to obtain a deduction for additions to these special reserves over the approximate average life of the mortgages guaranteed, but, at the same time, to deny them the earnings on the portion of such reserves representing deferred taxes during the time that portion is held for these special contingencies. The latter is

accomplished by requiring the investment of the tax savings attributable to the deduction of reserve additions in non-interest-bearing Government bonds. The fact that the tax savings are invested in special bonds of the Federal Government means that the companies have assets for purposes of their statements which are recognized by State commissions and for accounting purposes.

This provision is substantially the same as that initially reported by your committee on H.R. 4765. In the conference on that bill, the conferees concluded that the broader provision reported by the committee, rather than the provision passed by the Senate which related only to the year 1967, was preferable. Your committee's action in reporting this provision is, therefore, consistent with the action taken by the conferees on H.R. 4765.

(*b*) *Explanation of provision.*—Under the committee amendment, deductions for additions to a reserve for mortgage guaranty insurance losses resulting from adverse economic cycles will be allowed, but not in excess of 50 percent of premiums earned during the year. Any amount added to the reserve must be restored to income at the close of 10 years (rather than 15 years as is generally required under State regulations). The deduction is not allowed, however, unless the company purchases a special issue of "tax and loss" Federal Government bonds in the amount of the tax benefit of the deduction. These bonds are to be noninterest bearing, nontransferable, and redeemable only when the amounts added to the reserve are restored to income. It is expected that these bonds will be recognized, by both accountants and State insurance commissions, as an asset for statement purposes. At the time of restoration of the reserve to income, the bonds purchased when the addition was made to the reserve may be utilized to pay the resulting income tax. If the company has no tax to pay in the year of redemption because of other deducti ns, the bonds would be redeemable for cash.

The committee's amendment is less favorable to the taxpayer than the rulings issued by the Internal Revenue Service in 1966, since any amounts added to the reserve must be restored to income at the end of 10 years (rather than 15 years) and the tax benefit from the deduction must be invested in non-interest-bearing Federal bonds.

The bill amends the Second Liberty Bond Act to authorize the Secretary of the Treasury to issue the non-interest-bearing bonds for the purposes of the new tax provisions described above.

While the amendment of the Internal Revenue Code is applicable to taxable years beginning after December 31, 1966, the committee's amendment provides special rules for additions made prior to 1967 to reserves for mortgage guaranty insurance losses. These special rules are designed to validate the deductions taken in past years by all companies that made additions to such reserves. As a result, all companies in the industry will be treated alike. Tax-and-loss bonds are not required for past years, but the additions to reserves made prior to 1967 must be included in income at the end of 10 years following the year for which the addition was made. In addition, losses incurred for taxable years beginning after 1966, to the extent the losses exceed 35 percent of earned premiums for the year, are to be charged to the pre-1967 reserve rather than against current income.

(*c*) *Technical explanation of provision.*—This provision adds a new subsection (e) to section 832 of the Internal Revenue Code. The new

subsection (e) provides special rules in the case of taxable years beginning after December 31, 1966, for a company which writes mortgage guaranty insurance. Such a company may be organized under a special State statute relating solely to such insurance companies or organized under a general statute relating to credit guaranty insurance companies.

Subparagraph (A) of the new subsection (e)(1) refers to a reserve which is in substance a contingency reserve for extraordinary or unusual mortgage guaranty insurance losses. Mortgage guaranty insurance companies are generally required by certain State statutes or regulations to set aside an amount, usually a certain portion of their premiums, for a definite period of time in such a reserve for unusual losses. Such a reserve is not available for general corporate purposes, but subject to the approval of the State insurance commissioner is available in the event that the losses of a company in any year exceed its "normal losses."

Except as otherwise provided, in order for the deduction to be allowed under new subsection (e)(1), tax-and-loss bonds referred to in new subsection (e)(2) shall be purchased on or before the date that any taxes (determined without regard to new subsec. (e)) due for the taxable year for which the deduction is allowed are due to be paid, as if no election to make installment payments under section 6152 is made. If a company would make payments of estimated tax if new subsection (e) did not apply, then whether or not such company pays estimated tax after the application of subsection (e), such bonds must be purchased on or before the date for paying such estimated tax in order for them to be considered purchased on or before the date that any taxes due for the taxable year are to be paid. If an obligation to make payments of estimated tax is eliminated by the allowance of the deduction under new subsection (e)(1), in order to qualify for such deduction the company is required to purchase these tax-and-loss bonds at the time the estimated tax payments are due to be paid and in the amount of such payments.

