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## The Life Insurance Company Income Tax Act Of 1959: Tax-Exempt Intercorporate Distributions In Consolidated Filing

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longer be barred where it is alleged that the employer breached some duty to the third party which in turn primarily caused injury to the employee. Actions for contribution, however, would still be barred under the *Wiener* theory, unless it be found that a special rule of law took precedence, as was the case in *Weyerhaeuser*.

By permitting the case to be heard on the merits, *Bremen* offers the most equitable solution to the problem. The third party has the opportunity to prove the duty owed to it by the employer and that the breach of this duty was the main cause of the accident. If these factors can be proved, the Government should hear the blame, for if the United States can escape liability altogether in this situation, the third party has no way to protect himself.<sup>60</sup> At the same time, however, the Government is not placed at an unreasonable disadvantage, for if the third party cannot prove these factors, the United States will bear no liability.

JOHN H. WEST, III

#### THE LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959: TAX-EXEMPT INTERCORPORATE DISTRIBUTIONS IN CONSOLIDATED FILING

The Life Insurance Company Income Tax Act of 1959<sup>1</sup> provides for the determination of a final tax base to which ordinary corporate rates of taxation are applied. Section 804 divides every item of investment yield into a policyholders' share and a company's share. The policyholders' share is used to meet statutory reserve requirements,<sup>2</sup> the reserve being the amount the state requires that life insurance companies set aside to provide for policyholders' claims against the company. The company's share is simply the remainder of investment yield, which is available to the company for operating expenses and for distribution or retention as profit. Section 804 provides that the policyholders' share is not to be included in taxable investment income. The company's share of each item of investment yield, reduced by the com-

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<sup>60</sup>This is most vividly illustrated in *Bremen* where the shipowner, by law, had to submit to the inspection and thus apparently had no choice as to whether or not he would allow the allegedly disabled inspector to board his ship.

<sup>1</sup>Pub. L. No. 86-69, § 2, 73 Stat. 112, amending INT. REV. CODE of 1954, ch. 736, §§ 801-13, 68A Stat. 258; hereinafter referred to as the 1959 Act.

<sup>2</sup>See, e.g., CONN. GEN. STAT. ANN. § 38-25 (1958), N.Y. INS. LAW § 72 (McKinney 1966), N.C. GEN. STAT. § 58-79 (Cum. Supp. 1967), VA. CODE ANN. § 38.1-170 (Cum. Supp. 1968).

pany's share of certain specified items of tax-exempt income,<sup>3</sup> constitutes the company's taxable investment income.<sup>4</sup>

The formula of taxation provided by section 804 can best be explained by an example. Company X has total investment assets of \$100,000,000 of which \$80,000,000 is held in reserves to meet policyholders' claims as is required by state statute. From total investment assets company X receives \$5,000,000 gross investment income. A deduction of \$1,000,000 is then allowed for investment expenses and depreciation to arrive at an investment yield of \$4,000,000.<sup>5</sup> Assume that the section 804 formula, in this instance, allows a policyholders' share of 75%; then that percentage of every item of investment yield is not included in the company's taxable investment income. The remaining 25% constitutes the company's share. This is reduced by the company's portion of certain specified items of tax-exempt income<sup>6</sup> to arrive at the company's taxable investment income.

The recent case of *Jefferson Standard Life Insurance Co. v. United States*<sup>7</sup> involved the question of how the dividends from Pilot Life Insurance Company, a wholly owned subsidiary filing on a consolidated basis with Jefferson Standard, should be eliminated in computing taxable investment income. Treas. Reg. § 1.1502-31(b) (1) (i) (1955) provides only that these dividends are to be "eliminated" from taxable income. Neither the Regulation nor the Code specifies where or how they are to be eliminated, or, more specifically, at what stage of the section 804 computations the elimination is to be made. In the years in question, 1958 and 1959, dividends from the subsidiary, Pilot Life, were eliminated from gross income in arriving at investment yield.<sup>8</sup> The dis-

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<sup>3</sup>INT. REV. CODE of 1954, § 804(a)(2) eliminates from taxable investment income the company's share of interest from governmental obligations under Section 103; partially tax-exempt interest under Section 242; and dividends received under Sections 243-45.

