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TAX PLANNING OPPORTUNITIES AND DETERMINING EARNINGS AND PROFITS FOR LIFE INSURANCE COMPANIES

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In this article, discussion of the taxation of life insurance companies will be divided into two major areas.

First, we will consider a few of the many areas where lack of adequate planning produces unwanted tax results. Such unwanted results may be due to failure to consider a particular area in planning or to failure to thoroughly evaluate the effects of all points of a proposed action.

The second area of discussion will be the determination of earnings and profits for a life insurance company. This subject has not received a great deal of attention in life insurance taxation in prior years. I feel that it will become more important in the future because of the growth seen in recent years in the number of holding companies and multiple groups in the life insurance industry.

TAX PLANNING OPPORTUNITIES

The beginning point in tax planning for a life insurance company is to determine as accurately as possible the company's situation with regard to the three possible phases of taxation. This determination should be made for the current year and projected for succeeding years. Failure to recognize the current tax situation of a company or to consider that the company is about to change from one phase of taxation to another can upset the best of tax planning. At this point, I think that most companies are aware of the importance of an accurate projection of their position with respect to these tax situations. It has also been my experience that most companies have recognized the importance of determining marginal rates of return on investment income in their tax planning and have utilized marginal rates extensively in investment decisions over the years. I do not plan to discuss either of these concepts in this article.

- **Bad Debts** One common area where lack of planning can cause unwanted or unnecessarily severe tax results is the deduction for bad debts. Section 809(e)(2) of the Internal Revenue Code provides that a life insurance company will not be allowed a deduction for an addition to a reserve for bad debts. However, for various reasons many companies have begun to provide such reserves for financial reporting purposes. Often, particularly in cases where such a reserve has been provided for financial purposes, companies fail to consider the timely action necessary for a proper deduction of these bad debts for tax purposes.

Section 166 of the Code provides the general rule that a bad debt will be allowed as a deduction in the year in which it becomes worthless. It is important to remember that, in addition to the general rule, the Code provides that a deduction may also be taken for tax purposes when a debt becomes only partially recoverable. This deduction is allowed only in an amount not in excess of the partially worthless debt actually charged off on the books within the taxable year. A company, utilizing a reserve for bad debts to achieve proper financial reporting, can have a great deal of flexibility in choosing which year a tax deduction will be allowed for partial worthlessness. Of course, failure to consider this planning area and to make charge offs on the books reflecting the partial worthlessness of particular accounts can result in the deferral of substantial tax deductions to later years.

As an example, most companies usually have some agents' balances that are only partially recoverable. In these cases, the company can accelerate the year in which this partial worthlessness will be recognized for tax purposes merely by choosing the year in which the actual charge off is reflected on the books. If the partial worthlessness is not reflected by actual charge offs on the books, the bad debt deduction will be allowed only when the debt is totally worthless.

Claiming a tax deduction for bad debts arising from investment activities is another area where a company may have followed a practice that does not always produce the best tax result. Consideration should be given to whether such a deduction would be more valuable to the company in most years as a Phase I or a Phase II deduction. The question here is whether this expense is deductible under section 804(c)(1) as an "investment expense" for the taxable year or under section 809(d)(12) as an "other allowable deduction" not allowed in computing investment yield.

As pointed out earlier, it is section 809 that includes the provision that a life insurance company may not claim a tax deduction for an addition to a reserve for bad debts. However, there is nothing in that section or the related regulations that indicates that a bad debt is deductible only under that section. It should be pointed out that two old Board of Tax Appeal decisions held, under provisions of a predecessor section to section 804, that bad debts could not be included as an investment expense.

Even though these two decisions indicate otherwise, it appears that if a company has consistently taken the tax deduction for investment bad debts as an investment expense and has classified the item in its Annual Statement as an investment expense, there is a strong possibility that the deduction will be allowed in Phase I. The allowance of the deduction in Phase I can produce significant savings if the company is in one of the tax situations where it is important to obtain as many Phase I deductions as possible. It is also important to recognize that the deduction as a general investment expense might be subject to the statutory limitation of Section 804(c)(1) on the amount of general investment expenses deductible in Phase I.

- **Capital Gains and Losses** Timing the recognition of capital gains and losses for tax purposes has been a concern in tax planning for life insurance companies for many years. The problems in this area were eased somewhat by the provisions of the 1969 Tax Reform Act permitting a carryback of capital losses by a corporation to the three preceding years. Failure to consider the tax implications of when gains and losses should be recognized may cause the company to fail to receive the benefits of offsetting gains and losses in a way to minimize the resulting taxes.