The Secretary of the Treasury is authorized under the provision to prescribe the terms and conditions under which such bonds shall be purchased, and may provide, for example, that deposits may be made toward the purchase of such bonds. At the time the company's tax return is filed, the deposits could be so applied, or to the extent not needed for such purchases or for the payment of the company's taxes, such amounts could be refunded to the company. In accordance with the provisions of new section 832(e)(1), all amounts are to be taken into account on a first-in-time basis, including for purposes of determining the deposits which have been applied to purchase bonds.

In computing the aggregate amount in the State reserve for purposes of new subsection (e)(5)(B), such amount shall be reduced, for example by the amount of losses incurred which is permitted to be charged to such reserve under State law or regulation. Although under new subsection (e)(1) such a charge to the reserve does not affect the computation of losses incurred, such reserve, nevertheless, shall be reduced by the amount of such charge.

The application of new subsection (e) may be illustrated by the following example: Company A was organized on January 1, 1967, and is required by State law or regulation to set aside 50 percent of premiums earned on insurance contracts (as defined in sec. 832(b)(4))

with respect to mortgage guaranty insurance in a reserve referred to in new paragraph (1)(A). For 1967 the amount so set aside is $300x. However, company A's taxable income, computed without regard to the deduction allowed by new paragraph (1) or any carryback of a net operating loss, was only $100x and, thus, such deduction could not exceed $100x. By purchasing the amount of tax and loss bonds required by ew paragraph (2) company A was allowed a deduction of $100x under new paragraph (1) for 1967 and reduced its taxable income to zero. Company A added $100x to its mortgage guaranty account.

In 1968 company A suffered a net operating loss computed without regard to new paragraph (5)(C) of $50x. Under State law or regulation company A was required to set aside $30x for 1968 in such reserve but was required to reduce such reserve by $75x, a net reduction of $45x. Consequently, for purposes of new paragraph (5)(B) the aggregate amount remaining in such reserve for 1968 was $255x ($300x+$30x−$75x). Since no deduction was allowed under new paragraph (1), because company A had no taxable income for 1968, no amount was added to the mortgage guaranty account for 1968. As a result, for purposes of new paragraph (5)(B) the aggregate amount in such account was $100x.

Since no amount can be added to company A's mortgage guaranty account for years prior to 1967, no amount is subtracted from such account or included in gross income for 1968 under new paragraph (5)(A) with respect to amounts added to such account for the 10th preceding taxable year. In addition, since for 1968 there is no excess of the aggregate amount in the mortgage guaranty account ($100x) over the aggregate amount ($255x) in the reserve referred to in new paragraph (1)(A), no amount is subtracted or so included in gross income under new paragraph (5)(B) for 1968.

However, $50x would be subtracted from the mortgage guaranty account and included in gross income for 1968 under new paragraph (5)(C), since in 1968 company A suffered a net operating loss of $50x computed without regard to new paragraph (5)(C). As a consequence, the inclusion of $50x in gross income under new paragraph (5)(C) offsets any net operating loss for 1968.

In this connection, it should be noted that section 26 of the Second Liberty Bond Act as added by section 2(f) of the bill provides in part that with respect to any taxable year in which amounts are subtracted from such mortgage guaranty account, an amount of tax and loss bonds which was purchased under new section 832(e)(2) with respect to the amount so subtracted shall be redeemed. In the above example, since $50x of the $100x which was allowed as a deduction in 1967 under new paragraph (1) was so subtracted in 1968, 50 percent ($50x/$100x) of the bonds so purchased in 1967 shall be redeemed. No amount, however, is subtracted under more than one subparagraph of new paragraph (5).

In determining the amount of the deduction under new paragraph (1) (as limited by taxable income computed without regard to such paragraph or any carryback), net operating loss carryovers or amounts which are subtracted from the mortgage guaranty account and included in gross income for the taxable year under new paragraph (5) are, of course, taken into account.

