



1965

Treatment of Tax-Exempt Interests in the Taxation of Life Insurance Companies

Michael M. Boone

Follow this and additional works at: <https://scholar.smu.edu/smulr>

Recommended Citation

Michael M. Boone, Note, *Treatment of Tax-Exempt Interests in the Taxation of Life Insurance Companies*, 19 Sw L.J. 826 (1965)

<https://scholar.smu.edu/smulr/vol19/iss4/11>

This Case Note is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

him of a depreciation deduction for the year of sale. This position is supported by prior legislative, judicial, and administrative interpretation of the depreciation provisions.

The Commissioner, on the other hand, argues that the purpose of the depreciation deduction is to allow cost recovery, and that, despite prior interpretation to the contrary, the taxpayer should not be allowed to deduct non-existent depreciation and thereby convert ordinary income into capital gain.

Both arguments are persuasive; the Supreme Court justifiably could uphold either one. In reaching its decision, however, the Court might observe that although section 1245 will govern future cases involving fact situations similar to that found in *Fribourg*, a great number of pre-section 1245 cases are pending which will be affected by the outcome in *Fribourg*.

Frank Marion Keeling, Jr.

Michael N. Maberry

Treatment of Tax-Exempt Interest in the Taxation of Life Insurance Companies

I. TAX-EXEMPT INTEREST

An outgrowth of the doctrine of intergovernmental immunity from taxation set forth in *McCulloch v. Maryland*¹ is the tax exemption that has been afforded interest on municipal and state bonds. The argument against a tax on such interest has been based mainly on the reasoning that the tax would reduce the borrowing power of the state governments and their instrumentalities, thereby imposing a direct burden on their operations.² In 1895 the United States Supreme Court in *Pollack v. Farmers Loan & Trust Co.*³ gave effect to this argument, holding that a tax on income from state bonds was an unconstitutional interference with the borrowing

¹ 17 U.S. (4 Wheat.) 316 (1819).

² See Betters, *The Proposal to Tax Income from Governmental Securities—The Case Against Taxation*, 7 Law & Contemp. Prob. 222 (1940); Shultz, *The Proposal to Tax Income from Governmental Securities—The Case for Taxation*, 7 Law & Contemp. Prob. 217 (1940).

³ 157 U.S. 429 (1895), *rev'd and remanded on rehearing*, 158 U.S. 601 (1895). The *Pollack* case held the 1894 Income Tax Act unconstitutional on the ground that a tax on the income from property was a direct tax and invalid under article I, section 9, clause 4 of the Constitution, because it was not apportioned according to population. The decision pre-dated the passage of the sixteenth amendment.

power of the states.⁴ Section 103(a)(1)⁵ of the Internal Revenue Code is the statutory implementation of the view opposing a tax on interest from municipal and state bonds.

II. TAXATION OF LIFE INSURANCE COMPANIES AND THE AVOIDANCE OF A DOUBLE BENEFIT

The Life Insurance Company Income Tax Act of 1959⁶ marked the end of a forty-year period in which Congress had sought to find a formula for the taxing of life insurance companies which would be effective and yet constitutional. Historically,⁷ the federal government has encountered complex problems in the taxing of life insurance companies due to the unique operations of the industry. The differences in the operations of mutual companies and stock companies are responsible for some of the problems, but the greatest difficulty has arisen from the matter of determining what is income to a life insurance company. The interplay of the exemption required for interest from municipal bonds and the deduction allowed to companies to maintain their policy reserves has created considerable problems in effectively taxing this industry.

A. Reserve Deduction

State statutory provisions⁸ require that companies place a certain amount of their investment income into a reserve so that the interests of the policyholders will be protected against insolvency. These reserves are funds which, together with future premiums and interests, will be sufficient to pay future claims.⁹ Beginning with the first tax placed on insurance companies, Congress has viewed the reserve requirement as a type of business expense and, accordingly, has permitted a deduction therefor from each company's income. The allow-

⁴ See Brown, *Intergovernmental Tax Immunity: Do We Need a Constitutional Amendment?*, 25 Wash. U.L.Q. 153 (1940); Lowndes, *Current Constitutional Problems in Federal Taxation*, 4 Vand. L. Rev. 469 (1950); Rouzer, *Legal Problems in Taxing Income from Governmental Securities*, 7 Law & Contemp. Prob. 235 (1940).

⁵ Int. Rev. Code of 1954, § 103(a)(1) reads in part as follows: "(a) General Rule. Gross income does not include interest on—(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or the District of Columbia."

