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The Federal Income Taxation of Financial Intermediaries*

Robert Charles Clark†

TABLE OF CONTENTS

Introduction 1605

I. A Framework for Understanding and Evaluating the Tax Treatment of Financial Intermediaries 1609
- A. *Similarity of Economic Function* 1611
- B. *The Case for Similarity of Tax Treatment* 1613
- C. *Similarity at the Individual Level: The Concept of Public Suppliers of Capital* 1616
- D. *The Case for Integrated Tax Treatment* 1618
- E. *General Remarks on Present Tax Treatment* 1621

II. Investment Companies and REIT's: Fortuitous Integration 1623
- A. *Introduction* 1623
- B. *Present Tax Treatment* 1624
- C. *Deviations from Full Integration* 1628

III. Banks and Thrift Institutions: A Quasi-Conventional "Overtax" Pattern 1629
- A. *Introduction* 1629
- B. *Present Tax Treatment* 1630
- C. *Deviations from Full Integration* 1635

IV. Life Insurance Companies: A Unique "Undertax" Pattern 1637
- A. *Introduction* 1637
- B. *Present Tax Treatment* 1640

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† Assistant Professor of Law, Yale University.

1. *Summary* 1640
a. *Life insurance companies* 1640
b. *The life insurance policyholder and beneficiary* 1645
2. *Analysis of Important Special Aspects* 1646
a. *Tax on one-half of underwriting gain* 1647
b. *Limit on deduction for policyholder dividends* 1648
c. *Legerdemain in the computation of policyholders' share of investment income* 1650
C. *Conceptual Dilemmas in the Taxation of Insurance Companies: Underwriting "Income" and Mutuality* 1657
D. *Deviations from Full Integration* 1663
V. Fire and Casualty Insurance Companies: A Chaotic Conventional Pattern 1664
A. *Introduction* 1664
B. *Present Tax Treatment* 1665
1. *Stock and Ordinary Mutual Fire and Casualty Companies* 1665
2. *Small Mutual Companies* 1671
3. *Stockholders and Policyholders of Fire and Casualty Insurance Companies* 1673
C. *Deviations from Full Integration* 1674
VI. Qualified Pension Plans: A Model of Overriding Policies 1675
Conclusion: A Program for Reform 1676

Financial intermediaries accumulate capital for reinvestment in debt or equity claims against ultimate investors such as nonfinancial business enterprises, governmental units, and purchasers of real property.[1] They are called intermediaries because they serve as middlemen between suppliers of capital—more particularly savers, investors, depositors, shareholders, policyholders, or beneficiaries—and investors in real assets.[2]

Financial intermediaries may be grouped in two main classes according to their predominant source of funds. One major class includes commercial banks,[3] savings and loan associations,[4] mutual savings banks,[5] life insurance companies,[6] fire and casualty insurance com-

1. The concept of a financial intermediary might be approached in two steps. "Financial enterprises" can be said to include "all economic units—business enterprises as well as nonprofit and government organizations—that are primarily engaged in the holding of and trading in intangible assets (claims and equities)." The term "financial intermediaries" can then be taken to mean all financial enterprises except holding companies and closely held (or "personal") investment or holding companies. R. GOLDSMITH, FINANCIAL INTERMEDIARIES IN THE AMERICAN ECONOMY SINCE 1900, at 50-51 (1958).

2. "Intermediation" is the process whereby savings are channeled to investors through intermediaries rather than directly. The term "disintermediation" is used to describe net outflows of funds from intermediaries or from an especially vulnerable group of them, *e.g.*, thrift institutions. The lost funds often flow into direct investment in financial assets, *e.g.*, treasury bills. *See, e.g.*, Mullineaux, *Interest-Rate Ceilings and the Treasury-Bill Market: Disintermediation and the Small Saver*, NEW ENG. ECON. REV., July-Aug. 1973, at 19.

3. Commercial banks principally issue checking accounts and time and savings deposits. They invest funds received in business loans and government securities. Since demand deposits with them are typically included in the definition of the money supply, they occupy a peculiarly important role in the financial system. As of yearend 1973, their financial assets in the United States amounted to more than $713 billion. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS: 1965-1973, at 33 (Supp. 1974) [hereinafter cited as 1974 FLOW OF FUNDS]. Their assets at the time of writing approach $900 billion. Federal Reserve Statistical Release H.8 (May 13, 1975). For a general description of the major types of financial intermediaries, see R. ROBINSON & D. WRIGHTSMAN, FINANCIAL MARKETS: THE ACCUMULATION AND ALLOCATION OF WEALTH 44-56 (1974).

4. Savings and loan associations principally issue savings accounts and invest money in mortgage loans secured by residential real estate. Their financial assets at yearend 1973 were $272 billion. 1974 FLOW OF FUNDS, *supra* note 3, at 34. They may be chartered under federal law, 12 U.S.C. § 1464 (1970), *as amended*, 12 U.S.C.A. § 1464 (Supp. 1974), in which case they are mutual organizations (*see* p. 1630 *infra*), or under state law, in which case they may be stock or mutual organizations. As of December 31, 1972, there were 3,495 state chartered associations representing 63 percent of the total number and holding 44.6 percent of the total assets of the business. ABA HANDBOOK OF SAVINGS AND LOAN LAW 33 (1973). Only about 659 of all savings and loan associations were capital stock organizations and their assets then totalled $50 billion (out of $243 billion for all associations). *Id.* at 14.

5. Mutual savings banks, all of which are organized under state law, are similar to savings and loan associations in their liabilities and financial assets. They are concentrated, however, in the New England and Atlantic states. Their investment portfolios contain a somewhat larger proportion of debt securities other than mortgages. At yearend 1973 their financial assets were $107 billion. 1974 FLOW OF FUNDS, *supra* note 3, at 34.

6. Life insurance companies are chartered and regulated under state law and may be stock or mutual organizations. Their liabilities are principally to policyholders and consist of life insurance reserves ($142 billion, at yearend 1973) and pension plan reserves ($57 billion); they issue little ordinary debt. 1974 FLOW OF FUNDS, *supra* note 3, at 35. Their total financial assets exceeded $244 billion at yearend 1973 and consisted principally of corporate bonds and mortgages. *Id.* Of the 1,829 companies in business at

panies,[7] mutual funds,[8] real estate investment trusts,[9] and public and private pension funds.[10] This class, which might be called "first order financial intermediaries," obtains most of its capital from individual households.[11] The other class, or "second order financial intermediaries," includes the Federal Reserve Banks, the Federal Home Loan Banks, finance companies, and many other institutions, and obtains funds directly from other financial entities, such as commercial banks, thrift institutions, and bank holding companies, and only indirectly from households and nonfinancial business enterprises. It is with the tax treatment of first order financial intermediaries[12] that this article is concerned.

The enormous long term growth of financial intermediation is one of the most significant institutional facts about advanced economic systems as they have developed in this century.[13] The much stud-

mid-1972, more than nine-tenths were stock companies, but the remaining 153 mutual companies, which are generally older and larger, had about two-thirds of the assets of all United States life insurance companies and accounted for slightly over half of the life insurance in force. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1973, at 91.

7. Fire and casualty insurance companies are organized and regulated under state law and may be stock or mutual companies. They issue property and liability insurance policies and invest principally in tax-exempt municipal securities and in corporate stock. Total financial assets at yearend 1973 of all nonlife insurance companies exceeded $68 billion. 1974 FLOW OF FUNDS, *supra* note 3, at 35.

8. "Mutual funds" is the popular name given to open end investment companies (those which continuously issue shares redeemable at net asset value at the shareholder's option). They comprise the largest class of investment companies. Investment companies invest principally in corporate stock, though market conditions can produce other patterns, *e.g.*, funds invested in high-yield money market instruments. Though publicly owned investment companies technically are chartered under state law, they are normally registered, and extensively regulated, under the federal Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1970). The total financial assets of open end investment companies at yearend 1973 exceeded $46 billion. 1974 FLOW OF FUNDS, *supra* note 3, at 36.

9. Real estate investment trusts, which are organized as business trusts, issue large amounts of debt securities and debt paper in addition to shares of beneficial interest. They invest funds principally in real estate and in mortgages secured by real estate. Their total financial assets at yearend 1973 approached $17 billion and far exceeded their $3 billion investments in physical assets. *Id.*

10. Private pension funds invest principally in corporate stocks and bonds. State and local government employee retirement funds also invest in such securities, but the proportion of their assets in corporate stock is significantly smaller. The total financial assets at yearend 1973 of these two groups of pension funds exceeded $133 billion and $81 billion, respectively. 1974 FLOW OF FUNDS, *supra* note 3, at 35.

11. *See* R. GOLDSMITH, *supra* note 1, at 7. There are qualifications, however; for example, some real estate investment trusts get most of their capital in the form of bank loans.

12. Goldsmith's distinction between primary and secondary financial intermediaries is similar to my distinction between first and second order financial intermediaries. *See id.* at 51.

13. In the United States, for example, there has been a significant growth in savings since 1900, with the proportion of total savings attributable to households averaging about 80 percent, as compared to 15 percent attributable to corporations and five percent to governments. Harvard Business School Course Material No. 9-271-053 F1173, Capital Markets: The Determinants of Saving and Its Allocation, 1971, at 7 (Intercollegiate Case Clearing House, Boston, distrib.). The proportion of savings invested in financial assets,

ied[14] and vigorously debated[15] growth in the role of institutional investors in the stock markets is only one part of this movement, a part which for its own peculiar reasons has been highly publicized. The role of financial intermediaries in the other major capital markets,[16] such as the primary and secondary mortgage markets, the market for United States government securities, the market for corporate debt instruments, and the market for municipal securities, has been of equal or greater economic consequence.[17]

The growth of financial intermediation is not accidental, nor is it a mere manifestation of the increasing complexity of our economic institutions. The trend has its own economic logic. Financial intermediaries offer several advantages to individual suppliers of capital: putative financial expertise, economies of scale, and the ability to diversify and pool investments.[18] Intermediaries commonly advertise that their funds are managed by professional investment analysts, who might be thought to invest more wisely than the man in the street. Intermediaries may realize economies of scale by allowing savers to share the costs of security analysis, portfolio management, and market transactions. Diversification of financial assets allows savers or investors to reduce risk with no or little impairment of the expected return from their portfolios;[19] intermediaries are a necessary means of

such as stocks and bonds, as opposed to real assets, such as houses, has declined from 44.4 percent in 1900-1912 (as adjusted to conform to flow of funds data in 1945), to 34.2 percent in 1953-1962. However, the proportion of financial assets issued by financial intermediaries as opposed to ultimate users of invested capital has increased dramatically —according to one estimate, from 38 percent in the period 1900-1912 to 83 percent in the period 1953-1963. *Id.*

14. *See generally* SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971).

15. *See, e.g., Hearings on the Impact of Institutional Investors in the Stock Market Before the Subcomm. on Financial Markets of the Sen. Comm. on Finance,* 93d Cong., 1st Sess. (1973).

16. A *very* rough idea of the sizes of the major capital markets might be inferred from the 1973 yearend outstanding amounts of the corresponding types of securities: corporate equities, $968 billion (at market value); total mortgages, $640 billion; U.S. government securities, $422 billion; corporate and foreign bonds, $264 billion; and state and local government securities, $190 billion. 1974 FLOW OF FUNDS, *supra* note 3, at 40-43. These figures cannot, of course, indicate the relative amounts of outstanding securities that are "in" each market nor the relative vigor of primary and secondary trading in each market; the different markets do have distinct characteristics that reflect differences in the character of the issuers and the dominance of particular kinds of buyers in them. *See generally* R. ROBINSON & D. WRIGHTSMAN, *supra* note 3, at 225-363.

17. *See* R. GOLDSMITH, *supra* note 1, at 183 (role of intermediaries in external financing of main sectors of the economy); R. GOLDSMITH, THE FLOW OF CAPITAL FUNDS IN THE POSTWAR ECONOMY 9 (1965) (shares of financial institutions in four of the five major capital markets increased in the postwar period; but their share of total treasury securities issued was not substantially changed).

18. R. ROBINSON & D. WRIGHTSMAN, *supra* note 3, at 41.

19. *See* H. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS 112-15 (1959); Samuelson, *General Proof that Diversification Pays* (pt. II) J. FINAN. & QUANTITATIVE ANAL., Mar. 1967, at 1.

achieving diversification because many individuals do not have enough money to diversify their investments successfully by themselves.[20] The pooling of assets by intermediaries enables the individual saver, who cannot accurately predict future contingencies affecting his need for money, to invest in relatively liquid claims against the intermediary, while the intermediary can reinvest those funds safely in less liquid and longer term claims against ultimate investors. The reinvestment can be made with safety because of the law of large numbers: what is a dramatic contingency to the individual is a small one to the intermediary, which is only concerned with the probabilities of overall net changes in the flow of funds to and from its suppliers of capital. The pooling of assets is perhaps the basic reason for the growth of financial intermediaries. It encourages capital formation and investment in longer term financial assets, and therefore suggests that intermediation has a beneficial effect on economic growth and stability.[21] Because of their importance to the economy in general and to the investment patterns of individuals in particular, financial intermediaries have been a subject of serious legislative concern.[22] Perhaps the most significant recent proposals are those of the Hunt Commission Report,[23] which were submitted in modified form to Congress as proposed legislation.[24] These proposals, which covered a wide variety of related topics, focused principally on financial institutions in the narrow sense (commercial banks and thrift institutions). A significant part of the proposals was the establishment of equal tax treatment between these two types of institutions.[25]

This article attempts to approach the subject of the proper federal income tax treatment of first order financial intermediaries from a more general vantage point than did the Hunt Commission. The

20. For practical purposes, the advantages of diversifying a portfolio by buying securities whose rates of return at various risk levels are negatively correlated appear to become negligible at the point where the portfolio contains roughly 20 securities. *See* K. SMITH, PORTFOLIO MANAGEMENT 126-31 (1971); J. WILLIAMSON, INVESTMENTS: NEW ANALYTIC TECHNIQUES 120-21 (1971); Evans & Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FINAN. 761 (1968); Mao, *Essentials of Portfolio Diversification Strategy*, 25 J. FINAN. 1109 (1970). It thus seems that millions of less wealthy individuals in the United States who supply funds to financial intermediaries, via small demand and savings accounts, modest insurance policies, and small-sized mutual fund share accounts, could not directly and cheaply assemble an optimally diversified portfolio.

21. R. ROBINSON & D. WRIGHTSMAN, *supra* note 3, at 41-42.

22. *See generally* Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349 (1974); STAFF OF HOUSE COMM. ON BANKING AND CURRENCY, 93D CONG., 1ST SESS., FINANCIAL INSTITUTIONS: REFORM AND THE PUBLIC INTEREST (Comm. Print 1973).

23. PRESIDENT'S COMM'N ON FINANCIAL STRUCTURE AND REGULATION, REPORT (1972).

24. S.1267, 94th Cong., 1st Sess. (1975); S.2591, H.R. 10990, 93d Cong., 1st Sess. (1973).

25. The tax provisions of the bills cited in the preceding note are summarized in 5 CCH FED. BANKING L. REP. ¶ 96,092, at 81,167-68.

first part of the article develops a conceptual framework for understanding and criticizing the present tax treatment of financial intermediaries and their suppliers of capital. Its principal aim is to explore the importance of establishing a similar tax pattern for the different kinds of intermediaries, and then to outline the most general aspects of that pattern. Succeeding parts of this article explain the present tax treatment of the major types of first order financial intermediaries and analyze that treatment in light of the ideal pattern.[26] These parts will also state and criticize the reasons historically given for the major special tax provisions. The concluding section suggests some changes in the existing law.

I. A Framework for Understanding and Evaluating the Tax Treatment of Financial Intermediaries

Tax practitioners who specialize in giving advice to a particular kind of financial intermediary are not likely to be experts in the detailed tax treatment of all other intermediaries. This situation is indicated by the complexity of the subject, and by the fact that the law reflects real differences in the nature of the businesses conducted by intermediaries. Although economists and financial analysts perceive financial intermediation to be a coherent subject of historical study and theoretical analysis,[27] tax policymakers have considered each institution in a separate compartment; and treatises, articles, and hearings traditionally concern insurance companies, or banks, or investment companies, but not all major intermediaries as a group.

It is therefore prudent to preface an investigation of tax policy concerning all major first order financial intermediaries with an explicit statement of the framework of analysis. Before beginning the analyses of specific intermediaries, I will develop a framework of five analytical hypotheses which together support a certain view of the proper pattern of taxation. First, all financial intermediaries perform broadly similar economic functions. Second, this similarity of function suggests a broadly similar tax treatment, a conclusion which is strength-

26. The explanations in the text are intended to go beyond the broadest generalities without getting mired in detail. Available to the practitioner are useful, detailed tax treatises concerning some kinds of intermediaries. *E.g.*, R. DENNEY, A. RUA & R. SCHOEN, FEDERAL INCOME TAXATION OF INSURANCE COMPANIES (2d ed. 1966); FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL INSTITUTIONS (M. Wakeley *et al.* eds. 1971). In view of their intensely practical purpose, these books understandably omit discussion of the broad concepts and policy arguments historically given in support of the relevant taxing patterns.

27. *See, e.g.*, Pyle, *On the Theory of Financial Intermediation*, 26 J. FINAN. 737 (1971).

ened when one considers the effects of dissimilar tax treatment. A corollary is that the institution-specific concerns that have historically accounted for the existing patterns of tax treatment are relatively unimportant when compared to the broad functional similarity among intermediaries. Third, at least the public suppliers of capital[28] to all kinds of financial intermediaries should be viewed as similarly situated for tax purposes, regardless of their formal characterization as creditors, shareholders, policyholders, and so forth. Fourth, the arguments for integration of the corporate and individual taxes, which are sound generally, apply with equal or greater force in the case of financial intermediaries, and integration of the taxes on a financial intermediary and its public suppliers of capital is both a desirable and a feasible goal. Fifth, through a series of historical accidents,[29] the present patterns of tax treatment come close to achieving that goal, though some significant reforms remain to be made.

A. *Similarity of Economic Function*

Financial intermediaries perform broadly similar economic functions. They enable pooling and diversification of portfolio risk to take place more efficiently and on a larger scale. By pooling their claims against assets, a group of individuals can take advantage of the law of large numbers, according to which contingencies unpredictable on an individual basis are quite predictable for large numbers. In its simplest application, pooling enables financial intermediaries to accomplish liquidity intermediation. Individuals often want to hold liquid assets because they cannot accurately predict future contingencies that will affect their need for cash, whereas users of capital, such as corporations, often want capital left with them for long periods of time. An intermediary often issues relatively liquid claims against itself, that is, claims convertible to money within a short time at no or little sacrifice of their full value, and uses the proceeds to invest in fairly illiquid claims.[30] The intermediary can safely invest in illi-

28. *See* p. 1617 *infra*.