Nothing in this provision shall be construed as requiring the Secretary of the Treasury to redeem tax and loss bonds as a result of improper subtractions under subparagraph (A), (B), or (C) of new paragraph (5). New subparagraph (D) only applies after such bonds have been redeemed. Such bonds, however, shall be treated as redeemed when applied to pay tax, buy other tax and loss bonds, or otherwise redeemed.

In order to qualify for this deduction under new section 832(e) a company is required to make timely payments or deposits toward the purchase of bonds. When payments or deposits are made before a company's tax return is filed, the Secretary of the Treasury would be authorized under the bill to delay issuing bonds until the company's tax return is filed, and then to issue bonds backdated to the date of the payments or deposits. The Secretary of the Treasury is also authorized to provide, for example, that payments or deposits not applied toward the purchase of bonds, or not otherwise used, will be returned to the company.

In general, the date (determined without regard to new sec. 832(*e*)) on which such bonds may be redeemed is the due date of any tax due (other than estimated tax) for the taxable year for which an amount is so subtracted from the account and included in income. However, since subtraction from the mortgage guaranty account and inclusion in income are made under new subsection (e)(5)(A) with respect to amounts added to the account for the 10th preceding year, such bonds may be redeemed 10 years from the date purchased. Thus, if, for example, the Secretary of the Treasury requires a company to make deposits toward the purchase of bonds by the due date for paying estimated tax in order to qualify for the deduction under new subsection (e)(1), such bonds (unless redeemed for an earlier taxable year) may be redeemed 10 years from the date of the deposit to the extent of the deposit. In lieu of the application of tax due as a result of the inclusion of amounts in gross income under new section 832(b)(1)(E), the Secretary of the Treasury may permit the bonds to be redeemed to be applied toward the purchase of other tax and loss bonds.

Under the provision in special circumstances, the Secretary of the Treasury could redeem such bonds at an earlier date than would otherwise be the case. Such a special circumstance could be, for example, when a company suffers heavy losses and needs to pay claims with the proceeds from the redemption of such bonds.

A reserve described in subsection (g)(1) of this provision would be a reserve of the type described in new section 832 (e)(1)(A).

Under the second and third sentences of subsection (g)(1) of this provision, in determining, for example, the earned premiums for 1967, the amount of unearned premiums on outstanding business at the end of both 1966 and 1967 shall be computed without any amount which had been treated as unearned premiums under such subsection (g)(1).

Subsection (g) of this provision may be illustrated as follows: For taxable years beginning before 1968, a company has added an aggregate of $\$100x$ to such a reserve. However, pursuant to reductions ordered by a State insurance commissioner, the amount thereof which remains in the reserve at the close of 1968 is $\$80x$. For all taxable years beginning before 1967, $\$100x$ was so treated as unearned premiums, and for 1967, $\$7x$ had been included in gross income under

such subsection (g)(2). For 1968, \$5x is included in gross income under subparagraphs (A) and (B) of such subsection (g)(2). In applying subparagraph (C) to 1968 the aggregate amount so treated as unearned premiums for all taxable years beginning before 1967 (\$100x) less the total of the amounts included in gross income under subsection (g)(2) for prior taxable years (\$7x) and the amounts included in gross income under subparagraphs (A) and (B) for 1968 (\$5x) is \$88x (\$100x —\$12x). The excess of such amount (\$88x) over the aggregate of the additions made for taxable years beginning before 1967 which remain in the reserve at the close of 1968 (\$80x) is \$8x (\$88x —\$80x). Thus, \$8x is so included in gross income under subparagraph (C).

Subsection (g)(2) further provides that for purposes of section 832(e) of the code and of such subsection (g), if part of such reserve is reduced under State law or regulation, such reduction shall first apply to the extent of amounts added to the reserve for taxable years beginning before 1967, and only then to amounts added thereafter. As previously stated, the reserve referred to in subsection (g)(1) of the provision is the same reserve referred to in section 832(e)(1)(A) of the code as added by subsection (c) of this provision. Thus, a State insurance commissioner, for example, could order a reduction in such a reserve which contains amounts added to the reserve both for years prior to 1967 and subsequent to 1966. In such a case, subsection (g)(2) provides that a first-in-time rule shall apply. As a consequence, no amount which is included in income under such subsection (g)(2) shall also be included in income under new codes section 832(e)(5).