<sup>4</sup>Section 802(b) of the 1959 Act provides the formula for determining life insurance company taxable income and involves three phases of computations. Phase one determines taxable investment income. Phase two is devoted to determining gain or loss from operations. Phase three determines the amount subtracted from policyholder's surplus accounts. See generally Pub. L. No. 86-69, § 2, 73 Stat. 112 as amended INT. REV. CODE of 1954, §§ 801-20. Because the problem of intercorporate distributions and tax exemption is dealt with more clearly and directly in phase one, this discussion will be solely concerned with that phase.

<sup>5</sup>INT. REV. CODE of 1954, § 804(c). Hereinafter INT. REV. CODE of 1954 is referred to in text as the Code.

<sup>6</sup>Note 3 *supra*.

<sup>7</sup>408 F.2d 842 (4th Cir. 1969), *petition for cert. filed*, 37 U.S.L.W. 3485 (U.S. June 17, 1969) (No. 1506).

<sup>8</sup>The Pilot Life dividend was eliminated when the investment yields of the two separate companies were combined. "Consolidated filing" might imply that all the figures for both the companies are combined and that each item of income

strict court approved Jefferson Standard's treatment of the consolidated returns and the elimination of the Pilot dividend, thereby insuring the full tax-exemption of such income.<sup>9</sup> The Fourth Circuit reversed, upholding the government's claim that tax-exempt intercorporate distributions should be treated the same as other exempt income under section 804.<sup>10</sup> That is, it should be included in investment yield for all computations and divided into a policyholders' share and a company's share. As a result the only dividends rendered non-taxable by consolidated filing are those in the company's share. The immunity does not extend to the policyholders' share which is otherwise non-taxable. The full intercorporate distribution is included in the section 804 computations which determine the shares. The ultimate effect of this inclusion is to increase the company's percentage share of every item of

and deduction is computed on a combined basis. Instead, actual consolidation is limited to certain specified items of income and deduction which after separate computation are aggregated for both companies. See 8A J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 46.01 (1964). See generally Treas. Reg. §§ 1.1502-30 to -31 (1955).

<sup>9</sup>Jefferson Standard Life Insurance Co. v. United States, 272 F. Supp. 97 (M.D.N.C. 1967).

<sup>10</sup>The result is that under the Fourth Circuit formula a life insurance company's taxable investment income is greater than under the district court formula. The following merely illustrates the result and are not the actual figures.

|  | <i>District Court</i> | <i>Fourth Circuit</i> |
|--|-----------------------|-----------------------|
| <i>Basic Assumptions:</i>  |                       |                       |
| Investment assets  | \$100,000,000         | \$100,000,000         |
| Life insurance reserves  | 80,000,000            | 80,000,000            |
| Assumed interest rate  | 3%                    | 3%                    |
| <i>Income Assumptions:</i>   |                       |                       |
| Gross income   | 5,200,000             | 5,200,000             |
| less investment expenses & depreciation  | 1,200,000             | 1,200,000             |
| less intercorporate distributions  | 200,000               | (not eliminated)      |
| TOTAL INVESTMENT YIELD   | \$ 3,800,000          | \$ 4,000,000          |
| Adjusted Reserves Rate   | 3.8%                  | 4.0%                  |
| Adjusted Reserves  | 73,600,000            | 72,000,000            |
| [life insurance reserves + (10 x assumed interest rate) - (10 x adjusted reserves rate)] |                       |                       |
| Policyholder's Percentage Share  | 73.0%                 | 72.0%                 |
| [(adjusted reserves x adjusted reserves rate) divided by investment yield]               |                       |                       |
| Reserve Deduction (Policyholder's share)   | 2,796,800             | 2,880,000             |
| Company's Percentage Share   | 26.4%                 | 28.0%                 |
| Company's Share of Investment Yield  | \$ 1,003,200          | \$ 1,120,000          |
| less Company's Share of  |                       |                       |
| Intercorporate Distributions   | —                     | 56,000                |
| TAXABLE INVESTMENT INCOME  | \$ 1,003,200          | \$ 1,064,000          |

Assumptions: current earnings rate equals adjusted reserves rate; pension reserves, other dividends received, and interest paid equal zero.