⁶ 73 Stat. 112 (1959), 26 U.S.C. §§ 801-820 (supp. 1960), amending Int. Rev. Code of 1954, §§ 801-813, hereinafter referred to as the 1959 act.

⁷ See Kaufman, *The Life Insurance Company Income Tax Act of 1959*, 16 Nat'l Tax J. 337 (1963); Mayerson, *The Life Insurance Income Tax Act of 1959*, 14 J. Am. Soc'y C.L.U. 171 (1960); Wurzel, *Tax-Exempt Interest of Life Insurance Companies, A Study in "Discriminatory" Taxation*, 70 Yale L.J. 15 (1960).

⁸ For the applicable provision in Texas see Tex. Ins. Code Ann. art. 3.28 (1963).

⁹ See Int. Rev. Code of 1954, § 801(b)(1) for the tax statutory definition of life insurance reserves. For a thorough explanation of policy reserves see 8 Mertins, *The Law of Federal Income Taxation* § 44.16, at 135 (1964).

able reserve deduction acknowledges the fact that a part of each company's investment income belongs to the interest of policyholders, and that the company should be taxed only on its *free* investment income. The government's formulas used in calculating the allowable deduction for tax purposes were often inequitable and inadequate to tax life insurance companies effectively. The formulas usually were based on the operating experience of the entire industry rather than that of each company, and as a result, many prosperous companies often paid little taxes while others with little income paid a greater percentage of the total tax receipts from the industry.¹⁰ Conscious of its previous mistakes, Congress passed the 1959 act to stabilize the taxation of life insurance companies by adopting a tax formula that reflects each individual company's experience and operating results.

The deduction is calculated by multiplying the accumulated reserve funds of the company by the current earnings rate. The reserve deduction rate is now the average rate of income of the company for the current and four prior years, with the proviso that in no case is the deduction rate to exceed the actual current earnings rate.¹¹ The application of the deduction rate, however, often would allow a deduction in an amount larger than that which companies actually credit to the reserve, because the annual addition made by the company is determined by multiplying the accumulated reserve by an assumed interest rate which is considerably less than the rate earned.¹² To alleviate this disparity, the policy reserve is recalculated for tax purposes by reducing it by ten per cent for every one per cent by which the applicable earnings rate exceeds the rate assumed by the company.¹³

B. Tax-Exempt Interest And The Reserve Deduction

The reserve deduction necessitated special treatment by the 1959 act of tax-exempt interest received by the life insurance companies

¹⁰ A drop in interest rates between 1938 and 1940 caused a wide fluctuation in income to insurance companies. As a result the reserve deduction of many companies, calculated by applying a uniform 4% rate set by the 1921 act, was greater than their income. The government never collected more than \$500,000 annually in taxes during this period as compared to an average of \$12 million per year in the late 1920's. The 1942 formula based on the average activity of the industry was equally sensitive to any change in the net earnings of the industry, and again, as a result of a decline in interest rates, the companies paid no taxes in 1947 and 1948. See Mayerson, *supra* note 7, at 173, 174.

¹¹ Int. Rev. Code of 1954, § 805, as amended, 73 Stat. 118 (1954).

¹² Wurzel, *supra* note 7, at 22.

¹³ *Hearings on H.R. 4245, Tax Formula for Life Insurance Companies, Before the Senate Finance Committee, 86th Cong., 1st Sess. 51 (1959)* (hereinafter called the "Hearings") at 307.

as part of their investment income. The government did not desire to give life insurance companies a double benefit through the operation of both of these deductions, but at the same time it did not wish to disturb the well-established immunity of tax-exempt interest. When H.R. 4245 (tax formula for life insurance companies) came before the Senate Finance Committee in 1959, the treatment of tax-exempt interest was a matter of great concern and controversy.¹⁴ In the hearings on H.R. 4245 before the committee the life insurance companies argued that the treatment of exempt interest discriminated against them, was invalid under the holdings of previous decisions,¹⁵ and would seriously affect the municipal bond market.¹⁶ The Treasury countered that the H.R. 4245 method of treating tax-exempt interest was necessary to avoid a double benefit and was legally sound.¹⁷ After two months of hearings, the committee turned out a bill that attempted to remove the double benefit, but inserted a clause which guaranteed adjustments if it were established in any case that a tax had been placed on exempt interest.¹⁸ Apparently, the adjustment clauses¹⁹ were added to the bill to convince Congress and the insurance companies that no tax was intended to be imposed on municipal bond interest and that the exemption status of such interest was to be continued under the new formula.