Amounts shall be included in gross income under such subsection (g)(2) in accordance with the usual limitations of section 111 of the code.

Changes in Existing Law

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

* * * * * * *

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) General Rule.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

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

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described

in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

* * * * * * *

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

* * * * * * *

[(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.]

(*22*) SUCCESSOR INSURANCE COMPANY.—*If the acquiring corporation is an insurance company taxable under subchapter L, there shall be taken into account (to the extent proper to carry out the purposes of this section and 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 subchapter L in respect of the distributor or transferor corporation.*

* * * * * * *

SEC. 832. INSURANCE COMPANY TAXABLE INCOME

(a) DEFINITION OF TAXABLE INCOME.—In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c).

(b) DEFINITIONS.—In the case of an insurance company subject to the tax imposed by section 831—

(1) GROSS INCOME.—The term "gross income" means the sum of—

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners,

(B) gain during the taxable year from the sale or other disposition of property,

(C) all other items constituting gross income under subchapter B, except that, in the case of a mutual fire insurance company described in section 831(a)(3)(A), the amount of single deposit premiums paid to such company shall not be included in gross income, [and]

(D) in the case of a mutual fire or flood insurance company described in section 831(a)(3)(B), an amount equal to 2 percent of the premiums earned on insurance contracts during the taxable year with respect to policies described in section 831(a)(3)(A) after deduction of premium deposits returned or credited during the same taxable [year]. *year, and*

(E) in the case of a company which writes mortgage guaranty insurance, the amount required by subsection (e)(5) to be subtracted from the mortgage guaranty account.

* * * * * * *

(c) DEDUCTIONS ALLOWED.—In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

* * * * * * *

(13) in the case of a company which writes mortgage guaranty insurance, the deduction allowed by subsection (e).

* * * * * * *

[*(e) SPECIAL DEDUCTION AND INCOME ACCOUNT.—In the case of taxable years beginning after December 31, 1966, of a company which writes mortgage guaranty insurance—*

[*(1) ADDITIONAL DEDUCTION.—There shall be allowed as a deduction for the taxable year, if bonds are purchased as required by paragraph (2), the sum of—*

(A) an amount representing the amount required by State law or regulation to be set aside in a reserve for mortgage guaranty insurance losses resulting from adverse economic cycles; and

(B) an amount representing the aggregate of amounts so set aside in such reserve for the 8 preceding taxable years to the extent such amounts were not deducted under this paragraph in such preceding taxable years,

except that the deduction allowable for the taxable year under this paragraph shall not exceed the taxable income for the taxable year computed without regard to this paragraph or to any carryback of a net operating loss. For purposes of this paragraph, the amount required by State law or regulation to be so set aside in any taxable year shall not exceed 50 percent of premiums earned on insurance contracts (as defined in subsection (b)(4)) with respect to mortgage guaranty insurance for such year. For purposes of this subsection all amounts shall be taken into account on a first-in-time basis. The computation and deduction under this section of losses incurred (including losses resulting from adverse economic cycles) shall not be affected by the provisions of this subsection. For purposes of this subsection the terms "preceding taxable years" and "preceding taxable year" shall not include taxable years which began before January 1, 1967.

(2) PURCHASE OF BONDS.—The deduction under paragraph (1) shall be allowed only to the extent that tax and loss bonds are purchased in an amount equal to the tax benefit attributable to such deduction, as determined under regulations prescribed by the Secretary or his delegate, on or before the date that any taxes (determined without regard to this subsection) due for the taxable year for which the deduction is allowed are due to be paid, as if no election to make installment payments under section 6152 is made. If a deduction would be allowed but for the fact that tax and loss bonds were not timely purchased, such deduction shall be allowed to the extent such purchases are made within a reasonable time, as determined by the Secretary or his delegate, if all interest and penalties, computed as if this sentence did not apply, are paid.

(3) Mortgage guaranty account.—Each company which writes mortgage guaranty insurance shall, for purposes of this part, establish and maintain a mortgage guaranty account.

(4) Additions to account.—There shall be added to the mortgage guaranty account for each taxable year an amount equal to the amount allowed as a deduction for the taxable year under paragraph (1).