Figures taken from Kaufman, *The Life Insurance Company Income Tax Act of 1959*, 16 NAT'L TAX. J. 337, 348 (1963).

investment yield, thereby increasing the amount of taxable investment income.<sup>11</sup>

The question of tax-exempt income and the federal income tax on life insurance companies was first raised in the 1928 case of *National Life Insurance Co. v. United States*.<sup>12</sup> There the Supreme Court held invalid certain provisions of the Revenue Act of 1921<sup>13</sup> which not only required a company with tax-exempt interest to pay as much income tax as a company having no exempt interest but also subjected the company with tax-exempt interest to pay more tax per dollar on taxable income before deduction for the reserve.<sup>14</sup> This was, in effect, a penalty for receiving tax-exempt income from government obligations. The Supreme Court stated that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free."<sup>15</sup>

The rule of *National Life* was extended in *Missouri ex rel. Missouri Insurance Co. v. Gehner*<sup>16</sup> which involved the problem of a state property tax on certain insurance companies.<sup>17</sup> The state court interpreted the statute as requiring that the allowable reserve deduction be re-

<sup>11</sup>*Id.*

<sup>12</sup>277 U.S. 508 (1928).

<sup>13</sup>Ch. 136, § 245, 42 Stat. 261.

<sup>14</sup>The 1921 Act taxed only investment income. Insurance companies were allowed to exclude interest from government obligations from their gross income. The deduction from investment income for reserve requirements was set at 4% of the total amount in the reserve fund. However, they were required to subtract from this reserve deduction the amount of the exclusion they had taken for tax-free interest. So that, if two identical companies start with the same amount of gross income, yet company A received tax-exempt interest, company A's taxable income before the reserve deduction is smaller (gross income less exempt interest) than company B's. However, company A must reduce its reserve deduction by the amount of the exclusion for exempt interest. Thus, after the reserve deductions are taken, they each have the same amount of taxable income. Since the recipient of tax-exempt interest had a smaller amount of taxable income, after the exempt interest exclusion but before the reserve deduction, the Supreme Court held it was being subjected to greater burdens because of the receipt of such interest. 277 U.S. 508.

<sup>15</sup>*Id.* at 519.

<sup>16</sup>281 U.S. 313 (1930).

<sup>17</sup>The statute provided:

The property of all insurance companies organized under the laws of this state shall be subject to taxation.... Every such company or association shall make returns, subject to the provisions of said laws: First, of all the real estate held or controlled by it; second, of the net value of all its other assets or values in excess of the legally required reserve necessary to reinsure its outstanding risks and of any unpaid policy claims, which net values shall be assessed and taxed as the property of individuals....

Mo. REV. STAT. § 6386 (1919) as quoted in *Missouri ex rel. Missouri Insurance Co. v. Gehner*, 281 U.S. 313, 317-18 (1930).

duced by the proportion which the value of United States bonds bore to the total assets.<sup>18</sup> The Supreme Court reversed and invalidated the statute, holding that

[W]here 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.<sup>19</sup>

Thus, the doctrine of *National Life* that "one may not be subjected to greater burdens"<sup>20</sup> because of ownership of government obligations was extended in *Gehner* to mean that the value of government bonds must be wholly disregarded in estimating net taxable values.<sup>21</sup>

The reasoning of *Gehner* was impliedly repudiated a year later in *Denman v. Slayton*.<sup>22</sup> There, the taxpayer, engaged in the business of buying and selling municipal bonds, sought to have declared unconstitutional the sections of the Revenue Act of 1921<sup>23</sup> which denied deductions for interest on money borrowed to purchase or carry tax-exempt securities. The Supreme Court held that the circumstances presented were different from those in *National Life* and that the taxpayer was "not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities . . ." <sup>24</sup> The court declared that "[w]hile guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classifica-

<sup>18</sup>322 Mo. 339, 15 S.W.2d 334 (1929).

<sup>19</sup>281 U.S. at 321-22.

<sup>20</sup>277 U.S. at 519.

<sup>21</sup>Since there is no constitutional requirement that the state allow a reserve deduction, Justice Stone reasoned in dissent that:

Calling the deduction . . . an "exemption" and saying that the ownership of tax exempt securities is made the basis of denying the "full exemption," may give this case a verbal resemblance to [*National Life*] but it does no more. True, a change by appellant from taxable to tax free investments would result in a smaller deduction from its taxable assets, but it would also result in a proportionate reduction of its taxable assets with a corresponding decrease in taxable values, always in exact proportion of appellant's investment in tax exempt securities.