Assume that a company's reserve deduction is \$80,000 and that its total net investment income is \$100,000 which includes \$20,000 of tax-exempt interest. Under the 1959 act, the company's reserve deduction (\$80,000) for tax purposes is divided by net investment income (\$100,000), which includes tax-exempt interest, to determine the percentage of every item of investment income that will be apportioned to the reserve.²⁰ The percentage of each item of investment income that is allocated to the reserve as the policyholders' share is eighty per cent and the remainder (twenty per cent), the

¹⁴ Hearings at 19-60, 121, 187, 248-266, 304-318, 404-409, 516-518, 613-614, 646-654, 694-699, 700-703.

¹⁵ See notes 26 and 31 *infra*.

¹⁶ Hearings at 304-318, 404-409.

¹⁷ Hearings at 48-49.

¹⁸ Int. Rev. Code of 1954, §§ 804(a)(6) and 809(b)(4), as amended, 73 Stat. 116 (1959). These "adjustment" clauses provide that if in any case the application of the statutory formulas for taxing life insurance companies "results in the imposition of tax on" state and municipal bond interest, adjustments "shall be made to the extent necessary to prevent such imposition."

¹⁹ *Ibid.*

²⁰ Int. Rev. Code of 1954, § 804(a)(1), as amended, 73 Stat. 115 (1959). This section provides in part: "The policyholders' share of each and every item of investment yield . . . of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield. . . ."

company's share.²¹ This unique method of dividing each item of investment income between the company and its policyholders denies the company a deduction for one hundred per cent of the tax-exempt interest. Section 805(c) of the 1959 act allows the life insurance company to reduce its share of investment income by its pro rata share of tax-exempt interest which would be \$4,000 (twenty per cent of \$20,000). The company has a net taxable income of \$16,000. This method of apportioning exempt interest avoids a double benefit because a company cannot take a deduction for such interest as part of the reserve deduction and then again as an exemption required by section 103 of the Code.

C. Treatment Of Exempt Interest By Previous Formulas

The tax formulas applicable to the years 1942-1957 provided for a similar adjustment to prevent a double benefit, but because the method involved a percentage based on a national norm, there was little practical effect, and the formula was never contested.²²

Under the 1921 act, a life insurance company was allowed a full deduction from its gross income for interest received on municipal and state bonds but at the same time was required to reduce its reserve deduction by an equal amount.²³ The result was that a company that received tax-exempt interest paid as much tax as another company with the same gross income but with no interest from exempt securities; and paid more tax per taxable dollar of gross income.²⁴ The United States Supreme Court in *National Life Insurance Co. v. United States*²⁵ held that the 1921 act was unconstitutional because it indirectly placed a tax on income from tax-exempt securities. Mr. Justice McReynolds stated for the majority that "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free."²⁶ The decision was based on the holding of *Packard Motor Car Co. v. City of Detroit*²⁷ in which a

²¹ *Ibid.*

²² *Hearings* at 695.

²³ Revenue Act of 1921, ch. 136, § 245, 42 Stat. 261 (1921).

²⁴ *Example*: Company A and Company B both have gross investment income of \$100. Co. A has \$20 of exempt interest while all of Co. B's investment income is taxable. Assume that each has an allowable reserve deduction of \$70. By applying the 1921 formula to Co. A, $\$100 - \$20 = \$80 - \70 (\$70 reserve deduction minus \$20 to equal the amount of exempt interest), the result is \$30 net taxable income. Since Co. B has no exempt interest its taxable income is easy to determine: $\$100 - \$70 = \$30$. Both have a net taxable income of \$30, but Co. A has only \$80 worth of taxable gross income while Co. B has \$100. The burden on Co. A's taxable property is therefore increased per taxable dollar because it received exempt interest.

²⁵ 277 U.S. 508 (1928).

²⁶ *Id.* at 519.

