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# COMPUTATION OF POLICYHOLDER'S SHARE OF INVESTMENT YIELD ON LIFE INSURANCE COMPANY TAX RETURNS; CAPITAL LOSS CARRYBACKS OF LIFE INSURANCE COMPANIES

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Mr. Long, from the Committee on Finance, submitted the following

## REPORT

[To accompany H.R. 19881]

The Committee on Finance to which was referred the bill (H.R. 19881) consolidated returns of life insurance companies, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

## I. SUMMARY

H.R. 19881 as passed by the House resolves the principal ambiguities which have arisen under the Life Insurance Company Income Tax Act of 1959 regarding the manner in which the provisions governing the taxation of life insurance companies are to be correlated with the provisions of the tax law governing the treatment of affiliated companies which file consolidated income tax returns. In general, the bill provides that life insurance companies which file consolidated tax returns are to compute the amount of their investment yield which is taken into account in determining their taxable income as if they were filing separate returns. In addition, it is provided that life insurance companies which previously filed consolidated returns under the 1959 act may elect to refile on a completely separate basis for those prior years. The committee accepted this House-passed provision without change.

The committee also added an amendment to the bill which deals with the application in the case of life insurance companies of the 3-year carryback for capital losses which was provided for corporations in the Tax Reform Act of 1969. The amendment allows an insurance company whose tax for a year before 1970 would be increased by reason of a carryback of a capital loss sustained in 1970

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or a later year to elect not to have the carryback provisions apply to its capital losses which otherwise would be carried back to pre-1970 taxable years.

The Treasury Department has indicated that it does not oppose the enactment of this bill as amended.

## II. REASONS FOR BILL

*Treatment of consolidated returns*

In the Life Insurance Company Income Tax Act of 1959, Congress extensively revised the income tax treatment of life insurance companies. This revision, however, did not include rules dealing with the taxation of a group of affiliated life insurance companies which elected to file a consolidated income tax return. The Internal Revenue Code as well as the Treasury regulations under both the life insurance company provisions and the consolidated return provisions have remained silent on the manner in which these two complex areas of the tax law relate to each other and are to be applied.

In the past, faced with this ambiguous situation, life insurance companies which elected to file a consolidated tax return eliminated intercorporate dividends from the various life insurance company tax computations. The elimination of intercorporate dividends is what is provided for generally in the case of consolidated returns and was provided for in the Treasury Department consolidated return regulations as a general rule. A recent court case (*Jefferson Standard Life Insurance Company* v. *United States*, 408 F. 2d 842 (CA. 4, 1969)), however, held that this method of computing an insurance company's taxable income was incorrect. The court held that intercorporate dividends should not be eliminated in computing the amount of each life insurance company's investment yield. The basis for the court's position was that the elimination of intercorporate dividends allowed a life insurance company to deduct a portion of those dividends twice. First, by eliminating the dividends from the life insurance company computations, the companies had, in effect, deducted the entire amount of the dividends. Second, a portion of the dividend, in effect, was again deducted as a part of the deduction allowed life insurance companies for additions to their policyholder reserves.

It would appear to the committee that the principle enunciated by the court (namely, that life insurance companies filing consolidated tax returns should compute the amount of their investment yield which is taxable to them as if they were filing separate returns) is appropriate in view of the method provided in the tax law for taxing life insurance companies.

The committee, like the House, is concerned, however, with the effect this principle could have in the case of prior years where there was a lack of any official guidance as to the manner in which these provisions of the tax law were to be coordinated. The principle of the court deprived life insurance companies of the advantages they anticipated receiving from filing consolidated returns (primarily the elimination of intercorporate dividends) while not returning to them various benefits each company in the group would have had if completely separate returns had been filed (principally not having to pay

the 2-percent penalty tax imposed prior to 1964 on companies which filed consolidated tax returns).