29. By using the word "accidents," I do not imply that the present tax patterns were not put into law consciously and in light of extensively discussed policy goals, but only that the patterns were not consciously enacted into law in order to achieve the particular kind of integration here espoused.

30. A more sophisticated definition of liquidity would show the considerable complexity of the concept. *See* Pierce, *Commercial Bank Liquidity*, FED. RESERVE BULL., Aug. 1966; Tobin, *Liquidity Preference as Behavior Towards Risk*, 25 REV. ECON. STUD. 65 (1958). One of the basic problems is that although liquidity intuitively means that "quick" sales of an asset entail a relatively low discount from the maximum expected market price, the amount of the discount varies with the time between the decision to sell and the actual sale and will not follow the same pattern for all assets. Thus, asset *A* may

quid claims, up to a point, because of the relative stability and predictability of the exercise of claims against itself that comes with large numbers of them. Thus, the claim of even the smallest demand deposit accountholder at a commercial bank is, at any given time, quickly convertible into a fixed amount of currency or, indeed, usable as money itself. Otherwise demand deposit accounts would not be as popular as they are. Yet banks in turn do not simply make callable loans or invest in highly liquid securities on the strength of these assets, but make many business loans for which there is no significant secondary market, and which have substantial periods to maturity: 30, 60, and 90 day loans and even term loans for periods longer than a year. Similarly, thrift institutions, whose individual depositors—or, more appropriately, "suppliers of capital"[31]—hold savings deposits and time accounts that can be converted to cash on relatively short notice, make long term mortgage loans which are often not readily marketable.[32] Mutual fund shares are perhaps the ultimate in liquidity for the small investor who wishes to participate in the stock market, since he can always cash in his shares quickly for their net asset value.[33] Real estate investment trusts offer investors highly liquid shares in a portfolio of relatively illiquid realty and mortgage interests.

On the other hand, insurance companies and pension funds effect a different kind of intermediation between the time structures of the preferences for money of capital suppliers and capital users. In the absence of special legislation providing for cash surrender values and requiring that life insurance companies stand ready to make policy loans,[34] a life insurance contract would be an illiquid investment. Yet a principal function of insurance (and of pension plans) is to provide money upon the happening of a predicted event or uncertain contingency that dramatically increases the capital supplier's need for

sell at a lower discount from the maximum market value than asset *B* when the sale occurs one day after the decision to sell, but asset *B* may sell at the lower discount if one week is allowed for the sale. One therefore must specify a relevant time period before ranking assets in terms of liquidity.

31. *See, e.g.,* notes 19, 20 *supra.*

32. It has been suggested that the degree of liquidity intermediation of United States thrift institutions exceeds sound limits: they borrow short and lend *too* long. *See, e.g.,* Anderson & Eisenmenger, *Structural Reform for Thrift Institutions: The Experience of the United States and Canada,* NEW ENG. ECON. REV. July-Aug. 1972, at 3.

33. It is probably true that if (a) there were active, broad, and highly efficient secondary markets in *all* equity securities and (b) all investors were wealthy enough to be able economically to assemble their own diversified portfolios of such securities, there would be no need for financial intermediaries like mutual funds. Under such circumstances, the stock market would serve the need for intermediation perfectly; but these conditions are not fully satisfied in reality.

34. Most states have such legislation. *See* D. MCGILL, LIFE INSURANCE 295 (1959); Richardson, *Nonforfeiture Values and Policy Loans,* in D. GREGG, LIFE AND HEALTH INSURANCE HANDBOOK 153, 156, 160 (1964).

money. Even if the policy were illiquid in general, it would become quickly convertible to cash without penalty at precisely the time when cash is needed to make up for a sudden though previously specified loss. A capital supplier who wanted to provide for beneficiaries in the event of his death by investing in a financial asset such as a long term commercial mortgage, and who had funds to invest in only one or two such assets, would be foolish to do so directly, even though his life expectancy might exactly equal the term of the mortgage loan. If he should die at a time other than the projected one, the need to convert the loan quickly into cash might entail a considerable sacrifice. Similar remarks can be made about fire and casualty insurance and about pension rights.

The other significant common economic function of financial intermediaries, their ability to provide diversification for public suppliers of capital, has been thoroughly discussed in the literature.[35] It may be argued that financial intermediaries are not needed to provide pooling and investment diversification, because these functions can be served by the operation of ordinary corporations and the capital markets. As for pooling, if one looks only at the stock markets and the market for United States government securities, it might be thought that highly liquid assets are readily available for the buying without the help of intermediaries. This is true, of course, but the situation is not so fortunate in the markets for municipal securities and mortgage loans. As for investment diversification, it might be thought that corporations themselves could provide all of it that is needed; conglomerate mergers are routinely justified on the ground that they reduce risk to the shareholders. Why not allow conglomerates freely to diversify, so that even the smallest investor who can efficiently buy shares in only one public company can have the opportunity to buy shares in a widely diversified pool of business activities? Apart from serious doubts about the ability of managements to operate effectively conglomerate business empires, the answer is that diversification by this method will realize only a small portion of the possibilities for combining interests in different business activities. If claims against business entities are evidenced in readily transferable pieces of paper, or in their counterparts in the form of computer entries, it is a technically simple matter to achieve diversification by adjusting the pieces of paper or the computer entries, and it is far easier in this way to obtain a combined interest in almost any con-

35. *See* notes 19, 20 supra.

ceivable set of business activities. The conglomeration of business activities by merger is in this sense a clumsy way of achieving the same end as putting together a diversified portfolio of securities.[36]

B. *The Case for Similarity of Tax Treatment*

The broadly similar economic functions served by financial intermediaries suggest that they be taxed similarly under the federal income tax law. To assess the validity of this hypothesis, it is helpful to ponder the consequences of unequal tax treatment. The present system taxes financial intermediaries with different degrees of severity. Commercial banks and fire and casualty companies are most heavily taxed, and among the latter group mutual companies are favored. Life insurance companies and thrift institutions are treated more leniently. Mutual funds and real estate investment trusts are taxed, if at all, on small portions of their income. Qualified pension plans escape taxation.

These differences in tax treatment have at least two major consequences: they influence the extent to which different types of financial intermediaries invest in tax-exempt municipal securities, and they influence the relative rates of growth of different types of financial intermediaries.

Some immediate effects of differential tax treatment on investment in municipal securities are obvious from an inspection of investment portfolios. Commercial banks and stock fire and casualty companies operate under a strict tax regime, and as one might predict, they do in fact invest heavily in tax-exempt municipal securities.[37] Qualified private pension plans, by contrast, invest almost nothing in municipal securities.[38] The precise impact of the tax laws is not so easy to measure in the case of the other institutions, since the portfolio composition

36. *See* Levy & Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. FINAN. 795 (1970) (value cannot be created in perfect capital markets by diversifying mergers of firms, since individual stockholders could "self-diversify"); Smith & Schreiner, *A Portfolio Analysis of Conglomerate Diversification*, 24 J. FINAN. 416, 425 (1969) (acquiring firm, unlike diversifying individual, must ordinarily make a "lumpy" investment). The remarks in the text pertain to the achievement of investment diversification via merger; I am not here implying anything about the validity of other reasons for conglomerate mergers.

37. Of the $713 billion of financial assets held by commercial banks at yearend 1973, there were about $95 billion worth of state and local government obligations. If there were any sizable holdings of municipal securities by private pension funds, they are buried in the small "miscellaneous assets" category (less than four percent of total financial assets) used in flow of funds data. 1974 FLOW OF FUNDS, *supra* note 3, at 33, 35. Moreover, in 1973, commercial banks accounted for more than 40 percent of the net increase in outstanding state and local obligations (and even higher proportions in earlier years), while the role of pension funds was insignificant. *Id.* at 17.

38. *Id.*

of a financial intermediary is a function of at least two major factors in addition to the tax laws: legal regulations restricting kinds of investments that particular types of institutions may make (which, for example, explains why banks do not trade in the stock market in their own right, but only as trustees); and the liquidity problems faced by particular kinds of intermediaries (which, for example, explain why life insurance companies invest so heavily in privately placed long term corporate notes and in long term mortgage loans).

However, an important policy point can be extracted despite this causal uncertainty. Assuming that the growth of financial intermediation as a whole, and the relative growth of different types of financial intermediaries, are only partly determined by taxing patterns, whether there will be large amounts invested in municipal securities depends on the fortuity that relatively larger pools of capital will be in the hands of those particular types of financial intermediaries which operate under a relatively strict tax regime. If the relative amounts of assets managed by banks and life insurance companies were to remain the same,[39] but the severity of their tax treatment reversed, the demand for municipal securities would, *ceteris paribus,* drop and the amount of municipal securities purchased fall. Even assuming some rationality behind the tax-exempt treatment of municipal securities, I can think of no persuasive reason for letting the *amount* of the federal tax subsidy to municipal enterprises vary with the relative sizes of asset pools managed by institutional investors with different effective tax rates. A rational relationship between the need to aid local government and the growth of commercial banks is difficult to ascertain.[40]

A program of equalization of tax burdens on financial intermediaries might result in a decrease *or* an increase in the amount of municipal debt issued.[41] The point is simply that greater similarity of tax treatment would eliminate or reduce the influence of one major irrelevant variable—namely, differences in the growth rates of different types of financial intermediaries—on the quantity of municipal

39. Banks control financial assets worth about three times as much as those of life insurance companies. *See* notes 3, 6 *supra.*

40. In a sense, of course, this observation is but a part of a larger anomaly: the amount of the federal tax subsidy to local government varies with the amount of wealth controlled by high bracket taxpayers. To point this out is not, however, to detract from the seriousness of the results caused by tax patterns affecting intermediaries, because the institutional investors are more and more becoming the investors whose tax rates matter.

41. Whether a program of equalization of the tax treatment of financial intermediaries would increase or decrease the purchase of municipal securities would depend on the actual shapes of the relevant supply and demand curves and their relation to one another before and after implementation of the program.

securities purchased, and would tend to make the demand for municipal securities more stable. This result should make it easier to regulate the level of investment in municipal securities.

The second major effect of differential tax treatment, the effect on rates of growth of financial intermediaries, is most evident in the case of real estate investment trusts, which are veritable creatures of the tax law.[42] Similarly, the growth of pension plans clearly reflects the influence of tax considerations. Special tax benefits may encourage the flow to one intermediary of capital that would not have otherwise gone to any intermediary, as well as capital that would otherwise have gone to a different type of intermediary—for example, to an insurance company selling individual annuities instead of a qualified pension plan administered by a commercial bank.

Whether the effect of the tax laws on the relative growth of financial intermediaries is good or bad depends on a number of factors. One might start with a presumption against tax rules which affect the allocation of resources among institutions broadly similar in economic function. Absent a countervailing social policy as to which there is a clear political consensus, the tax law should not interfere with market choices of what sorts of financial intermediation should be provided in what amounts.

The only disparity in tax treatment of financial intermediaries which is clearly justified under this principle is the tax exemption for qualified pension plans. There has been a deliberate and fully conscious congressional determination, supported by large segments of society, that the exemption is necessary to induce a socially desirable level of saving for retirement. The Employee Retirement Income Security Act of 1974[43] is a strong reaffirmation of this policy. Curiously, there is no comparable consensus about a supposed national need to favor via the tax law the purchase of life insurance, on the paternalistic ground that people will, due to darkly irrational psychological causes, inevitably not buy enough of it without tax assistance. The present tax treatment of life insurance companies seems more the result of effective lobbying expressed partly in the guise of esoteric and confusing conceptual arguments about the nature of income. The same can be said about the arcane devices, such as special bad debt reserve computations and protection against loss accounts,[44] en-

42. *See* Schulkin, *Real Estate Investment Trusts: A New Financial Intermediary*, NEW ENG. ECON. REV., Nov.-Dec. 1970, at 1.

43. Pub. L. No. 93-406, § 2, 88 Stat. 829 (findings and declaration of policy) recites that employee benefit plans are "affected with a national public interest."

44. *See* pp. 1633-35, 1669-71 *infra*.

acted to aid thrift institutions and mutual fire and casualty companies. These devices do not rest upon a political consensus about public welfare sufficient to overcome the rule against tax-induced misallocations of resources. Furthermore, the commitment to housing as a national priority is a weak argument to justify peculiarities in the way that real estate investment trust and thrift institutions are taxed. I wonder, for example, why real estate investment trusts, real estate limited partnerships, commercial banks, and thrift institutions are all taxed differently from one another with respect to their income from mortgage loans. The policy to aid housing does not argue for differential treatment of institutions that invest in mortgage loans.

I suggest that financial intermediaries (except pension funds) should be taxed similarly because they perform broadly similar economic functions. Specifically, I propose a particular form of tax neutrality principle: absent a clear political consensus about overriding policy goals, the tax law should not influence differentially the portfolio composition of the different kinds of intermediaries, and it should not affect differentially the flow of funds into the different kinds of intermediaries.

C. *Similarity at the Individual Level: The Concept of Public Suppliers of Capital*

If financial intermediaries are considered for tax purposes as a coherent group of fundamentally similar entities, concomitant attention must be paid to the individuals who supply capital to these intermediaries. One of the most fundamental questions concerning the tax treatment of the intermediaries is whether it should be integrated with the tax treatment of some or all their suppliers of capital. Before taking up this question, I will distinguish among different classes of capital suppliers, and then consider separately the importance and political feasibility of integration with respect to each class. One way of doing this might be to divide capital suppliers into various groups —creditors, shareholders, policyholders—simply in terms of their legal status. This approach would achieve clarity and definiteness at low cost but is arbitrary and formalistic. Another approach would be to cut across these categories and divide the capital suppliers in terms of economic classes, such as wealthy investors and small investors. This approach would have greater usefulness for a policy-oriented analysis but might be enormously difficult of practical application. Rather, I think that the proper categories for use in comparing the tax treatment

of individuals supplying capital to intermediaries are to be defined in mixed yet politically intelligible terms. What I term "public suppliers of capital" to a given financial intermediary are those belonging to a legally distinct class comprised of members who are numerous, of relatively modest means on the average, and who typically supply the greatest bulk of capital to the particular kind of financial institution. What for lack of a better label I will call "elite suppliers of capital" are less numerous and typically wealthier. They generally supply a smaller proportion of capital to any given type of financial intermediary than do the public suppliers.

These descriptions are necessarily but not uselessly vague; an example may help to understand them. The investors who correspond, in the case of a commercial bank, to the class of shareholders in a mutual fund are not the shareholders of the commercial bank but its depositors, even though the depositors are technically creditors. The depositors may have contributed 11 times as much as did its stockholders;[45] the mutual fund shareholders will have contributed at least two-thirds of the assets of the mutual fund, with any other capital coming from a bank.[46] Bank depositors, and to a lesser extent, mutual fund shareholders, are extremely numerous and often of modest means. By contrast, bank shares are often closely held, or if not, they are predominantly owned by shareholders in the highest income classes, as in the case of holdings of corporate equity securities generally.[47] By an extension of the analysis, public suppliers of capital include depositors at banks, savings and loan associations, and mutual savings banks; shareholders in mutual funds and real estate investment trusts; and individual policyholders in all types of insurance companies. Elite suppliers of capital include bank shareholders, shareholders in stock savings and loan associations, and shareholders in stock life insurance companies and stock fire and casualty insurance companies.

Public suppliers of capital might also be designated "small savers"

45. As of April 30, 1975, gross demand and time deposits of all U.S. commercial banks were estimated at about $716.9 billion, while total capital accounts of the banks were estimated at about $64.7 billion. Federal Reserve Statistical Release H.8 (May 14, 1975).

46. Registered open end investment companies cannot issue senior securities but may borrow from banks, provided there is (and remains) an asset coverage of at least 300 percent for all loans. Investment Company Act of 1940, § 18(f), 15 U.S.C. § 80a-18(f) (1970). Mutual funds apparently keep well below this limit, for statistical compilations typically omit their liabilities, *e.g.*, 1974 FLOW OF FUNDS, *supra* note 3, at 36, or assume that they are zero, *e.g.*, STAFF OF HOUSE COMM. ON BANKING AND CURRENCY, *supra* note 22, at 85.

47. Blume, Crockett & Friend, *Stockownership in the United States: Characteristics and Trends*, SURVEY OF CURRENT BUS., Nov. 1974, at 16.

or "small investors," both of which are more common terms. I doubt that these terms are adequate to cover all the relevant cases. It sounds odd, for example, to describe a depositor in a bank as an "investor." It also sounds odd to call a purchaser of a home protection or automobile insurance policy from a property and casualty insurance company a "saver" or an "investor." Although some portion of his premium payments might be traced into investments in financial assets by the insurance company—that is, the policyholder has supplied capital to the intermediary and made intermediation possible—the policyholder may think of himself as buying a service, insurance protection, rather than as saving or investing money.[48]

D. *The Case for Integrated Tax Treatment*

The next hypothesis is that the arguments for integration of the corporate and personal taxes are sound generally and apply with equal or greater force in the case of financial intermediaries. The arguments for full integration have been exhaustively developed (and recently summarized in an excellent article).[49] Only the essentials need be discussed here. If the progressive rate structure made applicable to individual taxpayers[50] is taken as a norm, then the corporate tax introduces severe deviations from that norm. If corporate income is distributed to individual shareholders, it is taxed twice or, more precisely, about one and a half times. The net income is taxed once at the flat corporate rate and then the after-corporate-tax income is taxed at the progressive rates applicable to individual shareholders receiving dividends. Compared with equal income from other sources,[51] corporate source income is overtaxed, in what might be called a "vertical inequity." Again, comparing two taxpayers with equal incomes, only one of which is from a corporate source, the difference in tax treatment might be called a "horizontal inequity." Of course, if the markets for income-producing assets fully capitalize after-tax rates of return, the effect of differences caused by the corporate tax may be greatly reduced after an initial period of adjustment. For example, investors in a certain tax bracket may get the same after-tax return from a tax-free municipal bond as they would get from a taxable

48. *See* pp. 1637-38, 1658-59 *infra*.