²⁷ 232 Mich. 245, 205 N.W. 106 (1925). A Michigan court had found a property tax to be an invalid interference with the federal government's power to raise money by issuance

Michigan court had held that "in laying a tax on property, tax-exempt credits must be treated as non-existent."²⁸ The rule of *National Life* was extended in *Missouri ex rel. Missouri Insurance Co. v. Gebner*.²⁹ A state law that imposed a property tax on the net value of all property of insurance companies in excess of the legally-required reserve was interpreted by a Missouri court to require that the reserve deduction be reduced by the proportion that the value of U.S. bonds bore to total assets. The Court in *Gebner*, purporting to follow *National Life*,³⁰ declared the Missouri law as interpreted to be unconstitutional because the ownership of government bonds was made the basis for denying a full reserve deduction—a deduction accorded to those who owned no exempt securities. In other words, *Gebner* set forth the rule that a taxpayer cannot be denied a deduction accorded to others on the basis that he owns tax-exempt securities. The Court was of the opinion that "neither ingenuity in calculation" nor "form of words" can deprive a taxpayer of his exemption for interest received from governmental securities.³¹

III. UNITED STATES V. ATLAS LIFE INSURANCE COMPANY

The controversy in *United States v. Atlas Life Insurance Co.*³² laid before the United States Supreme Court an opportunity to consider the constitutionality of the treatment of tax-exempt interest by the 1959 act in light of previous decisions concerning apportionment formulas. By operation of the 1959 formula the Atlas Life Insurance Co. was required to apportion eighty-five per cent of its exempt interest to the reserve as the policyholders' share of that particular item of investment income. Because it was allowed a deduction for only its pro rata share (fifteen per cent) of exempt interest, the company was required to pay more taxes than if it had been allowed a deduction for one-hundred per cent of such interest. Atlas brought suit for a refund under the "exception clauses"³³ on the ground that this method of apportioning tax-exempt interest placed a tax upon exempt interest under the holdings of *National Life* and *Gebner*. The company viewed the "exception clauses" as safety valves to be

of securities. The Michigan law taxed the total credits of a company less its debts, but if the company had tax-exempt credits, it could deduct only that proportion of its debts represented by the ratio between taxable credits and total credits.

²⁸ *Id.* at 107.

²⁹ 281 U.S. 313 (1930).

³⁰ This holding was logical in light of the broad language of *Packard Motor Car* which was approved in *National Life*. 232 Mich. 245, 205 N.W. 106 (1925).

³¹ 281 U.S. 313, 321.

³² 381 U.S. 233 (1965).

³³ See note 18 *supra*.

operative on the final determination of a court of law that the 1959 act's method of treating exempt interest placed a tax on such interest within the meaning of previous court decisions.

The Court rejected the argument that this method of apportioning tax-exempt interest was invalid under the decision in *National Life Ins. Co. v. United States*. The Court reasoned that under the 1921 act a life insurance company was required to pay the same amount of tax on its gross income regardless of whether it owned exempt securities; whereas, under the 1959 act Atlas received its full reserve deduction plus a deduction for its pro rata share of exempt interest, thus making its tax less than that of a company with the same amount of gross income made up entirely of taxable investments.³⁴ Furthermore, the Court said that the 1921 act increased the burden on taxable property because a company receiving exempt interest paid more tax per dollar of taxable gross income than a person with the same amount of gross income but without any tax-exempt interest. The reverse holds true under the 1959 act, in that the tax burden per taxable dollar remains the same even though the amount of the exempt interest is changed.

Atlas contended that when *National Life* is read in conjunction with *Gebner*, the conclusion must be drawn that ownership of exempt property or income may not be made the basis of diminishing a deduction which would be allowed if the taxpayer owned no such property or income. The Court deemed this argument inapplicable, pointing to the fact that the rule in *National Life* was not the basis upon which the Missouri law was invalidated in *Gebner*. Under the Missouri law the method of reducing the reserve did not increase the tax burden upon the taxable property of the company; rather, the decision in *Gebner* was based purely upon the general proposition that ownership of government bonds cannot be made the basis for denying the full exemption which is accorded to those who own no such bonds.³⁵ This extension of *National Life*, according to the Court, was soon repudiated by the decision in *Denman v. Slayton*.³⁶ In upholding, contrary to *Gebner*,³⁷ a law that denied a deduction on the

³⁴ 381 U.S. 233, 243-44.

³⁵ *Id.* at 245.

³⁶ 282 U.S. 514 (1931). The Court upheld section 214(a)(2) of the 1921 act, which denied to dealers in securities a deduction for interest incurred on money borrowed to purchase or carry exempt securities. The holdings of *National Life* and *Gebner* were argued, but the Court spoke only of *National Life*, saying that it was radically different from the case at hand because the dealer in securities in *Denman* was not required to pay more upon his taxable investment merely because he had received tax-exempt interest.