In view of these considerations, the bill adopts the principle that life insurance companies filing consolidated tax returns are to compute their share of their investment yield as if they were filing separate tax returns. This rule is made applicable as of the effective date of the Life Insurance Company Income Tax Act of 1959. In addition, the bill deals with the problem of those insurance companies who, faced with a complex and unclear law, chose to file consolidated tax returns on the basis of the method of computation which it has subsequently been decided was incorrect. In these cases the bill provides that these companies may file separate tax returns for all prior years to which the Life Insurance Company Income Tax Act of 1959 was applicable beginning with the first year for which a consolidated return was filed. If this is done, the companies are to be allowed any credit or refund of tax, or reduction in a deficiency of tax, which may result solely from filing their returns on a separate, rather than a consolidated, basis. It is important to note that for this treatment to be available, however, the companies must file separate returns for all prior consolidated return years to which the 1959 act is applicable (other than years for which there has been a court decision or a closing agreement). In other words, the previous consolidation must be completely undone for this rule to apply.

*Capital loss carryback*

Another problem involving life insurance companies was called to to committee's attention. This problem arises as a result of the provisions of the Tax Reform Act of 1969 which provide a 3-year capital loss carryback for corporations in addition to the 5-year capital loss carryover previously allowed. It has been called to the committee's attention that this provision, which was intended to provide relief to corporate taxpayers, can have the effect in the case of a life insurance company of increasing the company's tax for a pre-1970 year (i.e., a year prior to the enactment of the 3-year capital loss carryback) if the capital loss is carried back to such a year. Although the carryback would initially reduce the life insurance company's tax which was imposed on its capital gains which are offset by the loss carryback, that would be a reduction of the 25 percent capital gains tax. However, the carryback could result in a so-called phase III tax to the life insurance company and this tax is imposed at the ordinary income tax rate of 48 percent. The 48 percent tax could more than offset the reduction of the 25 percent capital gains tax thus resulting in a net increase in tax to the life insurance company as a result of the loss carryback.

In view of the fact that the 3-year capital loss carryback was intended to be a tax relief provision, the committee believes that it is appropriate to allow those life insurance companies who would have an increase in tax for a pre-1970 year as a result of the capital loss carryback to elect not to have the capital loss carryback provision apply in the case of carrybacks to a pre-1970 year.

## III. EXPLANATION OF BILL

*Treatment of consolidated returns*

The bill provides that a life insurance company which files (or is required to file) a consolidated tax return for a year is to compute its share of its investment yield (i.e., the amount of its investment yield remaining after deduction of the policyholders' share of the investment yield) as if it were filing a separate tax return. This rule is to apply to the computation of the life insurance company's share of the investment yield under both phase I and phase II of the life insurance company tax provisions. Any determinations and computations which must be made in determining investment yield are to be made on a separate basis. Thus, each life insurance company included in the consolidated return is to separately determine its gross investment income, its deductions in arriving at its investment yield, its current, average, and adjusted earnings rates (including determinations based on the amount of its assets), and its policy and other contract liability requirements independently of the other companies included in the consolidated return. The same is true of the computation of the company's share of investment yield for purposes of the phase II life insurance company tax. The bill however, does not affect the manner in which other determinations which are necessary to arrive at the life insurance company's taxable investment income and gain from operations are to be made (i.e., determinations other than those which must be made in arriving at the insurance company's share of the investment yield).

This provision is to apply to all taxable years to which the Life Insurance Company Income Tax Act of 1959 is applicable (i.e., years beginning after December 31, 1957).

In addition, a rule is provided which allows those companies which filed consolidated income tax returns under the 1959 act for years ending prior to the enactment of the bill to file completely separate returns for those years up to 1 year after the enactment of the bill. This refiling on a separate basis is to be allowed for a taxable year notwithstanding any law or rule of law which would otherwise prevent it, unless there has been a court decision with respect to that year or the taxpayer has entered into a closing agreement with respect to that year.