49. McClure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975).

50. INT. REV. CODE OF 1954, § 1 [hereinafter cited by section only].

51. *Cf.* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 1-9 (3d ed. 1971) (table comparing taxation of a proprietorship with that of a corporation and its sole shareholder, on the assumption that all corporate income is distributed).

bond presenting a comparable risk; only taxpayers in a still higher bracket (if any) will be able to obtain preferential treatment by purchasing the tax-exempt bond. On the other hand, even assuming that tax differentials were fully reflected in the prices of capital assets, such differentials would still induce a misallocation of resources—for example, by shifting resources from the corporate sector into other sectors.[52]

When judged by the norm of the progressive rate scheme, corporate-source income may be undertaxed as well as overtaxed. If corporate income is not currently distributed but reinvested in the business, it is currently taxed only once, at the flat corporate rate, which may be much lower than the marginal tax bracket of wealthy shareholders. If the wealthy shareholder later realizes the increment in value of his investment attributable to the after-corporate-tax addition to retained earnings, as by selling his stock, he then pays only a capital gain tax. The corporate-level tax plus the deferred capital gain tax together may still amount to a lesser tax burden than would a current single tax on corporate-source income at the shareholder's personal rate.[53] Large, public, growth-oriented companies may adopt low dividend payout ratios and, because of the undertax possibilities, attract the investment dollars of high bracket taxpayers. Conversely, more mature companies may adopt high dividend payout ratios to attract the investment dollars of lower bracket taxpayers. In fact, there is evidence that companies and investors match themselves in this way.[54]

Conceptually, the simplest resolution of the problems of vertical and horizontal inequities and of the misallocation of resources is to treat all corporations like partnerships (and shareholders like partners), that is, not to tax the entity as such but instead to consider all of its income as income of the partners, whether currently distributed to them or not, and to tax the income at the partners' rates. This solution is thought to be administratively unfeasible; a mixed system approaching the same goal, detailed and justified in the Canadian Carter Commission Report,[55] now commands the respect of important tax theorists.[56] The system, which combines the partnership model with

52. *See* McClure, *supra* note 49, at 548.
53. *Cf.* B. BITTKER & J. EUSTICE, *supra* note 51, at 1-11 (table comparing taxation of a proprietorship with that of a corporation and its sole shareholder, on the assumption that all corporate income is accumulated and the stock is sold in 10th year).
54. Blume, Crockett & Friend, *supra* note 47, at 28-29.
55. REPORT OF THE ROYAL COMMISSION ON TAXATION (1966) (Canada).
56. *See, e.g.*, Break, *Integrating Corporate and Personal Income Taxes: The Carter Commission Proposals*, 34 LAW & CONTEMP. PROB. 726 (1969); McClure, *supra* note 49, at 558-61, 569-74.

a withholding system, distinguishes among distributed income, undistributed income that is allocated (at the company's option) to shareholders, and undistributed and unallocated income. The distributed and the allocated income are ultimately taxed only to the shareholders, at their personal rates. However, the corporation is taxed on such income at a flat rate (the highest applicable to individuals). Each shareholder is deemed to have received his pro rata portion of the allocated income, and is taxed on this amount as well as on the income actually distributed to him. Nevertheless, he is also deemed to have paid his pro rata share of the tax actually paid by the corporation on distributed and allocated income. He uses the tax deemed paid as a credit (with the result that in many cases he receives a refund). The basis of his shares is adjusted upwards to reflect his share of the post-tax allocated income, in order to prevent double taxation of this economic gain when he later sells his shares. Undistributed and unallocated income is simply taxed to the corporation.

The case for integration, which is persuasive for virtually all business enterprises, is even stronger for those intermediaries, such as investment companies and stock fire and casualty companies, which invest heavily in corporate stocks and whose suppliers of capital include shareholders. The overtax aspect of the corporate tax is compounded when corporations are formed which own shares in other corporations. Consider shareholder *A* in corporation *X* which owns shares in corporation *Y* (which is not, however, a subsidiary of *X*); *X* and *Y* both distribute all their current income to their shareholders. Income passing from *X* through *Y* to *A* is taxed at three levels. To be sure, if *Y* is a domestic (United States) corporation, *X* may claim an 85 percent dividend received deduction[57] and pay a tax of less than 7.5 percent on the dividend income. The additional layer of tax, therefore, is not as large in percentage terms as the others. This does not, of course, mean that its economic effects are insignificant.

Except in special cases,[58] corporations investing in other corporations can ordinarily claim only the 85 percent dividend received deduction, rather than a 100 percent deduction, apparently because of a Depression era hostility to complex holding company systems.[59] The survival of the limited deduction is, however, unfortunate. Its effects are felt principally by financial intermediaries like stock fire and casualty companies which invest substantial amounts of money in stocks, but

57. § 243(a)(1).
58. § 243(a)(2), (a)(3), (b)(1).
59. *See* B. BITTKER & J. EUSTICE, *supra* note 51, at 5-18.

which, unlike mutual funds, are not given special tax treatment. Whatever the propriety of allowing ordinary industrial corporations to receive a 100 percent dividend received deduction, there is no justification for denying it to stock fire and casualty companies with respect to ordinary stock investments in their portfolios. Their purpose in assembling a portfolio of stocks is certainly not tainted with a supposedly unsavory desire to erect a complicated holding company structure.

In sum, the integration of the corporate and individual taxes is considered socially desirable in order to prevent misallocation of resources and to remove horizontal and vertical inequities caused by the two-tax system. These arguments are generally applicable to financial intermediaries, and are particularly strong as applied to some of them. The next questions are whether any degree of integration has been achieved in the case of financial intermediaries, and to what extent further integration would be a politically feasible goal.

E. *General Remarks about the Present Tax Treatment*

The examination below of the present tax treatment of intermediaries reveals that in an important sense the Code comes close, through a series of historical accidents, to achieving the goal of full integration, though some significant reforms remain to be made. Specifically, a rough kind of integration has been achieved in a number of cases between the corporate tax on the intermediary and the personal tax on its *public* suppliers of capital.

There is no movement toward integration, however, in the area of income earned by financial intermediaries and allocable to their elite suppliers of capital (the stockholders of commercial banks, stock savings and loan associations, stock life insurance companies, and stock fire and casualty companies). These shareholders are taxed like ordinary corporation shareholders, whose socioeconomic attributes are probably more similar to those of elite suppliers of capital than to those of public suppliers of capital.[60] Thus, the case for integration of elite suppliers' income taxes is not as compelling as that for taxes of public suppliers. This is not to say that stockholders in different types of stock financial intermediaries are all taxed alike; this article will show that different financial intermediaries operate under different tax systems, and these differences inevitably affect the tax burden on the residual owners of the enterprise. But the tax burdens on

60. *See generally* Blume, Crockett & Friend, *supra* note 47.

elite suppliers of capital generally pose the same problems that have been discussed in the context of proposals to achieve full integration with respect to all corporations: if they (the elite suppliers of capital) are in relatively low tax brackets the intermediary-level tax means that they are overtaxed; if they are in very high tax brackets, they may very well be undertaxed. It does not appear realistic to hope that these problems can be solved before Congress makes up its mind, if it ever does, to adopt a technique of full integration for all business entities. By contrast, integration of intermediary taxes and taxes on public suppliers of capital does appear politically feasible; present law approaches that objective, and some improvements to complete the picture may realistically be suggested.

Assuming that full integration of the corporate level and personal level taxes is desirable, it does not follow as a matter of strict logic that a lesser degree of integration, as between financial intermediaries and their public suppliers of capital, is better than the existing pattern. Several general considerations, however, do suggest that an improvement might result from such a move. As for the problem of integrating with respect to financial intermediaries but not all other business corporations, one can argue that financial enterprises, by virtue of their similar economic functions, form a distinct and coherent segment of the economy. Even if integration with respect to them causes some resources to flow from the corporate sector into them, these resources would in turn be channeled into nonfinancial enterprises. And, as for the problem of integrating only with respect to intermediaries' public suppliers of capital, the public suppliers of capital furnish the bulk of capital to financial intermediaries.[61] Integrating public suppliers' taxes with those of the intermediaries to which they supply capital should therefore produce many of the benefits of full integration—especially if the remaining entity-level taxes (on income allocable to elite suppliers of capital) are imposed equally on different kinds of intermediaries.

We turn finally to the present tax patterns. They are presented in light of the model of restrained and hopefully feasible integration just proposed. For each type of intermediary, the analysis examines the tax treatment of it and its public suppliers of capital, the justifications

61. At the end of 1971, financial intermediaries as a group had liabilities estimated at $1,400 billion and a net worth of $100 billion. R. ROBINSON & D. WRIGHTSMAN, *supra* note 3, at 229. Only a very small portion of the liabilities could be owed to elite suppliers of capital, and a substantial part of the net worth—approaching $50 billion—must be allocated to mutual fund and REIT shareholders, who may be classified as public suppliers of capital.

historically given for special tax provisions, and the deviations from the model of integration. In addition, parallels are drawn between the tax treatment of the different kinds of intermediaries.

II. Investment Companies and REIT's: Fortuitously Integrated Treatment

A. *Introduction*

Regulated investment companies issue their shares publicly to investors and invest the money they receive in a diversified portfolio of securities, with particular emphasis upon common stock.[62] The most prominent class of investment companies are the open end investment companies, or "mutual funds." Mutual funds continuously offer shares to the public. These shares are not generally bought and sold on a secondary market but are instead redeemable at any time by a shareholder for an amount equal to their net asset value at the time of redemption.[63] Real estate investment trusts, or REIT's, are similar investment vehicles which invest in real estate interests. Many tend to concentrate on relatively risky mortgage loans which commercial banks and thrift institutions avoid either because of regulatory constraints or as a matter of traditional practice. Some very large REIT's, for example, specialize in short term construction and development loans, leaving permanent financing of projects to other lenders.[64] Investment companies and REIT's together own far smaller amounts of financial assets than do banks, thrift institutions, and insurance companies.[65] Investment companies, but not REIT's, are governed by a highly articulated federal regulatory statute, the Investment Company Act of 1940.[66]

The quite similar federal income tax treatment of these two types of intermediaries is one of the happier stories in the history of the Internal Revenue Code. The special tax treatment of mutual funds represents a deliberate legislative effort to encourage a desirable social objective, which effort has apparently succeeded. The law was drafted with reasonable clarity and simplicity, given the nature of the industry,

62. *See* note 8 *supra.*
63. *Cf.* Investment Company Act of 1940, §§ 2(a)(32), 5(a)(1), 15 U.S.C. §§ 80a-2(a)(32), -5(a)(1) (1970) (definitions of "open-end company" and "redeemable security").
64. *See* Schulkin, *Recent Developments in the REIT Industry,* NEW ENG. ECON. REV. Sept.-Oct. 1972, at 3, 6-9.
65. *See* notes 3-9 *supra.*
66. 15 U.S.C. §§ 80a-1 to -52 (1970).

and has produced little litigation in the nearly four decades since the basic pattern was first enacted into law.

B. *Present Tax Treatment*

The special tax treatment of regulated investment companies, now embodied in Part I of Subchapter M of the Code, is designed to give investors of moderate means some of the investment advantages available to wealthy individuals. By assembling a diversified portfolio of common stock, a wealthy investor can reduce the overall risk of his investment. The corporations in which he invests pay tax on their earnings, and he himself pays an additional tax on that portion of the earnings which is distributed as dividends to him. A small investor might lack the funds to diversify his portfolio efficiently, and if he tried to obtain the benefits of diversification by purchasing shares in an investment company, then, absent some special provision, he would be burdened by a third layer of tax. Subchapter M is designed to eliminate this third layer.

The particular tax treatment specified in Subchapter M, as well as its anomalies, can be best understood by considering its history. The first relevant statute, the Revenue Act of 1936, made the undistributed profits tax the only tax applicable to a "mutual investment company" which was publicly owned, had a diversified investment portfolio and distributed at least 90 percent of its "net income" to shareholders—who in turn would be taxed on whatever amounts were distributed.[67] The 90 percent requirement is, of course, a response to the problem of undistributed profits, the consideration of which pervades the 1936 Act. If an investment company were free to determine within very wide limits how much income to distribute, tax avoidance and frustration of the progressive rate structure of the personal income tax would be easy. If the company determined in any year that the great majority of its shareholders would be taxed at marginal tax brackets lower than the corporate tax rate, it would distribute all of its current income. Under the conduit treatment provided for this kind of financial intermediary, only the shareholders would be taxed, and at

67. Revenue Act of 1936, §§ 13(a)(3), 14, 27, 48(e)(1)(D), 49 Stat. 1652. Besides having to meet the current-distribution-of-income requirement in order to warrant the special tax treatment, an investment company today must meet a number of requirements related to the fundamental purpose of Subchapter M. The company must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940; it must be publicly owned; it must have a diversified group of investments; and at least 90 percent of its gross income must be derived from dividends, interest, and gains from the sales of securities. *See* § 851(a), (b)(2), (4).

their lower personal rates. If, however, the company knew its shareholders to be in substantially higher brackets than the corporate tax rate, it would retain its income, thereby paying only the lower corporate tax. The shareholders would realize the benefit of the income when they sold their stock at the cost of a deferred capital gain tax. If death intervened to give a stepped-up basis for the stock,[68] there would be no further tax on appreciation due to previous undistributed income. In a sense, then, the requirement that 90 percent of net income be currently distributed complements the personal holding company tax provisions,[69] an essential purpose of which was to prevent wealthy, high-bracket taxpayers from reducing the income tax liability on their investment portfolios by incorporating their investments, paying a comparatively lower corporate tax on the earnings from the investments, and simply refusing to declare dividends. The personal holding company tax itself applies only to companies with a few shareholders.[70] The 90 percent requirement therefore might be viewed as a means of nipping in the bud the bold idea of taking the "incorporated pocketbook" strategy public.[71]

The Revenue Act of 1942 extended this conduit treatment to closed end[72] as well as open end investment companies. In addition, it modified the 90 percent current distribution requirement by requiring only the distribution of 90 percent of the company's *ordinary* net income, exclusive of capital gains.[73] In a complementary provision, the Act provided that dividends paid out of capital gains were to retain their capital gains character in the hands of shareholders. Since 1942, therefore, "capital gain dividends" have been taxable to mutual fund share-

68. § 1014.

69. §§ 541-47.

70. §§ 542(a)(2) (requirement that 50 percent in value of stock be owned by or for not more than five individuals), 544 (relevant attribution rules).

71. At the present time, an investment company formed by very wealthy investors might fall between the Scylla of the personal holding company provisions by virtue of having more than five unrelated shareholders, and the Charbydis of Subchapter M by virtue of failing to qualify as a regulated investment company, *e.g.*, by being nonregistrable under the Investment Company Act of 1940 for some reason, in which case it would be taxed like a normal corporation. This does not mean that the shareholders, if in high tax brackets, could attempt the retained earnings gambit with complete safety, for they might run aground on the accumulated earnings tax provisions, §§ 531-37, which impose a penalty tax on a corporation's unreasonable accumulation of earnings. These provisions specify that a corporation's status as a "mere holding or investment company shall be prima facie evidence" of the unwholesome tax avoidance purpose which triggers the tax. § 533(b).

72. Closed end investment companies are defined in the Investment Company Act of 1940 as management investment companies other than open end companies. 15 U.S.C. § 80a-5(a)(2) (1970). They issue securities as do ordinary public corporations—periodically, not continuously—and do not stand ready at all times to redeem them.

73. Revenue Act of 1942, § 170, 56 Stat. 798.

holders as capital gains.[74] The purpose of modifying the 90 percent requirement was to ease the burdens that would be placed on closed end funds by mandatory capital gain dividend distributions. The net capital gain or loss of closed end funds fluctuates greatly from year to year. If in years when there were net capital gains, a closed end fund were required to flush out those gains to the shareholders, its assets would shrink toward nothing over a period of years.[75] (Open end funds do not face this problem, because they can replenish themselves by continually offering new shares to the public.) In accepting this modification, Congress presumably recognized that it would be difficult for investment companies to abuse their special conduit treatment by deliberately retaining capital gains in the corporate solution. If anything, the capital gains tax rate of moderate investors (the bulk of mutual fund investors), will be lower than the company's rate of tax on capital gains.[76] There is no incentive, then, to accumulate capital gains in an investment company for tax-avoidance reasons.

The final stone in the mosaic was inserted in 1956, when a provision was added permitting regulated investment companies to retain their net long term capital gains with almost the same effect for both company and shareholder as if the gain had been currently distributed as capital gain dividends and reinvested in the company by the shareholder. As indicated above, distributed capital gains are taxed to the shareholder but not to the investment company. Under the new provision, § 852(b)(3)(D), if the company retains its net long term capital gains, it pays tax at the corporate rate for such gains (30 percent, for taxable years beginning after December 31, 1974).[77] Each shareholder is deemed to have received a constructive capital gain dividend in the amount of his pro rata portion of the undistributed net long term capital gain. He is also deemed to have paid a pro rata portion of the capital gain tax actually paid by the corporation. The ordinary small investor having little or no preference income, is taxed on net long term capital gains at a rate of 25 percent or less. The capital gain tax due from such a shareholder because of the constructive

74. *Id.*

75. *See Hearings on Revision of Revenue Laws Before the House Comm. on Ways and Means*, 75th Cong., 3d Sess. 838, 844-48 (1938) (discussion of proposal like that enacted in 1942); *cf.* H.R. REP. No. 2333, 77th Cong., 2d Sess. 121-23 (1942); S. REP. No. 1631, 77th Cong., 2d Sess, 158-60 (1942); H.R. REP. No. 2586, 77th Cong., 2d Sess. 55 (Conf. Rep. 1942); Cohen, *Regulated Investment Companies—Tax Treatment*, in 3 HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM: COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1653, 1655-56 (Comm. Print 1959) [hereinafter cited as TAX REVISION COMPENDIUM].

76. *Compare* § 1201(a) *with* § 1201(b).

77. § 1201(a)(2).

capital gain dividend he has received will therefore be less than the amount already paid by the company, and he will therefore obtain a refund. If the shareholder's capital gain tax rate is higher than that of the company, he will receive a credit for the amount of the tax he is deemed to have paid. In addition, the aggregate basis of his shares in the investment company will be increased by 70 percent of the constructive capital gain dividend to him—an amount which corresponds to the net amount of appreciation in the value of his investment which has been realized and taxed.

The net effect of the treatment of undistributed capital gains is to integrate fully corporate and personal taxes by the method advocated in the Canadian Carter Commission Report. For reasons of administrative convenience the corporation actually pays the bulk of the tax; since the individual tax rate ultimately controls, however, the gains are in effect taxed almost as if they had actually been distributed and then reinvested.[78]

Notice, then, the ultimate pattern. Distributed ordinary income is taxed only to the shareholders, at their rates of tax. Undistributed ordinary income is taxed only to the corporation, at its rate of tax. Distributed capital gains are taxed only to shareholders, at their rates, but so, in effect, are undistributed capital gains.

While special tax treatment for REIT's is more recent,[79] the pattern of the tax provisions governing them is almost identical to that of regulated investment companies. For REIT's, as for investment companies, there is a policy of allowing small investors to participate in a diversified investment program—in this case, in mortgages and other interests in real estate—without an additional layer of tax.[80] Indeed, Part II of Subchapter M, which deals with REIT's, apes Part I, which

78. Cohen, *supra* note 75, at 1656. The equivalence is not exact, however, since an actual capital gain dividend followed by reinvestment of the after-tax proceeds in additional shares (which reinvestment, if all shareholders participated, would leave them all holding the same proportionate interests in the company) would often result in the shareholder's obtaining a somewhat different increase in the aggregate basis of his investment company shares. For example, if the capital gain dividend were $100 and his rate of tax on net long term capital gains were 25 percent, he would buy additional shares having a cost basis of $75, whereas under § 852(b)(3)(D)(iii) the basis of his shares would be increased by only $70. This apparent anomaly may be the result of a simple failure to follow completely through on the desire to equate the tax treatment of an undistributed capital gain dividend with that of a distributed capital gain dividend followed by a reinvestment, or it may reflect the more particular decision that the increase in the shareholder's basis should only reflect the actual after-tax increase in the value of his shares which is due to realized and taxed capital gains.