³⁷ The Court in *Atlas* pointed out that the taxpayer in *Denman* was in a position similar to that of the taxpayer in *Gebner*, because both were required to pay a greater tax than if the exempt securities had been ignored entirely and, therefore, that the court in *Denman* had impliedly rejected *Gebner's* extension of *National Life*. 381 U.S. at 246.

basis of ownership of tax-exempt securities, the Court in *Denman* stated that "while guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the payment of their just share of a burden fairly imposed."³⁸

Mr. Justice White, speaking for the Court in *Atlas*, stated, "We affirm the principle announced in *Denman* and *Independent Life*³⁹ that the tax laws may require tax-exempt income to pay its way. In our view, Congress has done no more in the 1959 Act than to particularize this principle in connection with taxing income of life insurance companies."⁴⁰ The Court considered the obligation of the insurance company to maintain reserves in the interest of its policyholders as basic to its operation; it felt that Congress' method of treating a major part of investment income not as income to the company but as income to the policyholders was not inherently arbitrary or irrational.⁴¹ The Court could find no sound reason for holding that only taxable investments should be allocated to the reserve. The fact that interest from municipal bonds may be exempt from tax does not require that it be exempt from the company's obligation to add a large part of its investment income to the reserve. The Court concluded that the increase in taxes resulting from the denial of a full deduction for tax-exempt interest in addition to the full reserve deduction was necessary in following "the principle of charging exempt income with a fair share of the burdens properly allocable to it."⁴² The doctrine of exempting interest on municipal bonds did not require that a purchaser be guaranteed the right to pay less tax per taxable dollar than those owning no such securities.

IV. CONCLUSION

The enactment of the 1959 act indicates that Congress has found, at least for the present, a valid solution to the complex problems involved in taxing the life insurance industry. The new method for

³⁸ 282 U.S. 514, 519.

³⁹ *Helvering v. Independent Life Insurance Co.*, 292 U.S. 371 (1937). The Court upheld an act which permitted a life insurance company a deduction for all depreciation and expenses on a building it rented only if the company included in its gross income the rental value of the proportionate space it occupied. At that time such expenses were not deductible by life insurance companies because the companies were taxed only on investment income and therefore could deduct only investment expenses. The Court recognized that the rental value was not income and could not be taxed constitutionally but, relying on the decision in *Denman*, it upheld the act as a valid apportionment of expenses between the space occupied by the company and the space rented out.

⁴⁰ 381 U.S. 233, 247.

⁴¹ *Id.* at 249.

⁴² *Id.* at 251.

determining the reserve deduction eliminates the inadequacies and inequities of the previous formulas that sometimes required companies with low income to pay a disproportionate tax.

Congress has prevented the double benefit that would result from the operation of both the reserve deduction and the tax-exempt interest deduction. From the record of the hearings on H.R. 4245, it is clear that Congress did not wish to remove the exemption that has been afforded interest on municipal bonds; but at the same time it did not intend that the insurance companies should escape a tax on their fair share of investment income.⁴³

The *Atlas* decision has declared this treatment of exempt interest to be constitutional on the basis that "tax laws may require tax-exempt income to pay its way." The Court refused to accept the broad rule of *Gebner* that a denial of a full exemption cannot be based upon the ownership of government securities. The Court declared that the decision in *National Life* was based solely upon the fact that the 1921 act increased the burden on taxable property because the company had received some tax-exempt interest and that it was not based upon the same rule as *Gebner*.⁴⁴

The Court acknowledged the fact that under the 1959 act a life insurance company will pay more taxes than if no special treatment had been given by the act to exempt interest. However, because of the circumstances created by the reserve deduction, it was reasonable and consistent for Congress to require that each item of investment income (including tax-exempt interest) be divided proportionately between the interests of the company and its policyholders.⁴⁵ This apportionment appears to be constitutional only as a result of the coincidental situation created by the reserve deduction. If the reserve deduction were removed it is doubtful that the formula would be upheld because there would be no reasonable basis for apportioning tax-exempt interest between the company and the reserve.

Apparently, the Court will uphold an apportionment formula that denies a full deduction on the basis of ownership of exempt securities, but only if the method used is not arbitrary or unreasonable under the circumstances and does not increase the tax burden on taxable property. Tax-exempt income requires a full exclusion from taxable income, but it does not require an exclusion from the share of investment income allocated to the reserve. The 1959 act, through

⁴³ 105 Cong. Rec. 8401-8402, 8429, 10400, 10413-10414. Senator Byrd, Chairman of the Senate Finance Committee, in explaining the bill to the Senate, stated without qualification that "it was the intention of the committee not to impose any [tax on] tax-exempt interest."

⁴⁴ 381 U.S. 233, 247.

⁴⁵ See note 41 *supra*.