The election provided by the bill may be made only if certain requirements are satisfied. First, the previous election to file consolidated returns must have been first made for a taxable year ending before March 13, 1969.[1] Second, a life insurance company which wishes to file a new separate return for a previous consolidated return year must elect (in the manner prescribed by the Secretary of the Treasury) this treatment and must file consents to the application of the election by all other companies which were members of the same affiliated group as the electing company for any taxable year beginning after 1957 and ending before March 13, 1969. Finally, the electing and consenting life insurance companies must file a separate return for the first taxable year under the 1959 act for which a consolidated return was

[1] This is the date on which the *Jefferson Standard Life Insurance Company* case decision was rendered and, thus, is the date on which the taxpayers were first aware of judicial acceptance of the principle embodied in the first section of this bill.

filed and for each subsequent taxable year ending prior to the enactment of the bill (whether a separate or a consolidated return was previously filed for any of those subsequent years). A separate return is not to be filed, however, for any taxable year if the allowance of a credit for that year is barred by a court decision (res judicata) or a closing agreement. The election by a life insurance company to file its returns on a separate basis, the filing of the consents to that election of the other affiliated companies, and the filing of the separate returns must be made within 1 year after the date of enactment of the bill.

Since it is intended that life insurance companies which previously filed consolidated returns under the 1959 act and which make the election to file separate returns completely undo the previous consolidation, the bill provides that if the statute of limitations on the assessment of a defficiency, or the allowance of a credit or refund, of income tax for any taxable year for which a refiling is required either ran or would run before the expiration of 2 years from the enactment of the bill, then a deficiency may be assessed, or a credit or refund allowed, for that year until the end of that 2 year period (whether a separate or a consolidated return was previously filed for that year). This waiving of the statute of limitations is only applicable, however, to the extent the deficiency or overpayment is attributable to the election to file separate, rather than consolidated, returns. For example, assume a life insurance company previously filed a consolidated return for a taxable year with respect to which the statute of limitations has run and eliminated intercorporate dividends from the computations of its taxable income (contrary to the rule provided by the bill) and paid the 2-percent penalty tax. If it makes the election provided under the bill and files a separate return, the election in general will extend the statute of limitations in two respects. First, there may be an assessment of the additional tax which arises from including the intercorporate dividends in the computation of the life insurance company's investment yield. Second, the life insurance company will be allowed to credit against that additional liability the amount of the 2-percent penalty tax it previously paid.

It is further provided that no interest may be assessed with respect to a deficiency of this nature and that no interest is to be allowed on any credit or refund of this nature for any period prior to 1 year after the enactment of the bill. Of course, if the statute of limitations for a prior taxable year with respect to which there is an outstanding deficiency has not run and the refiling of the company's tax return for that year on a separate, as opposed to a consolidated, basis results in a decrease in the amount of the deficiency, the company will not be assessed interest on the amount of the reduction in the deficiency (i.e. the amount for which it is no longer liable), but will be required to pay interest as compared under the normal rules with respect to the amount of the reduced deficiency. In addition, the committee intends that no additions to tax based on negligence or intentional disregard of rules and regulations should be imposed with respect to an underpayment which arises as a result of a life insurace company's failure to previously compute its income tax liability on the basis prescribed by the *Jefferson Standard Life Insurance Company* case and the first section of this bill.

*Capital loss carryover*

As indicated above, the committee added an amendment to the bill concerning the applicability to life insurance companies of the 3-year capital loss carryback provided for corporations by the Tax Reform Act of 1969. Under the committee amendment, a company may elect not to carryback the net capital losses which it sustains in 1970 (or a later year) to a year beginning before 1970, if the company was a life insurance company for a pre-1970 taxable year and if the carryback would increase the company's tax for a pre-1970 year. If an election under this provision is made, it is to apply with respect to all carrybacks of net capital losses of the electing company to any pre-1970 taxable year if the company's income tax liability (as a life insurance company) would be increased by the carryback for a pre-1970 year.

The election provided by this amendment is to be made in the form and manner the Secretary of the Treasury prescribes. The election may be made by a company at any time before the expiration of the limitations period on the filing of a claim for credit or refund of income tax for the company's first taxable year beginning after 1969 in which it has a net capital loss.

## IV. CHANGES IN EXISTING LAW

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

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