- **Policy Reserves** An area where it is imperative that tax planning be thorough and long range is that of increasing policy reserves either by reserve strengthening or by electing to revalue reserves on the net level basis as provided by Section 818(c). The failure of a company to consider the long range implications of such actions and the changes they may produce in the tax situation of a company can have dire consequences.

To the extent possible, companies should strengthen reserves to the net level basis in years prior to the making of the Section 818(c) election. This strengthening would be deductible over a ten year period and would reduce the "lost deduction" that results from making the Section 818(c) election. This "lost deduction" is the difference between the total of beginning reserves on the statutory basis and the total of such reserves recomputed on the net level basis. To the extent that this difference in beginning reserves can be reduced through reserve strengthening, the company receives the benefit of the deduction over a ten-year period instead of losing the deduction permanently.

Often companies desiring increased tax deductions for increases in reserves do not have adequate surplus for reserve strengthening. They are then faced with the problem of deciding whether the benefits of making the permanent election to revalue reserves on the net level basis are substantial enough to warrant its use. One alternative that should be considered in such a situation would be placing as many new policy issues as possible on the net level basis for statutory reserve purposes. This practice would have the effect of decreasing statutory earnings for the current year but would not reduce surplus as severely as strengthening reserves on policy issues of prior years. Such a practice might make it possible to avoid, at least temporarily, the necessity of making a final decision on the election to revalue reserves on the net level basis.

After a company has made a decision to strengthen reserves, additional opportunities for tax planning become available. Care should be used in selecting which reserves will be strengthened in a given year. If nonparticipating reserves are to be strengthened it is important to consider whether the company will be able to utilize the full special deduction allowed for the increase in such reserves by section 809(d)(5). In the Jefferson Standard case (23 AFTR 2d 69-974) the court held that, although the deduction under section 809(d)(2) for increase in reserves due to strengthening must be taken over a ten-year period beginning with the year following the year of strengthening, the same treatment was not required for special deduction provided by section 809(d)(5) for ten percent of the increase in nonparticipating reserves. The court held that the special deduction was allowable in the year that the reserves were strengthened. The Internal Revenue Service has not acquiesced in this position but companies should certainly consider the strengthening of nonparticipating reserves in a year when they can fully utilize the special deduction provided.

DETERMINING EARNINGS AND PROFITS

I would like to spend the remaining time allotted me in a discussion of earnings and profits and its application to life insurance companies.

Earnings and profits has importance in many areas of Federal income taxation. The presence or absence of earnings and profits determines whether a dividend to shareholders is taxable as ordinary income or is to be treated as a return of capital. The term earnings and profits is not defined in the Code. Its meaning has been developed over the years in many court cases and in regulations and rulings. It is generally accepted today that the earnings and profits of a corporation consists of the total undistributed gains derived by the corporation with respect to property contributed thereto by its shareholders since the time of such contribution. Generally, *tax-realized* net gains may be viewed as the source of earnings and profits.

Since the enactment of the 1959 Life Insurance Company Tax Act most of our attention as to surplus accumulation accounts has been focused on the areas of shareholders' and policyholders' surplus. The definitions of these accounts are included in the Internal Revenue Code. The balances in these accounts govern the tax consequences *to the company* resulting from distributions to shareholders and certain other actions. These accounts have no direct effect on the taxability *to the shareholders* of the distributions received. As mentioned earlier, it is earnings and profits that determines the taxability of distributions to shareholders.

In recent years the importance of earnings and profits (E & P) in tax planning of life insurance companies has increased because of the growth in the number of holding companies and multiple corporate groups in the industry. Last year at this conference Mr. Tom Jenness, Jr. presented an excellent discussion of planning opportunities arising from the operation of a life insurance company through a holding company. In the interest of brevity I will try to keep from repeating material covered at that time.

■ **Areas Where E & P May Be Important** A partial list of some areas where the determination of E & P may be important to a life insurance company would include:

□ E & P as the source of dividends subject to the 100% dividend received election (Section 243)

□ E & P as an adjustment to the tax basis of the stock of a subsidiary where consolidated life returns are filed

□ E & P as a source of increased dividends received deduction in the case of certain groups which elected multiple surtax exemptions prior to April 22, 1969 (Section 564)

□ Lack of E & P as an indication that dividends to shareholders are actually a return of capital and not currently taxable as a dividend

■ **Determination of E & P** As a general rule the determination of E & P has been accomplished by using a combination of proper tax accounting and generally accepted accounting in a way to measure the economic gain realized by the company in a given year. For our purposes, the logical place to begin in determining E & P of a life insurance company is with gain or loss from operations as shown by Schedule E of Form 1120L. With gain or loss as the beginning point, let us consider some adjustments which might be required in arriving at E & P for a given year.