(5) Subtractions from account and inclusion in gross income.—After applying paragraph (4), there shall be subtracted for the taxable year from the mortgage guaranty account and included in gross income—

(A) the amount (if any) remaining which was added to the account for the tenth preceding taxable year, and

(B) the excess (if any) of the aggregate amount in the mortgage guaranty account over the aggregate amount in the reserve referred to in paragraph (1)(A). For purposes of determining such excess, the aggregate amount in the mortgage guaranty account shall be determined after applying subparagraph (A), and the aggregate amount in the reserve referred to in paragraph (1)(A) shall be determined by disregarding any amounts remaining in such reserve added for taxable years beginning before January 1, 1967.

(C) an amount (if any) equal to the net operating loss for the taxable year computed without regard to this subparagraph, and

(D) any amount improperly subtracted from the account under subparagraph (A), (B) or (C) to the extent that tax and loss bonds were redeemed with respect to such amount.

If a company liquidates or otherwise terminates its mortgage guaranty insurance business and does not transfer or distribute such business in an acquisition of assets referred to in section 381(a), the entire amount remaining in such account shall be subtracted. Except in the case where a company transfers or distributes its mortgage guaranty insurance in an acquisition of assets, referred to in section 381(a), if the company is not subject to the tax imposed by section 831 for any taxable year, the entire amount in the account at the close of the preceding taxable year shall be subtracted from the account in such preceding taxable year.

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SEC. 5701. RATE OF TAX.

(a) Cigars.—On cigars, manufactured in or imported into the United States, there shall be imposed the following taxes:

(1) Small cigars.—On cigars, weighing not more than 3 pounds per thousand, 75 cents per thousand;

(2) Large cigars.—On cigars, weighing more than 3 pounds per thousand;

(A) If removed to retail at not more than 2½ cents each, $2.50 per thousand;

(B) If removed to retail at more than 2½ cents each and not more than 4 cents each, $3 per thousand;

(C) If removed to retail at more than 4 cents each and not more than 6 cents each, $4 per thousand;

(D) If removed to retail at more than 6 cents each, and not more than 8 cents each, $7 per thousand;

(E) If removed to retail at more than 8 cents each and not more than 15 cents each, $10 per thousand;

(F) If removed to retail at more than 15 cents each and not more than 20 cents each, $15 per thousand;

(G) If removed to retail at more than 20 cents each, $20 per thousand.

In determining the retail price, for tax purposes, regard shall be had to the ordinary retail price of a single cigar in its principal market, exclusive of any State or local taxes imposed on cigars as a commodity. *For purposes of the preceding sentence, the amount of State or local tax excluded from the retail price shall be the actual tax imposed; except that, if the combined taxes result in a numerical figure ending in a fraction of a cent, the amount so excluded shall be rounded to the next highest full cent unless such rounding would result in a tax lower than the tax which would be imposed in the absence of State or local tax.* Cigars not exempt from tax under this chapter which are removed but not intended for sale shall be taxed at the same rate as similar cigars removed for sale.

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SECOND LIBERTY BOND ACT

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SEC. 26. The Secretary of the Treasury is authorized to issue, from time to time, tax and loss bonds, the proceeds of which shall be available to meet any public expenditures authorized by law, and to retire any outstanding obligations of the United States issued under this Act. Tax and loss bonds shall be nontransferable except as provided by the Secretary of the Treasury, shall bear no interest and shall be issued in such amounts, subject to the limitations imposed by section 21 of this Act, as are necessary to permit persons to comply with section 832(e) of the Internal Revenue Code of 1954, Tax and loss bonds shall be issued in such amounts and on such terms and conditions as required by section 832(e) of such Code and as the Secretary of the Treasury shall prescribe. With respect to any taxable year in which amounts are subtracted from the mortgage guaranty account referred to in section 832(e)(3) of such Code, an amount of tax and loss bonds which was purchased under section 832(e)(2) of such Code with respect to the amount so subtracted shall be redeemed, and to the extent necessary shall be applied to pay any taxes due as a result of the inclusion under section 832(b)(1)(E) of such Code of amounts in gross income. In addition, tax and loss bonds may be redeemed as prescribed by the Secretary of the Treasury.

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