79. The present provisions, in Part II of Subchapter M, were basically added by Pub. L. No. 86-779, § 10(a), 74 Stat. 998 (1960).

80. *See* Kilpatrick, *Real Estate Investment Trusts,* in 3 TAX REVISION COMPENDIUM, *supra* note 75, at 1697, 1698-1701 (1958) (discussion of prior tax treatment and argument that REIT's should be treated like mutual funds).

deals with regulated investment companies. In addition, the favorable tax treatment for REIT's has been justified as a response to the particular needs of the real estate industry.[81]

The threshold requirements for qualification as a REIT are different from the requirements for qualification as a regulated investment company. The REIT requirements are designed to ensure that a sufficient portion of the entity's income is indeed from real estate and mortgage loan investments.[82] Again the requirement of 90 percent current distribution of ordinary income is present.[83] With REIT's, however, there is no provision corresponding to § 852(b)(3)(D). Distributed capital gains are therefore taxed to REIT shareholders at their personal rates and undistributed capital gains are taxed to the REIT at its rate. I have found no particularly cogent justification for this divergence from the investment company tax pattern. The treatment of REIT's should be made completely parallel to that of investment companies.

C. *Deviations from Full Integration*

The corporate tax on an investment company's capital gain income is completely integrated with the shareholder-level tax on that income, by the Carter Commission method—except that there is no withholding at the corporate level of the taxes to be paid on distributed capital gains. The corporate tax on an investment company's ordinary income is only partially integrated: the company gets a dividends paid deduction, but only if the 90 percent triggering requirement is met.

One is tempted to ask why the Code's treatment of investment companies' undistributed capital gains was not applied to their undistributed ordinary income as well. If such an approach had been followed, the 90 percent current distribution of ordinary income requirement would have been unnecessary, because tax avoidance through the retention of earnings could not possibly succeed. An investment company would then be free to adopt any income distribution policy which it and its shareholders wanted, without any risk to the federal treasury. The only answer suggested by an examination of the present

81. H.R. REP. No. 2020, 86th Cong., 2d Sess. 2-4 (1960) (reasons for bill). It was thought "desirable to remove taxation to the extent possible as a factor in determining the relative size of investments in stock or securities, on the one hand, and real estate equities and mortgages on the other. This is particularly important at the present time because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels."

82. *E.g.*, § 856(c).

83. § 857(a)(1).

history of the tax provisions is that the existing tax pattern is the accidental result of the particular way in which different elements of the investment company tax provisions were added to the Code. By the same token, this appreciation of the accidental nature of the historical evolution should encourage us to adopt the full integration technique in its entirety.

III. Banks and Thrift Institutions: A Quasi-Conventional "Overtax" Pattern

A. *Introduction*

Commercial banks comprise by far the largest single group of first order financial intermediaries.[84] They may be chartered under federal or state law,[85] and are virtually[86] unique in that their capital-supplying customers can open demand deposit accounts (checking accounts)[87] with them, as well as savings accounts[88] and time deposits.[89] On the investment side, they have historically concentrated on relatively short term business loans. These still comprise the largest class of investments in their portfolios, and are followed by holdings in United States government securities and tax-exempt municipal securities.[90] Because of legal restraints, commercial banks own very little common stock in their own right.

84. *See* notes 3-10 *supra.*

85. *See* 12 U.S.C. § 21 (1970) (organization of national banks). The net of federal regulation is wide and complex. All but a handful of the nation's state or federally chartered commercial banks are members of the Federal Deposit Insurance Corporation. National banks are regulated by the Comptroller of the Currency and—since they are all members of the Federal Reserve System—by the Board of Governors of the Federal Reserve System. Many state banks are also members of the Federal Reserve System. *See generally* STAFF OF HOUSE COMM. ON BANKING AND CURRENCY, *supra* note 22, at 55-65.

86. In some states, thrift institutions may allow customers to write "negotiable orders of withdrawal" against savings accounts. These orders are functionally similar to checks drawn on a demand deposit account. *See* Riordan, *Negotiable Orders of Withdrawal,* 30 BUS. LAW. 151 (1974).

87. "Demand deposits" are defined by the Federal Deposit Insurance Corporation as all deposits which are not time deposits or savings deposits (*see* notes 88, 89 *infra*). 12 C.F.R. § 329.1(a) (1974). The term includes deposit accounts as to which the depositor can legally demand repayment in less than 30 days. Interest may not be paid on demand deposits. 12 U.S.C. § 371 (1970).

88. 12 C.F.R. § 329.1(e) (1974):

> The term "savings deposit" means a deposit . . . [w]ith respect to which the depositor is not required by the deposit contract but may at any time be required by the bank to give notice in writing of an intended withdrawal not less than 30 days before such withdrawal is made and which is not payable on a specified date or . . . time . . . .

89. Time deposits include time certificates of deposit and open account time deposits. Generally with these deposits, a 30-day waiting period is not just a right reserved by the bank, but is required of the depositor and noted in the instrument or contract. 12 C.F.R. § 329.1(b), (c), (d) (1974). The FDIC regulates interest payments on savings deposits and time deposits with insured commercial banks. 12 C.F.R. § 329.3 (1974).

90. 1974 FLOW OF FUNDS, *supra* note 3, at 33.

Thrift institutions, which include savings and loan associations and mutual savings banks, historically were conceived as serving the dual purpose of promoting thrift among small savers in local communities and providing mortgage loans for the purchase of residential housing.[91] Their principal sources of capital are the time deposits and savings accounts of their depositors, as they generally do not offer demand deposit accounts or checking services.[92] They usually invest the bulk of their funds in mortgage loans, though they also hold portfolios of United States government and municipal securities and some corporate bonds.[93] All federally chartered savings and loan associations are in mutual form. There are no stockholders, and the depositors theoretically "own" the intermediary[94]—a fact reflected in the practice, only recently curtailed,[95] of calling the depositors "share" savings accountholders and referring to the interest paid them as "dividends," even though a depositor's status was clearly that of a creditor. At one time, thrift institutions were truly mutual in the sense that consumer cooperatives now are: their customers (the borrowers from them), were usually also depositors. A vestige of this communal ideal persists in the practice of deeming borrowers to be "members" of the association and giving them a token vote.[96] Mutual savings banks are all state chartered and are, of course, in mutual form; state chartered savings and loan associations may be organized as mutual or stock organizations. Among all thrift institutions, those in mutual form predominate.[97]

B. *Present Tax Treatment*

Banks and thrift institutions are taxed in a similar manner to corporations and pay the same rate of tax on their taxable income.[98] Their depositors, even those with claims against mutual organizations, are taxed as creditors. Interest payments to depositors in a commercial bank are thus deductible by the bank and taxed as ordinary income to the depositor; by a special provision,[99] even payments to depositors

91. As to federal savings and loan associations, these purposes were clearly enunciated by Congress. 12 U.S.C. § 1464(a) (1970).
92. *But see* note 86 *supra*.
93. 1974 FLOW OF FUNDS, *supra* note 3, at 34.
94. *See* 12 U.S.C. § 1464(b) (1970); Elliot v. Federal Home Loan Bank Bd., 233 F. Supp. 578 (S.D. Cal. 1964); Wisconsin Bankers' Ass'n v. Robertson, 190 F. Supp. 90 (D.D.C. 1960), *aff'd*, 294 F.2d 714 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961), *rehearing denied*, 368 U.S. 979 (1962).
95. As to federal savings and loan associations, see 12 C.F.R. § 545.1-3 (1974), *implementing* Pub. L. No. 90-448, 83 Stat. 476 (1968). ABA HANDBOOK OF SAVINGS AND LOAN LAW 36-37 (1973).
96. 12 C.F.R. § 544.1(a)(4) (charter N) (1974).
97. U.S. SAVINGS & LOAN LEAGUE, 1973 SAVINGS AND LOAN FACT BOOK.
98. § 11.
99. § 591; *cf.* § 7701(a)(19) (definition of "domestic building and loan association").

in thrift institutions which are denominated "dividends" are treated as interest.

There are two major exceptions to the general rule that banks and thrift institutions are taxed like other corporations. The first is the Code provision[100] that sales or exchanges of debt securities (bonds, debentures, notes, or certificates or other evidences of indebtedness) by banks and thrift institutions are not to be treated as sales or exchanges of capital assets, but instead as giving rise to ordinary income and losses. Since banks own little common stock, the possibility of preferentially taxed capital gains from the sale of stock is of minor consequence. Since banks typically do not trade extensively in the notes received from their business loans, the provision chiefly affects their sales of United States government and municipal securities.

The history of this treatment of debt securities is illuminating. The Tax Reform Act of 1969[101] substituted the current Code provision, subsection 582(c), for the prior rule that, though gains from sales of debt securities by banks and thrift institutions were taxed as capital gains, losses from such sales were treated as ordinary losses deductible against ordinary income. Both the House and Senate reports[102] at the time of the 1969 revision state that the prior rule of "nonparallel treatment"—treating gains as capital gains and losses as ordinary losses —was adopted in 1942 to encourage financial institutions to support the large new issues of bonds then being offered to help finance the war. In fact, the relevant 1942 House report had simply recommended the proposed nonparallel treatment and noted laconically that the treatment is recommended for banks "since bonds are a necessary type of investment for them."[103] Nonparallel treatment was introduced into

100. § 582(c)(1).
101. Pub. L. No. 91-172, § 433(a), 83 Stat. 623 (1969).
102. H.R. REP. No. 91-413, 91st Cong., 1st Sess. 129, 130 (1969).
103. H. REP. No. 2333, H.R. 7378, 77th Cong., 2d Sess. 33 (1942). The corresponding Senate Report does not even add the laconic comment. S. REP. No. 1631, 77th Cong., 2d Sess. 119 (1942). Originally the proposal covered bond sales by insurance companies, too; this aspect was dropped in favor of continuing the then existing rule that capital gains and losses of insurance companies, being likely to produce little revenue, were exempt. *Id.* at 32 (citing as an additional reason for inertia the burden placed on the insurance companies of separating their assets by dates of purchase). The House bill provided for the special treatment of bank and insurance company bond losses and, for the first time, included capital gains in the gross income of insurance companies. But the bill which passed the Senate undid the changes regarding insurance companies. *Compare* H.R. 7378, 77th Cong., 2d Sess. (1942) (as passed by the House), §§ 136(d)(1), 201(c)(1), in REVENUE ACT OF 1942, BILL IN VARIOUS FORMS pt. 1 (Carlton Fox compilation, Yale Law Library) *with* H.R. 7378, 77th Cong., 2d Sess. (1942) (as passed by Senate), §§ (131)(d), (205), *deleting* § 201(c)(1), in REVENUE ACT OF 1942, BILL IN VARIOUS FORMS, *supra*, pt. 2. The present treatment of insurance companies' capital gains and losses is similar to that of ordinary corporations. See §§ 802(a)(2) (life insurance companies), 821(f)(2) (mutual fire and casualty companies), 831(c)(1) (stock fire and casualty companies).

the tax laws in 1942 to benefit taxpayers who suffered wartime involuntary conversions not followed by replacement of the converted property—for example, a shipper whose ship was destroyed by the enemy at sea and thus converted into insurance proceeds.[104] In a questionable extension of the policy, the same treatment was given to what are now called § 1231 assets—certain real property and other, depreciable property used in a trade or business—on the theory that the war was indirectly forcing many businesses to sell such assets and that it would be too difficult to distinguish involuntary war-related sales from those which were not.[105] It may well be that the nonparallel treatment given in 1942 to bond sales by banks was a further extension of this notion, perhaps by a combination of mindless analogizing—viewing a bank's investment bond portfolio as functionally similar to an ordinary business's stock of depreciable property—and a deliberate congressional effort to encourage bank purchases of government securities.

Although § 1231 is still with us, a vestige long outliving its purpose, Congress acted in 1969 to remove the favorable nonparallel treatment of sales or exchanges of debt securities by banks and thrift institutions. A change more consonant with the treatment of the securities trading of other, arguably similar financial intermediaries, such as fire and casualty insurance companies, would have been to consider the gains and losses from such sales as capital gains and capital losses, since only a few large banks which make markets in government securities can realistically be thought of as dealers in securities. The bond portfolios of most banks are designated, thought of, and managed as investment portfolios, and the securities are considered to be investment securities by regulators.[106] The 1969 act, however, treats both the gains and the losses as ordinary. Congress felt that banks' portfolios of debt securities should be considered inventory in their hands, because of both the "size" of banks' holdings and "the extent of their transactions" in them.[107] In addition, Congress realized that banks and thrift institutions were reducing their taxes by bunching the realization of bond gains and losses in separate years.[108]

104. B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 578-79 (4th ed. 1972).

105. *Id.*

106. *See* 12 C.F.R. §§ 1.1-1.12 (1975) (Comptroller of the Currency's investment securities regulation). To be sure, the connotations are different. For tax law purposes, one would focus on whether securities are *held* for investment purposes; the Comptroller's regulation distinguishes investment securities themselves from those which are "predominantly speculative in nature." 12 C.F.R. § 1.3(b) (1975).

107. S. REP. No. 91-552, 91st Cong., 1st Sess. 166, 167 (1969).

108. *Id.* For a discussion and illustration of the principle of not offsetting gains and losses in the same year and of the significant tax benefits that banks could realize prior to 1969 by utilizing the principle, see FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL

A second major exception to the principle that banks and thrift institutions are taxed like ordinary corporations has received more attention in recent years because it affects the competitive position of banks as against thrift institutions. The deduction for additions to bad debt reserves is of enormous importance to both banks and thrift institutions because the assets of banks and thrift institutions consist predominantly of business loans and mortgage loans, respectively. In lieu of a deduction for the charge-off of specific bad debts as they become worthless, ordinary taxpayers, including corporations, are allowed a deduction for a "reasonable" addition to a reserve for bad debts.[109] This reserve is an accounting device for smoothing out the impact on reported annual income of fluctuations in bad debts. The corresponding regulations[110] give the Service flexibility in dealing with different kinds of industries and the different experiences of individual taxpayers with bad debts. Banks and thrift institutions, however, have the benefit of special statutory provisions,[111] which derive from earlier administrative rulings,[112] that allow an especially generous deduction for additions to bad debt reserves. The deduction may be computed under two separate methods. The first limits the size of the reserve to a stated percentage of eligible loans, which percentage is based on an industrywide 20-year experience with bad debts during a period spanning the Depression era. This method yields deductions considerably in excess of modern bad debt experience.[113] In recognition of its overgenerous treatment, the Code now contains a schedule calling for a periodic scaledown of the maximum percentage of allowable reserves, from 1.8 percent for taxable years beginning before 1976 to a more realistic 0.6 percent for taxable years beginning after 1981.[114] The second, and conceptually sounder, method limits additions to re-

INSTITUTIONS, *supra* note 26, at 1741-43. As the discussion indicates, the principle still has its uses. At the present time, the major incentive for banks to avoid the status of dealers in securities has been reduced since, regardless of their status, all sales of debt securities give rise to ordinary gain or loss. Indeed, there is now some incentive to obtain dealer status, since by doing so a bank may be able to adopt favorable inventory valuation methods. *Id.* at 1802, 1808-11.

109. § 166(c).

110. Treas. Reg. 1.664-4(b)(1) (1959), *as amended,* T.D. 6728, 1964-1 Cum. Bull. 195.

111. §§ 585, 593.

112. *See* Schoeneman & McCoy, *The Bad Debt Reserves of Financial Institutions,* 11 WM. & MARY L. REV. 797, 799 n.12 (1970) (list of relevant rulings).

113. A 1969 House report asserted that if commercial banks were subject to the same bad debt reserve rules as taxpayers generally, they would be allowed to build up a bad debt reserve of, on the average, less than 0.2 percent of outstanding noninsured loans, rather than the 2.4 percent reserve then allowed to them. H.R. REP. No. 91-413, 91st Cong., 1st Sess. 120-21 (1969). Bad debt losses of banks for 1974 were reported to be unusually large, but they do not seem to have been enough to justify revoking the gradual scaledown in the statute of the maximum percentages.

114. § 585(b)(2).

serves in terms of a six-year moving average of the individual bank's actual bad debt experience.[115]

The Code gives thrift institutions, but not commercial banks, the option, not only of using the better of the percentage method or the experience method, but also of using a third method for computing the maximum addition to its reserve for losses on its "qualifying real property loans":[116] the addition may not exceed a statutory percentage of the institution's taxable income for the year.[117] This third method results in a much lower effective[118] rate of tax for thrift institutions than for commercial banks. Again in recognition of the tax bonanza that it had created, Congress has provided a periodic scaledown of the statutory ceiling on the addition to bad debt reserves for qualifying real property loans, from 60 percent of taxable income beginning in 1969 to 40 percent for a taxable year beginning in 1979 or thereafter.

Regardless of which of the three methods is used, there is an overall constraint on the addition to the reserve for losses on qualifying real property loans. The addition can in no case exceed the larger of (1) the addition which would be permitted under the experience method or (2) the amount which, added to the addition to the reserve for losses on other loans, equals the excess of 12 percent of total deposits at the end of the taxable year over the sum of the institution's surplus, undivided profits, and reserves at the beginning of the year.[119] This peculiar overall constraint, which at first glance may appear to be a meaningless jumble of unrelated concepts and arbitrary tests, actually provides the best clue to the policy behind the favorable treatment afforded thrift institutions by the percentage of taxable income method. The overall constraint provides in essence that, unless the institution's recent bad debt experience was sufficiently extraordinary to warrant an exception, the institution's bad debt reserves, together with its undivided profits and surplus (some part of which may be required by governing nontax law) cannot be accumulated tax-free beyond 12 percent of total deposits. This lumping of the bad debt reserves with

115. § 585(b)(3).

116. § 593(b)(1)(B). Regardless of the method used for the qualifying loans, nonqualifying loans are governed by the experience method. § 593(b)(1)(A).

117. § 593(b)(1)(B).

118. Use of the term "effective" in this context implies that one has in mind a given tax base that is a normative reference point and from which the law deviates. It is, in a sense, a way of stating that the income of banks and thrift institutions ought to be computed in the same way, rather than a reason for equal treatment. *See generally* Bittker, *Effective Tax Rates: Fact or Fancy?* 122 U. PA. L. REV. 780 (1974).