Missouri *ex rel.* Missouri Ins. Co. v. Gehner, 281 U.S. 313, 330 (1930) (dissenting opinion).

<sup>22</sup>282 U.S. 514 (1931).

<sup>23</sup>Section 214(a) provides:

that in computing net income there shall be allowed as deductions: . . .  
(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities . . . the interest upon which is wholly exempt from taxation under this title . . . .

Revenue Act of 1921, ch. 136, 42 Stat. 239.

<sup>24</sup>282 U.S. at 519.

tion designed to subject all to the payment of their just share of a burden fairly imposed."<sup>25</sup> While *Gehner* was not referred to, it was rejected by implication since the taxpayer was not allowed the full, undiminished exemption for tax-free income. In *Denman* the exemption was decreased, in effect, by the amount of interest on obligations incurred to purchase and carry tax-exempt assets.

The Supreme Court in *Helvering v. Independent Life Insurance Co.*<sup>26</sup> followed *Denman* and again distinguished *National Life* without mentioning *Gehner*. In *Independent Life*, the Court ruled constitutional the sections of the Revenue Acts of 1921<sup>27</sup> and 1924<sup>28</sup> which permitted deductions for depreciation and expenses of buildings owned by life insurance companies only if the companies included in their gross incomes the rental value of the space they occupied. Under the *Denman* rule this formula was held to be a valid apportionment of expenses between the space occupied by the company and the space for which rents were received. The sections were held to be constitutional since they did not lay a direct tax on the rental value of space occupied by the companies, which had been held previously not to be income within the meaning of the sixteenth amendment.<sup>29</sup>

The problem of tax-exempt income under the 1959 Act had been dealt with previously in *United States v. Atlas Life Insurance Co.*,<sup>30</sup> which specifically concerned the exemption of income from municipal bonds. The *Atlas* decision held that the formula of the 1959 Act for determining taxable investment income did not place an impermissible tax on tax-exempt interest from municipal bonds. The Court, interpreting *Denman* and *Independent Life* to mean that "tax laws may require tax-exempt income to pay its way,"<sup>31</sup> held that there was no basis for the contention that the policyholder reserve must be satisfied by resort to taxable income alone. The reasons given were that policyholder claims run against all income, taxable or not, and tax-exempt income is not exempt from the company's obligation to add a large portion of investment income to the policyholder reserve.<sup>32</sup> The Court

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<sup>25</sup>*Id.*

<sup>26</sup>292 U.S. 371 (1934).

<sup>27</sup>Revenue Act of 1921, ch. 136, § 245(b), 42 Stat. 261.

<sup>28</sup>Revenue Act of 1924, ch. 234, § 245(b), 43 Stat. 289.

<sup>29</sup>*Eisner v. Macomber*, 252 U.S. 189 (1920); *cf. Stratton's Independence v. Howbert*, 231 U.S. 399 (1913).

<sup>30</sup>381 U.S. 233 (1965).

<sup>31</sup>*Id.* at 247.

<sup>32</sup>*Id.*

noted that the insurance company's insistence on excluding both the full and reserve and tax-exempt income was

tantamount to saying that those who purchase exempt securities . . . are constitutionally entitled to reduce their tax liability and to pay less per taxable dollar than those owning no such securities. The doctrine of intergovernmental immunity does not require such a benefit to be conferred on the ownership of municipal bonds.<sup>33</sup>

In the instant case, Jefferson Standard and its subsidiary filed consolidated returns in 1958 and 1959. The filing of consolidated returns is not a right but a privilege which exists at the discretion of Congress<sup>34</sup> and results in the availability of substantial tax savings to the taxpayer.<sup>35</sup> This privilege is given on the condition that all members of the affiliated group "consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return."<sup>36</sup> Furthermore, the Regulation<sup>37</sup> permitting the exemption of intercorporate distributions in consolidated filing is subject to the general reservation of Treas. Reg. § 1.1502-3 that whenever a problem arises in consolidated filing that is not covered by the Regulations, the matter should be determined in accordance with the provisions of the Code or other applicable law.<sup>38</sup> The court in *Jefferson Standard* remarked that "[m]anifestly this reservation should be given wider latitude where, as here, the Regulation preceded the Act and the Act made fundamental changes in the mode of taxing life insurance companies."<sup>39</sup>