It has become clear over the years that some common major items applicable to both life and non-life companies should be treated differently for E & P and taxable income purposes. Major items applicable to all companies that increase E & P but which are not treated as taxable income include:

- Life insurance proceeds received by reason of death of the insured.
- Tax-exempt interest.

Most items of expense are taken into account in arriving at E & P whether or not they are currently deductible for income tax purposes. Major expense items common to all companies which are treated differently for E & P and Federal income tax purposes include:

- E & P reduced currently for capital losses in excess of amounts currently deductible
- E & P reduced currently for charitable contributions in excess of amounts currently deductible
- No current E & P reduction for net operating loss deduction or operations loss deduction
- No E & P deduction for dividends received deduction
- E & P reduced for premiums on officers' life insurance
- E & P reduced for Federal income taxes
- E & P currently reduced for excess employer contributions to a plan of deferred compensation
- For taxable years beginning after June 30, 1972, depreciation for E & P purposes must be computed generally on the straight-line method
- One court has held that in the case of qualified stock options the difference between the fair market value of stock and its exercise price was a current reduction of E & P even though not deductible by the company for tax purposes (Luckman v. Comm., 24 AFTR 2d69-5901 (CA7, 1969))

In addition to the above items common to all companies, there are several items peculiar to the life insurance industry which appear to require different treatment for E & P and taxable income purposes. If we apply the concept that E & P represents the economic gain for a particular period, it seems logical to conclude that some items should be treated differently for E & P and Federal income tax purposes. In determining E & P:

Any small business deduction should be added back

Special deductions for accident and health and group life insurance premiums should be added back

Special deductions for increase in certain non-participating reserves should be added back

Any dividends paid to policyholders which were not deductible for Federal income tax purposes because of statutory limitations should be deducted

A special area of concern in determining E & P for a given year or period of years has to do with reserve strengthening and net level adjustments.

In the case of reserve strengthening, the deduction is allowed for Federal income tax purposes over a period of ten years beginning with the year following the year of strengthening. Although this is not a change in accounting method as the term is used in section 446(e) of the Code, the treatment of the deduction (ten-year spread) is the same as the treatment provided for deductions arising in connection with changes in accounting methods. *Tax Management,* in its portfolio, 175T.M., "Earnings and Profits – General Principles and Treatment of Specific Items," p. A-46, indicates that the Internal Revenue Service is understood to take the position that a change in accounting method should be considered as a deduction for E & P purposes at the beginning of the year of change even though the effect of the change will be claimed over a ten-year period for income tax purposes. In view of this, it seems possible that a reserve strengthening may be a deduction for E & P purposes in the year in which the strengthening is recorded by the company. This obviously could produce some extreme results as to what the E & P of a company for a given year or period of years might be.

In the case of the net level election under section 818(c) we have previously discussed the "lost deduction" that arises in the first year of the election for the differences in the beginning reserves computed on the net level basis and the method previously used for statement and tax purposes. The regulations (Reg. 1.810-3(f)) state that the difference in the beginning reserve shall not be taken into account as a deduction under section 809(d) for the year of change or any subsequent taxable year. For other purposes (required interest, etc.) the higher reserve is treated as having been established for tax purposes. For these reasons, there is some possibility that this difference in beginning reserves, while not deductible for Federal income tax purposes, could be treated as a current reduction of E & P. Any different treatment of this "lost deduction" for E & P purposes would result in something less than the total reserves established by the company serving as a reduction of E & P over the life of the company.

Determining the taxability of distributions to shareholders is measured by looking at E & P in two parts; E & P of the current taxable year and E & P accumulated after February 28, 1913 and prior to the end of the current taxable year. A distribution is treated as a dividend if it is made out of E & P for the current year *or* accumulated E & P. The order in which distributions in excess of current E & P or deficits in current E & P reduce prior accumulations is covered by the regulations under section 243 and 316. These regulations provide that distributions or deficits come first from the E & P of the current year and then from the most recently accumulated E & P.

This consideration of differences between proper Federal income tax reporting and the determination of E & P was not intended as a complete listing of all the differences which might arise and must be recognized as primarily my own conclusions as to the proper handling of the items discussed. In summary, I think it is important that each life insurance company consider carefully the significance of earnings and profits in their particular tax situation. In many multiple groups, thorough tax planning will require the consideration of not only the Federal income tax effect but also the earnings and profits effect of proposed actions. ●