119. § 593(b)(1)(B)(i)-(ii).

surplus and undivided profits in the formula suggests that Congress viewed the reserves *not* primarily as an account which should accurately reflect a reasonable expectation of actual losses on loans, but as a *functional substitute for the capital stock account* of an ordinary stock corporation—the "cushion of equity capital" which every sound business enterprise is supposed to have.[120] This interpretation is bolstered by the fact that Congress was apparently oblivious to the existence of the large California stock savings and loan associations when it enacted the predecessor of the overall constraint, and thus apparently thought that the thrift institutions benefiting from the special bad debt reserve provisions were all organized in mutual form.[121] Viewed in this way, however, the special tax treatment of thrift institution bad debt reserves is open to the criticism that mutual thrift institutions should be restricted to augmenting their retained earnings account with *after*-tax dollars, in the same manner that banks and ordinary corporations must. It might be argued in response that stock corporations get an initial injection of capital from the stockholders' capital contribution which is not taxed to the corporation,[122] and that mutuals should therefore have an opportunity for the tax-free acquisition of a roughly comparable reserve.[123] Since capital contributions to a corporation do not represent its own earned income from operations, however, the argument is not persuasive.

C. *Deviations from Full Integration*

Bank and thrift institution income is taxed on the conventional corporate model, although the computation of their income is different from that of ordinary corporations in those respects already indicated. Nevertheless, the tax on bank and thrift institutions' income is in effect partially integrated with the tax on public suppliers of capital, because interest payments to depositors are deductible by the institution and taxable to the depositors at their personal rates. This fortuitous result is not, of course, the consequence of a conscious policy of integration, but instead results from the legal characterization of depositors as creditors. Apart from the lack of integration with respect to bank and thrift institution shareholders (elite suppliers of capital), the pattern departs from the Carter Commission model in (1) its failure

120. *See* Lent, *Comparative Tax Treatment of Mutual Savings Institutions and Commercial Banks*, in 3 TAX REVISION COMPENDIUM, *supra* note 75, at 1767, 1775.
121. *See id.* at 1778.
122. § 118; *cf.* § 1032(a).
123. *Cf.* Keith, *The Corporation Income Tax and Its Application to Mutual Finance Companies*, in 3 TAX REVISION COMPENDIUM, *supra* note 75, at 1783, 1792-93.

to withhold a portion of the tax on depositors' interest at the entity level, and (2) its failure to allocate, and then tax in an integrated manner, undistributed income of the institution. The former discrepancy is only a problem of efficient tax collection procedures, but probably results in serious underreporting of interest income by individual depositors. The latter defect stems from the fact that there is no feasible basis for allocation. Even mutual thrift institutions, which the depositors theoretically own, cannot realistically allocate undistributed income to *particular* depositors, any one of whom may well sever his connection with the institution without having received the benefit of undistributed entity income.[124] In this respect depositors are unlike mutual fund shareholders, and complete integration with respect to depositors is not presently feasible.

Since depositors are characterized as creditors, and all interest paid to them is deductible, a bank heedless of its shareholders, or a mutual thrift institution, might try to eliminate all tax on itself by paying out all current income as interest to depositors. Neither is, in fact, free to do so. A coordinated phalanx of regulations imposes interest rate ceilings on savings accounts and time deposits at both commercial banks and thrift institutions. Even a thrift institution with all the reserves it wants and without any efficient investment opportunities for its recent earnings may be forced to keep some of those earnings. Mutual financial institutions would in any event retain some earnings for many of the business reasons for which stock corporations accumulate them—for example, to provide for growth, to seize opportunities that provide a better return than the depositors could get for themselves, or to boost the social status of the managing group. Thus, a bank or thrift institution cannot in practice achieve full integration of the entity tax on itself with the personal tax on its depositors by currently distributing all income to its depositors.

Unlike investment companies and REIT's, banks and thrift institutions face no minimum distribution requirement before integrated treatment is given to amounts actually distributed to depositors. That is, banks and thrift institutions need distribute no minimum amount to public suppliers of capital to avoid double taxation (at the entity and the personal levels) of the institution's earnings allocated to those public suppliers.

Since banks and thrift institutions are formally taxed like ordinary

124. A depositor in a mutual thrift institution might share in residual earnings upon the institution's liquidation, merger, or conversion into stock form. All three kinds of events are relatively rare.

corporations but receive special treatment in some aspects of the computation of their income, their tax treatment may be described as a quasi-conventional overtax pattern. Nevertheless, because depositors, who are the predominant source of funds for these institutions, are technically creditors, this pattern in effect allows a substantial degree of integration of the tax on the institution with the tax on the public suppliers of capital. Under the present system, only income allocable to the elite suppliers of capital, the shareholders, is not integrated.

IV. Life Insurance Companies: A Unique "Undertax" Pattern

A. *Introduction*

After commercial banks and savings and loan associations, life insurance companies are the third largest group of first order financial intermediaries. In contrast to banks, they are organized and regulated almost exclusively under state law, but like thrift institutions they may exist as stock or mutual organizations. They invest principally in corporate bonds and mortgages on property other than homes. Their capital structures tend to be simple, because they rarely issue debt instruments to ordinary creditors. Their major liabilities are those owed their policyholders.

At one time life insurance companies received extremely favorable federal income tax treatment. Although the law was tightened in 1959 in order to produce a greater tax yield from them, the treatment they receive under the Internal Revenue Code is still generous. The detailed mechanics of the special tax provisions applicable to life insurance companies are so peculiar and convoluted, and the reasons behind them so difficult to ascertain from the Code itself, that I must present a more extended exposition of their tax treatment than I have for other financial institutions, before I draw any general conclusions about the overall tax pattern.

In order to understand the taxation of life insurance companies, one must first grasp the different economic components of the ordinary whole life insurance policy.[125] From the policyholder's viewpoint, the premiums he pays for his policy can be divided into three constituent parts. One portion goes toward commission expense and similar, im-

125. *See* J. MACLEAN, LIFE INSURANCE 13-16, 21-23 (9th ed. 1962); D. MCGILL, LIFE INSURANCE 58-70 (rev. ed. 1967); R. MEHR & R. OSLER, MODERN LIFE INSURANCE 51-55 (rev. ed. 1956); Williams, *Contracts—Whole Life*, in D. GREGG, LIFE AND HEALTH INSURANCE HANDBOOK 50-58 (2d ed. 1964); Vickrey, *Insurance under the Federal Income Tax*, 52 YALE L.J. 554, 560-62 (1943). In the ordinary whole life policy, coverage is provided throughout the insured's life and fixed-amount or "level" premiums are payable continuously throughout his life.

mediately payable expenses from which the policyholder can derive no further value. A second portion covers pure insurance protection, that is, protection against the risk of dying prematurely (a protection made possible because the company can pool the premiums contributed by many policyholders). A third portion goes toward building up a retrievable investment, or "cash surrender value," akin to a savings deposit in a bank or thrift institution. The relative proportions of premiums going into the latter two categories varies greatly according to the kind of life insurance contract purchased. At one extreme is the short period "term" insurance policy, which has no savings element for the policyholder, since the policy has no cash surrender value.[126] At the other extreme is the single premium endowment policy in which the premium is paid in advance; such a policy contains a very small pure insurance element.[127] Many other types of policies lie between these extremes. The ordinary whole life policy, for example, can be viewed as a combination of a decreasing term insurance policy with a savings deposit.[128]

On the company's side, the analysis is roughly similar. After the payment of commissions and other expenses immediately incurred in issuing the policy, an insurance company invests its premium receipts and carries the investments on its books as assets of the company. As balance sheet liabilities against these assets, however, the company must set up "reserves" to meet its obligations under its policies.[129] These

126. *See* J. MACLEAN, *supra* note 125, at 28-34; D. MCGILL, *supra* note 125, at 43-52; R. MEHR & R. OSLER, *supra* note 125, at 34-45; Beadles, *Contract—Term Insurance*, in D. GREGG, *supra* note 125, at 37-49. A term policy offers financial protection against death within the time stated in the policy. It offers no protection or values in case of survival beyond the specified period.

127. *See* J. MACLEAN, *supra* note 125, at 25-28; D. MCGILL, *supra* note 125, at 71-76; R. MEHR & R. OSLER, *supra* note 125, at 45-49; Black, *Contracts—Endowment*, in D. GREGG, *supra* note 125, at 63-72.

Endowment insurance provides not only for payment of the face amount of the policy in the event of the insured's death during a specified period of years, but also for payment of the full face amount at the end of the period if the insured is living. As an economic matter, it may be viewed as a combination of *decreasing term insurance and increasing investment.* Especially when the premiums are paid over a short period and the maturity is relatively long, it might be called a savings fund protected by term insurance.

128. Annuities are in many ways the obverse of life insurance. Because annuities are similar to life insurance contracts in combining a savings and a risk-spreading element, they both are considered in determining whether a company is a "life insurance company" for tax purposes. § 801(a), (b)(1)(B). *See generally* J. MACLEAN, *supra* note 125, at 53-67; D. MCGILL, *supra* note 125, at 81-105; R. MEHR & R. OSLER, *supra* note 125, at 69-87; Mehr, *Contracts—Annuities*, in D. GREGG, *supra* note 125, at 73-86.

For the sake of simplicity, the taxation of annuities is not considered as a separate subject in this article.

129. *See* J. MACLEAN, *supra* note 125, at 111-26; D. MCGILL, *supra* note 125, at 218-45, 276-90; R. MEHR & R. OSLER, *supra* note 125, at 553-58. Mehr and Osler stress that "there is no such thing as a reserve for an individual policy," since the assets held to meet the reserve liability are held in the aggregate for the benefit of all policyholders. *Id.* at 557.

reserves correspond to the savings element on the policyholder's side. The reserves may serve as an indicator to regulators of the company's financial soundness,[130] may limit both policyholder dividends and, in the case of stock companies, dividends on stock,[131] and may help determine the company's legally permissible investments.[132] Generally, the reserves must equal that amount of money which, increased at an assumed rate of interest, will yield a fund large enough to meet policy obligations at their actuarially estimated dates of maturity.[133]

By using a high assumed rate of interest in its computations, a company can reduce the size of required reserves and limit regulatory restrictions on its activities that are based on the amount of its reserves. Accordingly, state law[134] usually sets a statutory ceiling for the assumed rate, or requires that the rate satisfy other legal conditions designed to assure a conservative approach that will protect policyholders against the threat of insolvency.[135] State law will also specify, in most cases, what mortality or morbidity tables must be used in the computation of reserves, as well as the method of computation.[136]

There are various types of life insurance reserves, which might be classified by types of policies or features of policies.[137] Even a five year term insurance policy has a reserve element, though of course it bulks less large than the reserve for a whole life policy of the same face amount.

In the early years of a policy, reserves are normally derived from the company's surplus rather than from premiums paid on the policy, because of high expenses during the policy's first few years. Partly for this reason, the individual policy's cash surrender value at any time may be less than the amount of the reserve set up by the com-

130. *See* J. MACLEAN, *supra* note 125, at 126-31 (discussion of net-level-premium reserve as a test for insolvency).

131. Because accounted for as liabilities, policy reserves reduce the net worth of a company. When the net worth is lower than a stock company's legal capital or a mutual company's "required surplus," the capital or required surplus fund is said to be "impaired." If such impairment is prohibited, *e.g.*, NEW YORK INS. LAW § 95 (McKinney 1966) (impairment of mutual or reciprocal insurer), then payment of a dividend which causes impairment is forbidden. *Cf. id.* § 195 (McKinney 1966) (superintendent may disapprove dividend payment to stockholders if he finds "that the financial condition of the company does not warrant the payment").

132. *E.g., id.* §§ 73, 80-81 (McKinney 1966).

133. Put otherwise, "the reserve may be defined as the difference between the present value of future benefits and the present value of future net premiums." D. MCGILL, *supra* note 125, at 218. Computation of these present values involves making assumptions about future mortality experience, interest rates, policy lapses and the like.

134. State law governs because the McCarran-Ferguson Insurance Regulation Act, 15 U.S.C. §§ 1011-15 (1970), leaves the regulation of the business of insurance to the states.

135. *See, e.g.*, NEW YORK INS. LAW § 205 (McKinney Supp. 1974-1975).

136. *See, e.g., id.* § 205(3).

137. *See* Kirkpatrick, *Premiums and Reserves*, in D. GREGG, *supra* note 125, at 301, 305-08.

pany on account of the policy.[138] Reflecting this difference, the Standard Valuation Law,[139] which concerns the valuation of reserves, employs the same assumed rate limits and specified mortality tables as, but uses different methods of computation than, the Standard Nonforfeiture Law,[140] which defines the minimum forfeiture benefits and cash surrender values companies must offer to policyholders.[141] The build-up of all policyholders' cash surrender values, then, cannot be taken as the equivalent of the build-up of the company's reserves. Indeed, life insurance contracts do not by their terms link the cash surrender values set forth therein to a requirement that the company maintain a specific amount of reserves on account of the particular policy. The requirement that reserves be set aside is a regulatory mandate applicable to the company as a whole, not a contractual obligation owing directly to particular policyholders. The difference between these terms creates complications[142] for proposals to reform the tax law by eliminating the widely perceived tax-free build-up of a policyholder's "investment."

B. *Present Tax Treatment*

1. *Summary*

a. *Life insurance companies.* Tax policymakers have historically faced two major difficulties when considering the taxation of life in-

138. *See* J. MACLEAN, *supra* note 125, at 177-83. Maclean offers two other reasons to support the idea that cash surrender values may properly be less than reserves. (1) The reserve is an *average* figure of no real significance as applied to the *individual* policy. It is believed that those who surrender their policies are, on the average, in better health and more likely to live longer than those who do not. This pattern of termination means that if the company gave each surrendering policyholder the full reserve amount, it would sustain a loss in aggregate. (2) Surrenders are more likely during economically troubled times, when interest rates tend to be high and the company's opportunities for earnings therefore greater. In other words, policy terminations tend to be systematically adverse to the company. Nevertheless, the Standard Non-forfeiture Law mentioned in the text seems to be concerned principally with the problem of high initial expenses. Minimum values are based on the assumption that specific excess initial expenses will be incurred and on the assumption that these expenses are amortized over the whole of the premium paying period. *Id.* at 180; *cf.* TEX. INS. CODE art. 3.44a, § 5 (Supp. 1974) (computation of "adjusted premiums" under Texas Standard Nonforfeiture Law). To speak of "the" reserve attributable to "a" policy is thought by insurance experts to be misleading. *See* note 129 *supra.*

139. *See, e.g.,* TEX. INS. CODE art. 3.28 (Supp. 1974) (Texas version of Standard Valuation Law). Texas law is chosen as an example because Texas is one of the three states (Arizona, Texas, and Louisiana) that charter the largest numbers of life insurance companies. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1973, at 90.

140. *See, e.g.,* TEX. INS. CODE art. 3.44a (Supp. 1974) (Texas version of Standard Nonforfeiture Law).

141. The Standard Valuation Law uses the commissioners' reserve valuation method, whereas the Standard Non-forfeiture Law uses the adjusted premiums method. For a discussion of these methods, see D. MCGILL, *supra* note 125, at 280-82, 295-305.

142. *See* pp. 1678-79 *infra.*

surance companies: what items should be included as "income" to the company, and whether and how additions to life insurance reserves should be reflected in taxable income.

The income of a life insurance company can be divided into two separate streams. First, the company earns income in the way that most financial intermediaries principally earn it; the company invests receipts in securities, mortgage loans, and the like. The return on these items, net of investment expenses, may be called its "investment income." Second, a life insurance company may realize underwriting gains and losses, which are more specifically related to its operations *qua* insurer. In setting its premiums, the company will act on the basis of an assumed mortality experience. Should policyholders outlive the assumptions, the company will pay out more slowly than anticipated on its policies, thereby realizing "mortality gains." The company will also have anticipated administrative expenses of a given magnitude. Should the expenses be less than projected, the company experiences "loading gains." Mortality gains and loading gains together make up "underwriting gains."[143] Underwriting gains should probably be considered taxable income; the company provides a service, insurance protection, for a price, and if its costs are less than that price it makes a profit which appears to be like that of any other corporation.

Life insurance companies could conceivably take deductions on account of obligations to policyholders at one of two times. They could take deductions only when these obligations accrue, that is, when they become payable by reason of the death of the insured or otherwise. Alternatively, they might take deductions or exclusions when additions are made to the policy reserves, on the theory that, though the policy obligations have not matured, they are real, substantial, and statistically predictable. A failure to take deductions when additions are made could constitute unrealistic accounting, especially for rapidly growing or shrinking companies. On the other hand, while ordinary corporations can establish reserves for bad debts, they generally cannot deduct additions to reserves for contingent liabilities, despite the fact that the liabilities may be statistically predictable with a high degree of accuracy. For example, an automobile manufacturer on the accrual method

143. "Underwriting gains" is a tax law term. Basic insurance texts often describe a "surplus" made up of "mortality savings," "excess interest" and "loading savings." D. McGILL, *supra* note 125, at 326. *See also* J. MACLEAN, *supra* note 125, at 142. "Underwriting gains" are viewed more precisely in the tax law as the difference between the gain from total operations of a life insurance company and the company's portion of its investment income. S. REP. No. 291, 86th Cong., 1st Sess. 6 (1959).

cannot deduct from its taxable income additions to a reserve established for predicted product warranty payments. Indeed, when a Code provision (§ 462) was added in 1954 to allow all taxpayers a deduction for reasonable additions to reserves for expenses that could be estimated with reasonable accuracy, it proved to have a woefully short life. This concession to generally accepted accounting principles was repealed in 1955 on the ground that it would create a serious revenue loss during the transitional period.[144] The problem can therefore be phrased as whether life insurance companies deserve special treatment in this regard, on the ground that policy obligations are so long term and form such a large element of their business that not to use a reserve method of accounting for those obligations would be extremely unrealistic. The tax law has accepted this general position for many years,[145] and its acceptance seems sound. The special tax accounting treatment of policy reserves is perhaps the greatest conceptual difference between the taxation of life insurance companies and ordinary corporations.

We turn from general concepts to the actual tax pattern. The Code imposes a tax, at regular corporate tax rates, on "life insurance company taxable income."[146] There is an alternative tax on long term capital gains which is similar to the alternative tax on capital gains realized by ordinary corporations.[147] Life insurance company taxable income is defined[148] as the sum of three elements, or "phases." The first phase is "taxable investment income," which can best be understood as the company's income from investments, net of investment-related expenses and *minus* the policyholders' share of that income.[149]

144. *See* B. BITTKER & L. STONE, *supra* note 99, at 837-38.

145. Under the Revenue Acts prior to 1921 (1909 Act, § 38; 1913 Act, § IIG; 1916 Act, §§ 10, 12; 1918 Act, §§ 233, 234) premium receipts were included in the gross income of all insurance companies, but a reserve deduction was provided for the purpose of postponing the taxation of these receipts until "earned." 8 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 44.01, at 44-4 n.3 (1970). The 1921 Act taxed life insurance companies only on their investment income, thus making the question of when to treat premium receipts as accrued or "earned" income irrelevant; but deductions for net additions required by law to be made to reserves were still allowed. *Id.* at 44-5; *id.* § 44.15, at 44-35. For an account of the special meaning of the phrase "reserves required by law," see T. NASH, FEDERAL TAXATION OF LIFE INSURANCE COMPANIES § 6.01[2], at 6-7 to -11 (1974).