The privilege of making consolidated returns and thereby receiving the exemption on intercorporate distributions is predicated solely on legislative grace, and the taxpayer making consolidated returns is made expressly subject to the Regulations and the provisions of the Code or other applicable law. It does not appear that the exemption on in-

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<sup>33</sup>*Id.* at 251.

<sup>34</sup>INT. REV. CODE of 1954, § 1501. 8A J. MERTENS, LAW OF FEDERAL INCOME TAXATION 46.01 (1964); see *Smith Paper Co. v. Comm'r*, 31 B.T.A. 28 (1934), *aff'd sub nom. Export Leaf Tobacco Co. v. Comm'r*, 78 F.2d 163 (2d Cir. 1935).

<sup>35</sup>See Crestol, *Consolidated Return Regulations and Related Tax Provisions*, N.Y.U. 26TH INST. ON FED. TAX 731 (1968).

<sup>36</sup>INT. REV. CODE of 1954, § 1501.

<sup>37</sup>Treas. Reg. § 1.1502-31(b)(1)(i) (1955).

<sup>38</sup>The Regulation provides:

[a]ny matter in the determination of which the provisions of the regulations . . . are not applicable shall be determined in accordance with the provisions of the Code or other law applicable thereto.

Treas. Reg. § 1.1502-3 (1955).

<sup>39</sup>408 F.2d at 846 n.6.



come from municipal obligations, grounded in constitutional law<sup>40</sup> and specifically provided for in the Code,<sup>41</sup> is any lesser right. Therefore, the reliance on *Atlas* seems well founded. If the full exemption is not granted for income from municipal bonds under the 1959 Act, there seems no logical reason why it should be granted for intercorporate distributions in consolidated filing. In addition, the general reservation that a problem not covered by the Regulations should be resolved in accordance with the Code and law applicable thereto is satisfied by relying on *Atlas* and the section 804 treatment of other forms of tax-exempt income.

The court in *Jefferson Standard* rejected the taxpayer's elimination of intercorporate distributions at the outset of section 804 computations on the reasoning, presented in *Atlas*, that a portion of the intercorporate distribution belongs to the policyholder's share. The court said,

If Pilot's dividend to taxpayer is to be eliminated at the outset of the . . . computations, in effect, the Act would be construed as if liabilities to taxpayer's policyholders were to be satisfied solely by other income. . . . [B]oth taxpayer's investment in Pilot and the income derived therefrom are available and legally liable for the satisfaction of taxpayer's liabilities to its policyholders.<sup>42</sup>

This reasoning is in accord with the language in *Atlas* that "the tax laws may require tax-exempt income to pay its way."<sup>43</sup> Thus, the tax-exempt character of the income is not recognized at the outset of the computation, but is recognized at its conclusion, when the life insurance company's share of investment income is determined.

Looking behind *Atlas* to the rule in *National Life*, it is evident that the formula of the 1959 Act as applied in the instant case does not subject *Jefferson Standard* to "greater burdens" because it is the recipient of tax-exempt income. Although *Jefferson Standard* is not accorded the benefit of both the full exclusion of intercorporate distributions and the full reserve deduction, the receipt of such tax-exempt income does result in a lower total tax. The full portion of intercorporate distribution relegated to the company's share is eliminated before the tax is applied, thereby lowering the total tax.

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<sup>40</sup>*Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 (1895) held income from state and municipal obligations constitutionally immune from federal taxation. There is controversy as to whether this case still represents valid constitutional doctrine. Cf. Powell, *The Waning of Inter-governmental Tax Immunities*, 58 HARV. L. REV. 633 (1945); Powell, *The Remnant of Intergovernmental Tax Immunities*, 58 HARV. L. REV. 757 (1945).

<sup>41</sup>INT. REV. CODE of 1954, § 103(a)(1).

<sup>42</sup>408 F.2d at 846-47.

<sup>43</sup>381 U.S. at 247.