146. § 802(a)(1).

147. § 802(a)(2).

148. § 802(b).

149. § 804(a)(2) defines taxable investment income as an amount equal to the amount (if any) by which net long term capital gain exceeds net short term capital loss *plus* the life insurance company's share of each item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), *reduced* by certain deductions allowed by other Code sections for interest on government obligations, partially tax-exempt interest, and dividends received and by the small business deduction, equal to 10 percent of the investment yield up to $25,000, provided in § 804(a)(4).

To obtain the "investment yield," one must first compute "gross investment income,"

The policyholders' share is a function of the company's "policy and other contract liability requirements,"[150] which means at its simplest the investment income the company is permitted to allocate to its insurance policy reserves plus the interest it pays on indebtedness to others, such as holders of its bonds.[151] Given the nature of the insurance business, the exclusion for these allocations means that something like 70 percent of the insurance company's net investment income may go untaxed to the company.[152] The exclusion for the policyholders' share rests on the notion that policyholders are basically creditors, and that allocating amounts to reserves for later maturing obligations is similar to making interest payments to creditors, which are deductible.

The second phase of life insurance company taxable income can be

defined in § 804(b) as the sum of (1) income generally from interest, dividends, rents, and royalties, (2) the amount (if any) by which net short term capital gain exceeds net long term capital loss, and (3) income from any noninsurance trade or business except that income included in (1). Except as provided in (2), gain from the sale or exchange of a capital asset or gain considered as gain from the sale or exchange of a capital asset is not included.

§ 804(c) defines "investment yield" as the gross investment income less (1) investment expenses, (2) taxes and other expenses exclusively on or with respect to real estate owned by the company, (3) depreciation allowed by § 167, (4) depletion allowed by § 511, and (5) noninsurance trade or business deductions excluding (a) losses from the sale or exchange of capital assets or property used in the trade or business and from compulsory or involuntary conversions of property used in the trade or business, (b) any item to the extent attributable to the carrying on of the insurance business, and (c) the net operating loss deduction in § 172 and the special deduction for corporations provided in §§ 241-50.

150. As defined in § 805(a) the term "policy and other contract liability requirements," is the sum of

(1) The adjusted life insurance reserves [§ 805(c)(1)], multiplied by the adjusted reserves rate [§ 805(c)(2)],

(2) The mean of the pension plan reserves [§ 805(d)] at the beginning and end of the taxable year, multiplied by the current earnings rate [§ 805(b)(2)], and

(3) The interest paid [§ 805(e)].

151. Since life insurance companies issue no or small amounts of debt securities, the deduction for interest paid is not nearly as important a factor as additions to policy reserves.

152. The staff of the Senate Committee on Finance estimated that the average policy and other contract liability requirement deduction would "work out to be somewhere around 75 percent." *Hearings on H.R. 4245 Before the Sen. Comm. on Finance*, 86th Cong., 1st Sess. 256 (1959). *See also* J. MACLEAN, *supra* note 125, at 529: "The 1959 law taxes on the average, about 25 percent of [net investment] income."

The 1955 formula for taxing life insurance companies assumed that each company needed approximately 85 percent of its net investment income for additions to reserves. S. REP. No. 291, 85th Cong., 1st Sess. 129 (1959) (Supplemental views of Sens. Douglas and Gore).

Dr. Gerard Brannon of the Department of Economics of Georgetown University has statistics, as yet unpublished, on this question. He states that based on 1972 data, the phase one tax base is approximately 28 percent of net investment income, *i.e.*, 72 percent of the insurance company's net investment income is untaxed because of the § 805 calculation. Interview with Dr. Gerard Brannon, Apr. 24, 1975 (telephone). Dr. Brannon explained that the insurance company's share is increasing in this period of rising interest rates. The § 805 formula is very sensitive to interest rates; the higher the rate of interest, the larger will be the insurance company's share of net investment income. *See* note 186 *infra*.

characterized roughly[153] as one-half of the company's underwriting income—or more precisely, 50 percent of the excess of its "gain from operations" (its total income[154]) over taxable investment income.[155] In figuring total income or gain from operations in phase two, the taxable investment income component is again reduced by the "policyholders' share" of that component but, oddly and perhaps pointlessly,[156] the mechanics and the result of the computation are different. Moreover, the taxable half of underwriting income is *net* of policyholder dividends. Thus, a mutual company, or a stock company which issues a great many participating policies, can reduce or eliminate its underwriting income for tax purposes simply by declaring policyholder dividends and taking a deduction therefor. Policyholder dividends can also be deducted against phase one taxable investment income, but only up to a ceiling of $250,000. That ceiling applies, however, only to dividends; underwriting losses not caused by the declaration of policyholder dividends can be fully deducted against taxable income.

The third phase of an insurance company's taxable income is imposed only on stock life insurance companies, and is based on the "amount subtracted from the policyholders' surplus account" for the taxable year.[157] The policyholders' surplus account is essentially the account into which the untaxed one-half of previous years' underwriting income has been placed. When the account builds up beyond certain limits, or when distributions to shareholders are deemed made out of it, the company finally pays the tax. The limits are of no concern to most companies,[158] however, and distributions are deemed

153. *See* pp. 1655-56 *infra,* for an explanation as to why the phase two tax base is not composed entirely of underwriting gains.

154. § 809(b).

155. § 802(b)(2).

156. *See* pp. 1656-57 *infra.*

157. §§ 802(b)(3), 815.

158. The limitations are set forth in § 815(d)(4):

> There shall be treated as a subtraction from the policyholders surplus account . . . the amount by which the policyholders surplus account . . . exceeds whichever of the following is the greatest—
>
> (A) 15 percent of life insurance reserves at the end of the taxable year,
>
> (B) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or
>
> (C) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1).

These limits are not likely to be reached. *Hearings on H.R. 4245 Before the Sen. Comm. on Finance,* 86th Cong., 1st Sess. 28-29, 274, 587, 669 (1959); S. REP. No. 291, 86th Cong., 1st Sess. 131 (1959) (supplemental views of Sens. Douglas and Gore); J. MACLEAN, *supra* note 125, at 532; T. NASH, *supra* note 145, § 8.02[2], at 8-13.

After sampling 40 companies of various sizes, Dr. Gerard Brannon of Georgetown University's Department of Economics concluded that the § 815(d)(4) limitations were set so high in comparison to the companies' phase three accounts that he would not consider the phase three tax in his analyses. Brannon Interview, *supra* note 152.

to come first out of taxed income. For all its complexity and noble intentions, the phase three computation adds very little to life insurance company taxable income.[159]

b. *The life insurance policyholder and beneficiary.* Premium payments for life insurance are not deductible, but life insurance proceeds received in a lump sum upon the death of the insured are exempt from income tax.[160] The reason appears to be that the beneficiary receives something similar to a bequest, which is not treated as income. Bequests, however, generally represent after-income-tax accumulations—the deceased or his own donor presumably paid income tax on the bequeathed wealth as he earned it. In contrast, the insured covered by a life insurance policy will not have paid income tax at any time on the income earned by the company with respect to his policy.

A beneficiary of a life insurance policy may often receive his benefits in periodic payments rather than in a lump sum. Should a beneficiary receive such payments, the total amount he will collect over time will exceed the face value of the policy, because the insurance company will pay him interest on that portion of the original lump sum which it has not yet distributed to him. Under such an optional payout plan, the beneficiary does incur income tax liability, but only for that portion of the payments which represents the after-death interest paid by the company.[161]

If policy proceeds are payable, not by reason of death, but on maturity or surrender of the policy, the policyholder is taxed only on the excess of what he receives over the premiums he has paid.[162] In most ordinary forms of insurance the cash surrender value or other amounts available to a living policyholder will usually be less than the premiums he has paid, so that no taxable income will result on

159. Dr. Brannon has agreed with the view that the phase three tax produces little revenue. Brannon Interview, *supra* note 152; *see* note 158 *supra.*

The Internal Revenue Service itself has no statistics which break down life insurance company taxes by phases. Interview with Art Gianelos, Corporation Statistics Division, IRS, May 1, 1975 (telephone).

There are indications in the Senate hearings on the Life Insurance Company Income Tax Act of 1959 that the phase three tax was never intended as a revenue raising measure. *Hearings on H.R. 4245 Before the Sen. Comm. on Finance,* 86th Cong., 1st Sess. 26-28, 219, 588 (1959).

160. § 101.

161. § 101(d). Actually, an amount akin to the lump sum is pro rated over the payout period, and only the portions of payments in excess of these pro rated amounts are taxed. For the individual beneficiary who receives life insurance proceeds on an annuity basis and who dies earlier than expected, this means that some income tax will have been imposed even though the total amount received was less than the amount that would have been received tax free under a lump sum option. Conversely, the beneficiary who outlives his or her life expectancy obtains a tax bargain.

162. § 72(e)(1).

surrender of the policy.[163] Cash surrender value is usually less than the aggregate of premiums paid because the amounts an insured has paid for pure insurance protection will ordinarily have exceeded the interest allocated to the reserve for his policy; in addition, the cash surrender value is often smaller than the reserve. In other words, even where the Code does attempt to tax the interest earnings allocated to a policy, it not only defers the tax but taxes only the excess of interest earnings over the cost of insurance protection and loading. In effect, though personal expenses are not usually deductible, personal insurance expenses are in this context charged against interest income.

The policyholders' share of the company's investment income is not usually taxed to the policyholders, even though the policyholders' reserves are credited with substantial amounts of "interest" on the company's books. Nor is there some substitute form of taxation, such as a tax on the build-up in the cash surrender value of each policyholder's policy. Apart from the partial exception covering payments other than by reason of death, the interest earned on the savings element of life insurance policies is simply not taxed, either at the company level or at the policyholder level. Life insurance policies with a heavy savings element, such as endowment policies, therefore offer substantial tax benefits to investors in very high marginal tax brackets who desire to build up an estate for their families. If such investors have not made greater use of these forms of life insurance, it is because they perceive even greater tax advantages in tax-exempt municipal securities.[164]

2. *Analysis of Important Special Aspects*

A few of the major peculiarities in the Code's computation of the taxable income of life insurance companies require critical examination before one can meaningfully assess the extent to which the tax treatment of such companies and their capital suppliers is integrated. It is difficult to consider the integration of the intermediary-level with the individual-level tax before one has some opinion about

163. This is not to say that voluntary terminations of policies are insignificant. During 1972, life insurance companies paid about $8 billion to the beneficiaries of policyholders and about $3 billion in cash surrender values. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1973, at 46-50.

164. § 103 excludes interest on state and municipal obligations from gross income. The higher one's tax bracket, the greater the benefit provided by this provision. For example, a taxpayer with a marginal rate of 70 percent requires a 16 percent interest on a taxable obligation to produce an after tax yield of 4.8 percent.

what ought to be included as income earned by the intermediary. In this subsection, I discuss three technical but important anomalies in the computation of life insurance company taxable income. I then turn to a conceptually more difficult issue affecting all kinds of insurance companies—whether underwriting gain ought to be considered income to mutual companies.

a. *Current taxation of one-half of underwriting gains.* The Life Insurance Company Income Tax Act of 1959 is the basic tax law governing life insurance companies today. One of its principal innovations was the taxation of underwriting gains. Previously, life insurance companies were taxed only on their investment income;[165] the new law, however, based tax liability on a "total income" theory. Despite this terminology, the Code presently taxes only about one-half of each year's underwriting gains. The official rationale for this rule is that only one-half is currently taxed "because it is difficult to establish with certainty the actual annual income of a life insurance company."[166] To the extent that this statement means that the actual computation of yearly income is arbitrary because of the possibility that the assumptions used in computing adequate additions to policy reserves may be wrong, a better solution would simply be to require the use of what appear to be the most realistic assumptions. At the very least, partial taxation of underwriting gain is inconsistent with allowing all underwriting loss (except that caused by declaration of policy dividends) to offset investment income. If the statement quoted above means that the tax law computation leads to wildly fluctuating underwriting gains and losses, the connection with partial taxation of gain is unclear. It has been pointed out that many other sorts of businesses are no less subject to the vicissitudes of a fluctuating stream of expenses and losses, but do not therefore receive halfhearted tax treatment.[167] Instead, extraordinary losses are not anticipated by the tax law, but, when they occur, must in effect be spread over past and future years' income, within defined limits.[168] Nor is it clear that such fluctuations are endemic to the life insurance business. Industry claims of uncertain income conflict with the high degree of predictability that lies at the heart of life insurance.[169]

165. *See* note 145 *supra;* Tye, *Taxation of Insurance Companies,* 2 TAX L. REV. 509 (1947).

166. S. REP. No. 291, 86th Cong., 1st Sess. 20 (1959). *See id.* at 7; *Hearings on H.R. 4245 Before the Sen. Comm. on Finance,* 86th Cong., 1st Sess. 24 (1959).

167. *See* Lent, *The Tax Treatment of Life Insurance,* in 3 TAX REVISION COMPENDIUM, *supra* note 75, at 1995, 2006-07.

168. § 172; *cf.* § 1212 (capital loss carrybacks and carryovers).

169. Lent, *supra* note 167, at 2006.

To make matters more perplexing, the currently untaxed one-half of current underwriting gains is taxed later (if at all) in phase three to stock companies alone. Why this is so will be suggested in the discussion of the next anomaly.

b. *The peculiar limit on the deduction for policyholder dividends.* Although only one-half of underwriting income is taxed currently, underwriting losses can be fully offset against investment income.[170] An exception is made for underwriting losses created by policyholder dividends; these are basically deductible only against gross underwriting income.[171] Thus, a mutual company[172] is in effect given discretion to eliminate the tax it might have to pay on one-half of its underwriting gains, by currently "distributing"[173] those gains as a policyholder dividend. As mentioned above, however, a mutual company cannot use the policyholder dividend device to reduce taxable investment income beyond the $250,000 ceiling designed to benefit small companies.[174]

Why, one may ask, was this peculiar limit drawn on the ability of a company to reduce or eliminate its taxable income by declaring policyholder dividends? Why not allow mutual companies, if they wish, to be taxed only on undistributed income regardless of type, in a manner similar to the taxation of regulated investment companies and real estate investment trusts? And why not allow stock companies, which often issue participating policies, the same privilege in theory, even if they would not in practice choose to offset policyholder dividends against investment income? The key seems to be that Congress was trying to design a tax that would make mutual life insurance companies, as a group, and stock life insurance companies, as another group, each contribute their fair share to the total tax revenues. We find the Senate Finance Committee pondering the fact that, at the time of its report, mutual companies accounted for 63 percent of life

170. If the gain from operations is less than taxable investment income, it is the basis of the phase one tax and there is no phase two tax. § 802(b)(1), (2). This effectively allows a deduction of 100 percent of any underwriting loss. *See* S. REP. No. 291, 86th Cong., 1st Sess. 20-21 (1959). The Senate Report states that this is to allow companies with underwriting losses to obtain immediately the tax benefits of the losses. Firms with such losses would likely be small, new, and growing companies about which the Senate Committee on Finance appeared to be specially concerned. *Id.* at 7.

171. § 809(f) (policyholder dividends and two related items deductible only to extent of $250,000 plus excess of gain from operations over taxable investment income).

172. A stock company also can deduct policyholder dividends paid on so-called participating policies. Stock companies principally issue nonparticipating policies, however. Such policies pay no dividends. *See* R. MEHR & R. OSLER, *supra* note 125, at 583. Stock companies are entitled to a special deduction, § 809(d)(5), with respect to nonparticipating policies.

173. "Distributing" may take the form of an actual cash payment, a part payment of premiums, a deposit at interest, or an equivalent amount of additional insurance. J. MACLEAN, *supra* note 125, at 209.

174. S. REP. No. 291, 86th Cong., 1st Sess. 22 (1959). *See* p. 1644 *supra*.

insurance in force and 75 percent of the total life assets of the life insurance industry.[175] The average of these percentages is 69 percent. The Committee then laments the fact that were the tax based exclusively on gain from operations—that is, on all income including investment income and underwriting gains, with full deduction for policyholder dividends—then, on the basis of 1958 data, mutual companies would bear only 58 percent of the tax burden imposed on all life insurance companies.[176] On the other hand, if the tax were only on investment income without any allowance for policyholder dividends (as under the 1942 and 1955 formulas), the tax paid by mutual companies would be 75 percent of the total. Apparently fiddling with the House bill's formula to produce the "perfect" result, the Senate committee produced a bill designed to assign mutual companies exactly 69 percent of the total tax burden. One may well wonder whether the law still achieves this purpose. If one were to average the relative percentages of life insurance in force and total life insurance company assets attributable to mutual companies for 1971, the resulting percentage would not equal the percentage paid by mutual life insurance companies of total life insurance company taxes. By the apparent standard of the Senate Finance Committee, the mutual companies are now paying considerably more than their fair share.[177]

Other components of the 1959 Act can only be understood as parts of a fantastic scheme to make mutual and stock companies pay their supposedly proportionate shares of the total tax burden by juggling the definition of taxable income. The isolation of investment income from underwriting "losses" caused by the declaration of policyholder dividends did not alone yield the exact percentages required. Consequently, a special 10 percent deduction was allowed with respect to reserves for nonparticipating life insurance business (or alternatively, a deduction of three percent of the premiums on such poli-

175. *Id.* at 10.
176. *Id.*
177. According to the latest available Internal Revenue Service statistics, total life insurance company assets in 1971 were $223,246,294,000, of which $151,072,518,000 or about 67.6 percent was attributable to mutual companies. IRS, CORPORATION SOURCE BOOK OF STATISTICS OF INCOME 221 (line 5), 219 (line 5) (1971) [hereinafter cited as SOURCE BOOK]. In 1971, mutual companies provided 51 percent of life insurance in force. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1972, at 28. The average of these two percentages is 59.3 percent.

Life insurance companies paid $1,300,054,000 in income taxes in 1971. SOURCE BOOK 221 (line 79). Mutual companies paid $896,031,000 or 68.9 percent of that amount. *Id.* at 219 (line 79). Thus, mutual companies paid almost 10 percent more than they "ought" to have paid. Since the sources relied on by the Senate report are not specified, and because IRS statistics for 1959 do not separate mutual and stock companies, it is difficult to establish the validity of these comparisons; but it seems clear that the tax law does not *ensure* the proportionality discussed in the Senate report.

cies).[178] Nonparticipating policies are issued much more commonly by stock than by mutual companies, and therefore the special deduction further adjusted the relative tax burdens of the two groups. This deduction was also justified as compensating stock companies for their lack of the "cushion" of "redundant [that is, actuarially excessive] premiums" which mutual companies collect.[179] Congress assumed that mutual companies deliberately charged higher original net premiums, would be saved from disaster were an extraordinary number of deaths to occur, and would return the excess as policyholder dividends were the business to go as predicted. One cannot help but compare this argument with the converse one made in a similar attempt to equalize the taxation of stock and mutual fire and casualty insurance companies. There a complicated scheme, since enacted into law,[180] to give mutual, but not stock, fire and casualty companies deferred tax treatment on a large part of their underwriting income was justified on the ground that mutual companies do not have the *cushion of equity capital* that stock companies do![181] Perhaps, in the congressional process of assigning reasons for bizarre tax formulas, the end justifies the argument.

c. *Legerdemain in the computation of the policyholders' share of investment income.* In the course of the intricate calculation of taxable investment income in phase one, a distinction is made between the policyholders' share of investment income and the residuum, which is the company's share. Crucial to the computation of the policyholders' share is the notion that the company can exclude from its income amounts deemed added to policy reserves. In computing these additions, however, the company does not simply multiply its reserves as reported for regulatory purposes by the assumed rate of interest used for those purposes; it does not add to reserve liabilities for tax purposes what it adds to reserves for regulatory purposes. Instead, the company multiplies its reserves as "adjusted" for tax purposes by what is called its "adjusted reserves rate" [of interest].[182] The latter term means the lower of the company's (1) current earnings rate on its earning assets (which in value usually exceed reserve liabilities) or (2) the average of its earnings rates for the current and last four taxable

178. § 809(d)(5).
179. S. REP. No. 291, 86th Cong., 1st Sess. 22 (1959).
180. *See* §§ 823(a)(1)(B), 824.
181. *See 3 Hearings on President's 1961 Tax Recommendations Before House Comm. on Ways and Means,* 87th Cong., 1st Sess. 1948-49 (1961); S. REP. No. 291, 86th Cong., 1st Sess. 11 (1959).
182. § 805(a)(1).

years.[183] The adjusted reserves rate reflects the company's actual investment experience—its *earned* rate of interest—rather than the *assumed* rate of interest it uses in reports to regulators. The tax adjustment of the reserves is usually downward: 10 percentage points for each one percentage point by which the adjusted reserves rate exceeds the assumed rate of interest.[184]

The effect of the Code's formula on taxable income is significant. For regulatory purposes, most companies assume a rate of interest for their policy reserves lower than their actual rate of return on their earning assets. The Code's formula thus usually increases the policyholders' share of investment income, thereby reducing the company's income tax liability below that which would be incurred were the company's actual assumed rate of interest used. This entity-level tax-reducing effect is mitigated, but not eliminated, by the involved downward "adjustment," for tax purposes, of the company's actual reserves. A more detailed description of the phase one computation is set out in the margin.[185] The conclusion that the downward adjustment of

183. § 805(b)(1)-(3).
184. § 805(c).
185. To appreciate the points in the text it is useful to understand the mechanics of computing taxable investment income. One first calculates gross income in the form of dividends, interest, rents, royalties, certain trade or business income, short term capital gains, and the like, § 804(b), minus various investment-related expenses and deductions, § 804(c)(1)-(5). The resulting figure is the company's "investment yield." § 804(c). Ignoring the excess of net long term capital gains over net short term capital losses, *cf.* § 802(a)(2), the taxable investment income is the life insurance company's share of each item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) reduced by the company's share of the exclusion or deduction for any totally or partially tax-exempt interest and dividends received. § 804(a)(2).

Thus if the company's share of each item is to be 20 percent, then it can allocate only 20 percent of each item of tax-exempt interest it receives to itself. Eighty percent is credited to the policyholders (who are not taxed on the income, whether or not it is from a tax-exempt source). This item-by-item treatment prevents the company from arbitrarily allocating all tax-exempt income to itself rather than to the policyholders, thus reducing its taxes substantially. This provision was perhaps *the* most controversial aspect of the 1959 act. *See* J. MACLEAN, *supra* note 125, at 533-34. A constitutional challenge to this provision was rejected. United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965).

The company's share of each item of investment yield is determined by what remains after excluding the policyholders' share. *See* § 804(a)(1). The policyholders' share is the percentage obtained by dividing "policy and other contract requirements" by (total) investment yield. *Id.*

The term "policy and other contract requirements" refers to the amount of investment income the company is considered to have set aside to meet policy requirements. In other words, the term means the amounts it must add to its policy reserves, plus the amount of interest it must pay on other sorts of obligations, *e.g.*, on bonds that the company has issued. § 805(a). To compute the amount deemed added to its policy reserves, one separates qualified pension plan reserves, § 805(a)(2), and "other" reserves. § 805(a)(1). As indicated previously, the amount set aside for the general or "other" reserves is determined by multiplying the company's reserves, "adjusted" for tax purposes, by what is called the "adjusted reserves rate" [of interest]. This rate is defined, § 805(b)(1), as the lower of the company's "current earnings rate," *see* § 805(b)(2), on its earning "assets," § 805(b)(4), or its "average earnings rate," that is, the average of its current earnings rates for the current and last four taxable years, § 805(b)(3).

reserves inadequately compensates for the favorable tax effect of using the adjusted reserves rate does not depend on the particular numbers chosen for the example. State regulators are unlikely to allow a company to assume on its books a rate of interest for reserve purposes higher than its actual earning rate. There is no feasible situation in which the statute's recomputation strategy would cut the other way and increase taxes.[186] At least two of the Senators on the Finance Committee at the time of its report on the 1959 Act perceived all of this clearly, and strenuously objected to the recomputation procedure.[187]

Two reasons, one true and one bogus, have been advanced for the Code's formula. The first is a desire not to discriminate against con-

An example will illustrate how these concepts work.

Assume a life insurance company that pays no interest on bonds or similar obligations and that administers no pension plan. It has a total investment yield of $3,000,000, none of which is attributable to tax-exempt interest, partially tax-exempt interest, or dividends received from other corporations. The mean of its life insurance reserves at the beginning and end of the year is $60,000,000. Its average assumed rate of interest is 2.4 percent. Its earnings rate has been steady at 3.5 percent for five years, so its "adjusted reserves rate" is 3.5 percent. If the law were to allow the company to exclude from its taxable investment income, for tax purposes, the amount which, for regulatory purposes, is considered added to policy reserves, the company could exclude $1,440,000 (that is, $60,000,000 times 2.4 percent of its investment yield). It would have $1,560,000 taxable investment income.

However, the actual computations are less straightforward. The company first adjusts its $60,000,000 of reserves as follows: the amount of reserves is multiplied by a percentage which equals (1) 100 percent increased by (2) 10 times the average assumed rate of interest (for the above exemple, 10 times 2.4 percent or 24 percent) and decreased by (3) 10 times the adjusted reserve rate (here, 10 times 3.5 percent, or 35 percent). In other words, the $60,000,000 of reserves are multiplied by 89 percent to yield adjusted reserves of $53,400,000. The adjusted reserves are then multiplied by 3.5 percent, the adjusted reserves rate, to yield $1,869,000, which is the policyholders' share. Their share is excluded from the company's investment income of $3,000,000. (Technically, each item of investment yield is multiplied by 1,869,000/3,000,000 and the results added; but, under the assumption that the company had no tax-exempt interest or dividends, the result is the same). The company thus has taxable investment income of $1,131,000. This amount is substantially *less* than the amount of taxable investment income derived by the use of unadjusted reserves and the unadjusted assumed rate of interest.

186. The lower tax given by the Code's formula, as compared to a formula based on reported reserves and assumed interest rates, must *not* be confused with the tax yielded by the Code's formula as compared to a tax based on unadjusted reserves and earned rate. The latter comparison reveals that the Code's formula is quite sensitive to changes in the company's earned rate of interest.

In general, as the adjusted reserves rate (the lower of current or average earnings rates) increases, the company's share of total net investment income increases. In periods of quickly rising interest rates and slowly rising or stable assumed rates, the company is taxed on a higher proportion of investment income.

Assume a company with $100,000 of earnings assets, $80,000 of reserves, an assumed rate of three percent and an adjusted reserves (earnings) rate of five percent. Its share of the investment income is about 36 percent, given the Code formula for adjusting reserves. If its adjusted reserves (earnings) rate were seven percent, its share of investment income would be about 52 percent. Given a trend to higher interest rates, one would expect companies to begin complaining to Congress about the formula. Notice that there is some lag in the effect of changing interest yields because the adjusted reserves rate is the *lower* of the current or average (five year) earnings rate.

187. S. REP. No. 291, 86th Cong., 1st Sess. 128-30 (1959).

servative companies.[188] None of the schemes enacted since 1921 has allowed a company to calculate the "policyholders' share" of its investment income by simply multiplying the company's actual policy reserves by the interest rate which the particular company actually assumed in computing its reserves for state regulatory purposes. Such an apparently straightforward method was never adopted in most states because companies can choose their *assumed* rates of interest as long as they do not exceed a statutory ceiling. Given this fact, legislators feared that the use of each company's assumed rates for tax purposes would cause an intolerable amount of "discrimination" between certain sorts of companies. Conservative companies assume a lower rate of interest, virtuously creating larger reserves. Larger reserves are, allegedly, "safer" for the policyholders, since various kinds of regulatory restraints are measured in terms of reserves.[189] Yet if the company's actual average assumed rate of interest is to be the basis for determining the policyholders' share of investment income, such virtuous companies will bear a greater tax burden than less scrupulous competitors.

On the other hand, a percentage rate of interest for reserves fixed by a federal tax statute might, depending on the percentage chosen, have the reverse kind of discriminatory effect. In any event a fixed rate was apt to become quickly out of touch with reality and to yield a "policyholders' share" that did not reflect the amount which by a sound actuarial analysis ought to have been regarded as set aside to meet future policy requirements. Weighting a fixed rate by industry average interest requirements on reserves (as under the 1942 formula) could mitigate this discrepancy somewhat, but not enough to ensure a correspondence between the amount of investment income a particular company "really" needs to set aside to meet its policy requirements and the amount the company is deemed to have set aside for tax purposes.

The 1959 approach can be seen as a rhetorical step toward effecting this correspondence. Indeed, the second basic justification offered for the Code formula was based on the belief that in the long run the competitive market would force life insurance companies to price their premiums on the assumption that the policyholders' reserves

188. *See Hearings on H.R. 4245 Before the Sen. Comm. on Finance,* 86th Cong., 1st Sess. 40, 81-82, 92, 245, 425, 643 (1959). Conservative companies are ones which assume a lower interest rate and therefore have higher reserves. *Id.* at 643.

189. *See* p. 1639 *supra.* I use the word "allegedly" because the use of actual policy reserves in determining solvency is of questionable validity. *See* J. MACLEAN, *supra* note 125, at 126-31.

would be built up for them at a rate equal to the company's actual rate of return on all its earning assets.[190]

Substantial criticisms can be leveled against this "perfect competition" rationale for the Code formula. There is abundant evidence that price competition at the retail level in the sale of life insurance policies is decidedly imperfect[191]—apparently because of ignorance and confusion on the part of many consumers—and no substantial improvement is foreseeable.[192] There is theoretical disagreement over the best way to take account of the time value of money, the uncertainty of the amount of future dividends on policies, and other factors.[193] Yet by using any of a number of methods which meet the basic conditions of a rational price comparison (such as discounting future benefits and outlays to present values instead of simply adding them up), the prices of comparable life insurance policies offered by various companies differ enormously. Moreover, the price rankings of the various companies do not vary significantly from one rational method to another.[194] Although the wide price disparities at least suggest that the companies are not engaged in price fixing, they also negate a belief in perfect competition among life insurance companies;[195] in a state of perfect competition no seller would have the power to deviate significantly or at length from the market price for any substantial period of time.

In the second place, the perfect competition argument fails, even theoretically, to explain the particular formula in the Code. While competition may force companies to price policies in the realistic be-

190. S. REP. No. 291, 86th Cong., 1st Sess. 5 (1959).

191. *See* J. BELTH, THE RETAIL PRICE STRUCTURE IN AMERICAN LIFE INSURANCE (1967); Belth & Maxwell, *The State of Competition in the Life Insurance Industry*, 15 ANTITRUST BULL. 213 (1970). *Cf. Hearings on the Life Insurance Industry Before the Subcomm. on Antitrust and Monopoly of the Sen. Comm. on the Judiciary*, 93d Cong., 1st Sess. 720-48 (1973) (report of special committee on life insurance costs); *id.* at 1515-1903 (statement of Herbert Denenberg, Pennsylvania Insurance Comm'r, together with material submitted for the record). For example, in a popular report of a price comparison survey of the 75 largest companies (done according to the interest-adjusted cost method advocated by the National Association of Insurance Commissioners), it was found that the cost per $1,000 of insurance of a $10,000 participating policy bought by a man at the age of 25 years and surrendered at the end of 10 years ranged from $3.15 to $9.12. Intermediate prices were fairly evenly represented, and similar spreads existed for other types of policies. *Life Insurance: How Costs Compare, Company by Company*, CHANGING TIMES, June 1974, at 25, 27.

192. *See* Kimball & Rapaport, *What Price "Price Disclosure"? The Trend to Consumer Protection in Life Insurance*, 1972 WIS. L. REV. 1025, 1034-35 (expressing skepticism about the supposed beneficial impact of mandatory price disclosure, but urging that it be tried).

193. *See* Joint Special Comm. on Life Insurance Costs, Report to American Life Convention, Institute of Life Insurance, and Life Insurance Association of America, *reproduced in Hearings on the Life Insurance Industry, supra* note 191, at 720-48.

194. *See id.*

195. The chief assumption here (reasonable, I think) is that the degree of variation in product quality is less than the degree of price disparity might abstractly suggest.

lief that they will earn more on their assets than the assumed rate reported to state insurance departments would suggest, the notion of competition does not tell us what the predicted rate will be in relation to the tax law's concepts of income. Competition might force a company, in pricing policies, to give policyholders credit for almost all income, including investment yield and underwriting gain. It might force a company to give credit for investment yield only, or for something much smaller than that amount. Instead, Congress has assumed that a company will be forced to give credit for that portion of investment yield which equals the ratio of the amount of "adjusted" reserves to the amount of earning assets. (Earning assets are, of course, larger than either reserves or adjusted reserves.) A claim of such a priori knowledge bespeaks a Congress more expert in haruspicy than many ordinary citizens would have supposed.

Policies may actually be sold at prices which imply that the company expects to credit reserves at a rate greater than its assumed rate but less than its earned rate.[196] In fairness, one must admit that the use of assumed rates for tax purposes could also be criticized as unrealistic. After all, there is no close link between policy obligations as stated in the contract and the establishment of reserves.

In summary, the statutory formula does not reflect the company's real needs as far as policy requirements are concerned, and the formula chosen leads generally to a lower tax than would a more realistic formula. On the other hand, it is difficult to imagine a feasible alternative which is realistic, tailored to each company's experience, and nondiscriminatory.

The foregoing analysis falls far short of a complete exposition of the actuarial hocus-pocus embedded in the 1959 act. One other significant provision needs examination. In phase two, as well as in phase one, the computation of gains from operations requires a determination of the excludable policyholders' share of taxable investment income (since gain from operations includes investment income as well as underwriting income). However, for *this* calculation, the excludable policyholders' share is determined by multiplying each

196. This possibility is implicit in the concept of a "deficiency reserve," which in many states the company must set up if the net premium (the actuarial cost of insurance, on regulatory assumptions) exceeds the actual gross premium charged the policyholder. The reserve comes out of surplus. *See* D. McGILL, *supra* note 125, at 154 n.15, 235-36.

Companies create deficiency reserves when they sell below the gross premium rates quoted in ratebooks in order to gain a competitive edge by working on volume. The companies are quite aware of what they are doing. Interview with John Stevenson, Ass't Actuary, Actuary-Life Division of Texas State Board of Insurance, Mar. 14, 1975 (telephone).

item of investment yield by the ratio of so-called "required interest" to investment yield.[197] The required interest represents the addition to reserves actually made by the company for regulatory purposes.[198] Thus, the phase two "gain from operations" will ordinarily contain a taxable investment income element that is larger than the phase one taxable investment income.

The phase two tax component (loosely referred to as the taxable half of underwriting income) will actually include, in most cases, not only one-half of the company's underwriting gains, but also a portion of the company's investment income.[199] Very roughly speaking, this portion represents one-half of the difference between the unrealistic calculation of the policy requirements made in phase one and the arguably more realistic calculation made in phase two. Only one-half of the "excess" investment income due to the phase two calculation is taxed currently. Further, all of it can be offset by true underwriting losses or eliminated from the tax base by an appropriate declaration of policyholder dividends—unlike the rest of investment income.

Why was the "required interest" approach used in phase two of the tax computation but not in phase one? No decisive reason appears in the legislative history,[200] but an explanation may be ventured. The

197. § 809(a)(1).

198. *See* Treas. Regs. §§ 1.809-2(d), 1.809-5(b) (1961). The required interest is defined, § 809(a)(2), as the product of certain reserves, including life insurance reserves, multiplied by the "required," *i.e.*, assumed, rate used in calculating those reserves.

199. S. REP. No. 291, 86th Cong., 1st Sess. 20 (1959).

200. H.R. 4245, 86th Cong., 1st Sess. (1959) as passed by the House, used for computing the phase one tax the interest rate assumed by the company or an industry average, whichever was larger. H.R. 4245, § 805(b)(2). This rate was dubbed the "deduction rate." "Required interest" under phase two was defined as the sum of (1) the products obtained by multiplying each assumed interest rate by the averages of the company's life insurance reserves at the beginning and the end of the year, (2) the policyholders' share of pension plan reserves computed under phase one, and (3) the deduction for interest paid computed under phase one. H.R. 4245, § 809(f)(2).

In the first three days of the six-day Senate hearings on H.R. 4245, industry witnesses urged the Committee on Finance to adopt the actual earnings rate or a five-year average of earnings rates in lieu of the deduction rate. *See, e.g., Hearings on H.R. 4245 Before the Sen. Comm. on Finance,* 86th Cong., 1st Sess. 66, 92, 178, 250-51 (Mar. 3-5, 1959). At that time there was no discussion of the effect on interest rates used in phase one and two that such a change would produce.

The Committee resumed its hearings on March 17, nearly two weeks after the first set of hearings. At that time, however, the Committee focused only in passing on the use of actual earnings rates in phase one. Apparently, the Committee was convinced in its first session that the recommended change in phase one would be made—as, in fact, it was. There was no discussion of the resulting differences in rates of interest used in the phase two computations. Indeed, at no point in the hearings was the term "required interest" discussed.

The Senate report is not helpful. The report states that underwriting income will include a portion of investment income not taxed under phase one because of "the difference between using the company's own required rate rather than the average earnings rate as in Phase I." S. REP. No. 291, 86th Cong., 1st Sess. 13 (1959). But the

required interest approach was the one used for all purposes in the original bill; the earned rate approach and the adjusted reserves concept were accepted only after considerable testimony.[201] It may be that the relevant Congressmen, realizing that acceptance of the earned rate approach was a substantial tax concession, simply decided not to carry it too far. The difference between the phase one and phase two computations may also reflect another aspect of the drive to equalize the taxation of mutual and stock companies.[202]

C. *Conceptual Dilemmas in the Taxation of Insurance Companies: Underwriting Income and Mutuality*

No issue in the taxation of financial intermediaries poses greater theoretical difficulty than the question of the proper taxation of mutual insurance companies. The problem is as critical for fire and casualty companies as it is for life insurance companies. The analysis of the issue progresses in four stages.

1. Consider first the arbitrary but well-settled world of the ordinary corporation. The customers, creditors, and shareholders of ordinary corporations form three easily distinguished classes whose members only accidentally overlap. For tax purposes, customer payments to the corporation are gross income. Refunds, rebates, and similar corporate payments to customers are not treated as income to them but as mere price adjustments. This result would not change, one supposes, even if the adjustments were called "customer dividends." Creditor payments to the corporation are nontaxable loans. Corporate payments to the creditors are either taxable interest payments, deductible by the corporation, or nontaxable repayments of principal, not deductible by the corporation. The parties have a reasonable amount of freedom to characterize a payment as one or the other. Shareholder payments to the corporation are nontaxable contributions to capital. The corporation's profit or income is computed and taxed before consideration of its payments to shareholders, and such payments are taxable

report does not explain why there is a difference in the rates adopted. *Cf. id.* at 20 (Committee statement that phase two uses the company's assumed rate rather than the average earnings rate without any further explanation). Neither the summary of principal changes made in the House bill nor the technical explanation of the bill mentions the difference, *id.* at 23-25, 52, even though "required interest" under the Senate Committee amendment was redefined.

201. *See Hearings on H.R. 4245, supra* note 200, at 68, 178, 250.

202. *See* pp. 1648-49 *supra*. Another possible explanation is that since one of the terms in the "required interest" equation, the number of reserves, was increased beyond those reserves used in phase one, the Senate Committee felt that the lower assumed rate should be maintained.

dividends to the extent of corporate earnings and profits, regardless of the label attached by the parties.

2. When the two capital-supplying classes, creditors and shareholders, become legally confused or merged, but customers remain a distinct class, application of the ordinary tax concepts becomes problematic but can be accomplished without insuperable discomfort. This is the case with mutual thrift institutions. The depositors are clearly creditors but technically are also the residual owners, as are stockholders. Yet the institution's customers—which can be defined to include borrowers and the issuers of debt securities which it purchases —are a distinct class. Because of the entity's dealings with these "outsiders," it is easy to regard it as earning income. The law, however, recognizes the depositor's role as creditor. Indeed, since many depositors may not maintain their connection with the entity long enough to share in the residual earnings (as on liquidation), the law treats them almost solely as creditors. It gives the entity interest deductions but taxes the interest to the depositors and, with a certain amount of backsliding and failure of nerve, views the undistributed profit (income minus ordinary deductions and the interest deductions) as income taxable to the entity, disregarding the fact that no group of identifiable individuals has a realistically definite claim to the fund. A very rough parallel appears in the treatment of farmers' marketing cooperatives,[203] the farmer members of which might be characterized as legally unique capital suppliers rather than shareholders. To the extent that entity profits are currently paid or committed to particular members, a deduction from entity taxable income is allowed,[204] thus achieving an integrated tax treatment.

3. A stock life insurance company, or a stock fire and casualty company, presents a new confusion of classes: the creditors are customers, though the shareholders remain distinct. As a purely formal matter, it is not difficult to assimilate this pattern to the ordinary one at the *entity* level because the ordinary corporate pattern distinguishes (indefensibly[205]) between debt and equity capital. The insurance company's investment activities constitute dealings with outside customers, and are thought to generate entity income for tax purposes. Congress therefore seems convinced that the investment income of all kinds of insurance companies ought to be taxed, absent special considerations.

203. §§ 521, 1381.
204. § 1382(b).
205. *See* Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1603-08 (1974).

But even if we assume this element away, as by imagining a stock life insurance company which issues only very short term policies and which has virtually no investments, the conclusion is similar. Such a company, which basically pays out on policies with current premium receipts, may have premium receipts which exceed its administrative expenses and the obligations incurred on policies; if so, it is easy to regard the excess amount, the underwriting gain, as taxable entity income, since it would be available for distribution to the distinct group of shareholders. Why would the shareholders have formed the company, if not to reap this profit?

At the *individual* level, the problem of how to treat policyholders is quite severe, because in economic fact they are both purchasers of insurance protection and suppliers of capital to a financial intermediary. The problem is compounded by those distributions or allocations called policyholder dividends. If a policyholder is viewed as wearing his customer hat, these dividends can be treated as mere nontaxable price adjustments. If he is viewed as wearing his creditor hat, they may be characterized as taxable interest payments or tax-free returns of loaned capital. If a policyholder dividend is viewed as first coming out of entity investment income, it might to that extent be dubbed interest payment to the policyholder *qua* creditor. If viewed as first coming out of prior years' gains from operations, it might well constitute a transfer payment from other policyholders, in which case it could also be classified as income to the policyholder. But if viewed as coming out of premium payments he himself recently made, it would constitute a tax-free return of loaned capital to the policyholder *qua* creditor. None of these characterizations is, I think, incontestably *the* correct one, though custom may make even experts think otherwise. Congress has basically viewed policyholders as customers, since their premiums are gross income to insurance companies and policyholder dividends are deductible by the companies. As seen above,[206] Congress has muddied the issue somewhat by restricting the policyholder dividend deductions available to life insurance companies in order to eliminate a supposed competitive advantage of mutual companies. No such restriction afflicts fire and casualty companies.[207]

206. *See* pp. 1648-49 *supra.*

207. *See* pp. 1665-66 *infra.* Congress apparently limited the deduction for policyholder dividends distributed by life insurance companies to ensure that mutual companies were taxed heavily enough. In the case of fire and casualty companies, Congress started with a situation in which only stock companies were taxed and then decided to tax mutuals on fairness grounds. All stock company policyholder dividends, of course, had always been treated as deductible. In extending the tax laws to mutuals, Congress apparently just mimicked the dividend deduction rule for stock companies.

4. Like nature, the business world leaves no gaps. Imagine a *three*-way confusion of classes: the residual owners are also creditors, actual or contingent, and customers. Such is the situation for mutual insurance companies. Again, one concludes easily that dealings with outside customers generate entity income (investment income, in this case). The problem is created by underwriting gain. It might be likened to the "net margin" earned by consumer cooperatives,[208] a type of organization in which the capital suppliers form the principal group of customers. Partly on the theory that the margins represent business done by the member patrons "with themselves," these cooperatives are treated favorably under the tax law. Although investment income and income from dealings with nonmember patrons are taxed to the cooperative, the net margin attributable to business with member patrons is not taxed to the entity if it is currently distributed each year.[209] When distributed, it is not taxable income to the patron,[210] apparently because it is viewed as a price adjustment.

The model of the policyholder as creditor has the least influence on the actual taxation of mutual insurance companies. If, for example, the policyholders of a mutual fire and casualty company were consistently treated as creditors alone, the company would disregard premium receipts and insurance losses paid as mere borrowings and repayments, and would presumably have an interest deduction if the repayments were to exceed the receipts. The policyholder receiving proceeds after a fire would be taxed on the excess of the proceeds over the premiums he paid. Conversely, the much more numerous policyholders whose policies expire without their having suffered a casualty and received proceeds could then deduct their past premium payments as a suddenly worthless bad debt. The law does not, however, treat the company and policyholders in such a manner.

For purposes of computing entity income, the Code does treat policyholders of even a mutual insurance company as customers rather than as capital suppliers. Premium receipts, viewed as received from cus-

208. Basically, "net margin" is the amount left over from sales less expenses and payments other than patronage refunds. The terminology is a way of avoiding the term "profit," which believers in cooperatives think that cooperatives do not generate. *See* Klein, *Income Taxation and Legal Entities*, 20 U.C.L.A.L. REV. 13, 32 (1972). *See generally* Lanahan, *Cooperatives*, in 3 TAX REVISION COMPENDIUM, *supra* note 75, at 1901; Magill, *The Exemption of Cooperatives from Income Taxation*, in *id.* at 1927; Nieman, *The Proper Treatment of Cooperatives*, in *id.* at 1967; Peel, *The Taxation of Cooperatives*, in *id.* at 1867; Rumble, *Cooperatives and Federal Income Taxes*, in *id.* at 1939; Warren, *Taxation of Cooperatives*, in *id.* at 1879.

209. §§ 1388(a), 1382(b).

210. § 1385(b).

tomers, are treated as gross income.[211] Amounts payable on policies (or additions to reserves), whether death benefits or losses incurred, are treated like excludable price adjustments or deductible business expenses incurred by the company in the course of providing a service, insurance coverage, to customers.[212] Policyholder dividends of fire and casualty companies are relentlessly treated as amounts paid to customers and thus deductible in full against entity income, including investment income.[213] Life insurance companies, for reasons already discussed, are limited in deducting policyholder dividends in roughly the same way that consumer cooperatives are limited in deducting patronage refunds: it is felt unfair to continue viewing the policyholder or patron as a customer after all "income" from dealing with the insiders (underwriting gain or net margin) is used up by such dividends.

Interestingly, after computing a mutual company's net underwriting gain (premiums less expenses, losses, and policyholder dividends) on the theory that policyholders are customers, the law then proceeds to tax this gain as income to the entity. This conceptual shift suggests several possibilities. The law could view the net remaining gain as corporate profit because it is *now* viewed as being available to benefit policyholders *in their role as residual owners.* Or the law may blindly and metaphysically regard the fictitious corporate entity as a separate taxpayer, and not care whether its "profit" (receipts less expenditures, computed in some intuitively plausible way) can be claimed by any definite individuals. In any event, when it actually imposes a tax, the law has stopped viewing the policyholders as customers. If the law still viewed them as customers, their receipt of the benefit of underwriting gain would not be a taxable event to them. Why, then, should there be a tax merely because the distribution of that benefit to policyholder-customers is deferred?

The problem at the individual level can be better understood by considering policyholder dividends. Assume there are tracing rules to determine when the dividends come out of investment income and when out of underwriting gain. Even as a theoretical matter, I submit, the question whether a policyholder dividend out of underwriting gain of a mutual company "is" a price adjustment or a distribution

211. §§ 809(c)(1) (life insurance companies), 832(b)(3), (4) (stock fire and casualty companies).
212. §§ 809(d)(1), (2) (life insurance companies), 832(b)(3), (5) (stock fire and casualty companies), 823(a)(1)(B) (mutual fire and casualty companies).
213. *See* §§ 832(c)(11), 823(a)(1)(B).

to a residual owner is indeterminate. The two roles are analytically but not actually separable. On the side of price-adjustment characterization, one could point to the fact that mutual companies often deliberately charge higher premiums with the expectation that dividends will later be paid. Yet, this fact does not make clear what the proper tax treatment should be. Should the amount of the perceived overcharge alone be treated as a price adjustment? Is the distinction between price adjustment and distribution to residual owner to depend on the intentions and conceptualizations of management? On the side of taxable dividend characterization, it can be pointed out that the particular policyholder is *not* "dealing with himself." The policyholder dividends may be viewed as benefits attributable, at least in part, to the company's experience with other policyholders, that is, as taxable transfer payments; or as payments in the nature of taxable windfalls; or as economic benefits made feasible only by virtue of the pooling operation itself. Yet one might obdurately insist on viewing the dividends solely from the perspective of the particular policyholder, who thinks he merely paid money for a service and is now getting a refund, without inquiring into the matrix of business relationships which makes it possible.

The Code responds to this uncertainty with a general strategy for mutual insurance companies of computing entity underwriting gain as net of policyholder dividends yet treating the remainder as taxable income. This solution has the virtue of simplicity. Moreover, it yields a formal (if not economic[214]) equality of treatment with stock companies, since they can deduct policyholder dividends to the same extent.[215] In the absence of a compelling reason to reject the Code's general strategy, one might choose to accept it and perfect it within its own terms, as by eliminating the taxation of only half of underwriting gain.

The fusion of three usually distinct classes of individuals connected with the corporation—customers, creditors, and shareholders—raises serious and difficult questions as to the proper tax treatment of mutual insurance companies, just as a similar fusion raises problems about how to tax consumer cooperatives. The conceptually possible modes of tax treatment of these entities depend on which of the three roles

214. It is hard to know what economic equality of income tax treatment means *before* one determines how "net income" ought to be defined. Arguing for application of the same formal rule for stock and mutual companies on the ground that "equal" tax treatment is desirable is in a profound sense circular.

215. Although different rules apply to life and other insurance companies, the same rules apply within each group to stock and mutual companies.

played by the individuals is accepted as controlling. The Code appears to give predominant consideration to the role of the individuals as customers, by treating premiums as gross income and policyholder dividends as deductible, in whole or in part. Yet it also appears to take some account of the policyholders as residual owners, since entity income is taxed as if it were ordinary corporate profit available to its residual owners. The best practical solution is probably to compromise, by acknowledging both the customer and capital-supplying roles of these individuals. This compromise could be accomplished by (1) following the present Code pattern as to treatment of premiums and policyholder dividends but stipulating a limit on the proportion of entity income which could be reduced by policyholder dividends and (2) integrating the tax on the entity income, as thus computed, with the individual tax imposed on the policyholders.

D. *Deviations from Full Integration*

Integration with respect to the investment income of insurance companies would call for a single tax at the policyholder level (though perhaps withheld at the company level) on the amount of such income which is currently distributed to policyholders. In deference to the reserve method of accounting for policy liabilities, distributed amounts might be defined as additions out of investment income to policy reserves, or, focusing on the policyholder's immediately realizable rights, as additions of investment income to cash surrender values. Treatment of the remaining amounts of investment income would pose a problem similar to that of bank or thrift institution income left over after the payment of interest to depositors: permission to allocate the income to the policyholders, who would then alone be taxed on it, would depend on whether reasonably definite commitments of funds to particular policyholders could be demonstrated. In fact, the law inexcusably departs from this pattern of integration, because it does not tax amounts of investment income currently added to policy reserves at all. Taxation of these additions is a prime area for reform.

The underwriting gain of an insurance company is not income it earns *qua* intermediary between fund suppliers and fund users, but *qua* insurer. It thus does not follow logically that a program of integrating the tax on financial intermediary income and the tax on individual public suppliers of capital calls for integration with respect to underwriting income. If, however, one believes that an entity tax on underwriting gain now exists because such gain is available for

ultimate distribution to capital suppliers, rather than because the law views the entity as a taxable person regardless of its relationships to individuals, integration with respect to the public suppliers of capital (policyholders) would seem desirable. If underwriting gain could be shown to be committed to the benefit of the policyholders, it could be treated as allocated to the policyholders, and thus taxed only to them at their rates. The law does not do this, of course, choosing instead to tax some underwriting gain to the insurance company at its tax rate.

In sum, though the intermediary income earned and allocated to public suppliers of capital by investment companies, banks, and thrift institutions is taxed in a fairly well integrated manner, the comparable income of life insurance companies escapes taxation entirely.

V. Fire and Casualty Insurance Companies: A Chaotic Conventional Pattern

A. *Introduction*

As a group, nonlife insurance companies possess a far smaller amount of financial assets than do banks, thrift institutions, or life insurance companies. Their holdings do, however, exceed those of investment companies by a substantial amount.[216] Most nonlife insurance companies fall into the category of companies issuing property and liability insurance—the so-called fire and casualty companies. Such companies are chartered under state law in either stock or mutual form. They invest principally in tax-exempt bonds and corporate stock[217] and, unlike life insurance companies, frequently trade in secondary markets. Their policy obligations are not as long term as those of life insurance companies; yet, they too must rely on substantial reserve funds because their contingent liabilities are far less predictable than those of life insurance companies.[218] Consequently, although premium payments to fire and casualty companies are not ordinarily thought of as savings, they do in fact contribute to substantial funds that are invested in financial assets.

216. *See* notes 3-9 *supra.*
217. *See* note 7 *supra.*
218. In the spring of 1974, for example, a series of devastating tornadoes struck populated areas of the midwestern United States with such fury that the resulting damage claims totalled $450 million. This sum was the single highest insured loss absorbed by the American fire and casualty industry in a decade, and one of the worst losses in the history of the industry. Wall St. J., Jan. 20, 1975, at 1, col. 6. Unfortunately, this was also a time when the industry's stock market holdings were declining in value.

B. *Present Tax Treatment*

1. *Stock and Ordinary Mutual Fire and Casualty Companies*

Life insurance companies are taxed under special Code provisions because of the overwhelming importance of the long term reserve element in their business. Other insurance companies reckon their income in terms of a somewhat different actuarial jargon.[219] As with life insurance companies, the income of fire and casualty companies can be seen as the composite of investment and underwriting income. There is a kind of distant correlative to the exclusion for additions to policy reserves in the notion that premiums are income to fire and casualty companies only when "earned."[220]

In general, the two sets of provisions in the Internal Revenue Code which deal specifically with property and liability insurers (§§ 831-832 and 821-826) govern companies which are organized as stock companies and as mutual companies, respectively.[221] At one time there were significant differences in the tax treatment of the two types of companies.[222] The discrepancy has been partly reduced, however, by a system of statutory cross-references which results in a bizarre pattern. Small mutual companies still receive special treatment, and there is one significant computational advantage[223] available to all mutuals having positive underwriting income. Fire and casualty companies operate under a harsher federal income tax regime than do life insurance

219. The major liabilities of fire and casualty companies also are referred to as reserves, but the major types of reserves are differently termed. Two major types of reserves usually are mandated by statute. The "unearned premium reserve" measures the company's obligations to the policyholder at every point during the term of the insurance contract and protects the right of the policyholder to cancel the contract, thereby obtaining a return of a portion of the premiums. Shortcuts are allowed in this calculation—*e.g.*, the assumption that all policies written during a given year were issued on July 1. The other important reserve mandated by statute is called "loss reserves." It reflects the amount of claims that have been incurred on issued policies but not yet paid by the company as of the date of the financial report. It includes those claims which have been incurred, reported and adjusted, but not yet paid; those incurred and reported, but not adjusted; and those estimated to have been incurred, but not yet reported. Some states additionally authorize a third important type of reserve, the "reserve for catastrophes." *See generally* Denenberg, *Finance Function*, in H. DENENBERG *et al.*, RISK AND INSURANCE 409-27 (1964).

The extent to which additions to reserves for catastrophes are sound as an actuarial or accounting matter, and the extent to which such additions ought to be deductible (if at all) for tax purposes, are specialized questions beyond the scope of this article.

220. Basically, premiums are earned when the period of insurance coverage expires. *See* Utah Home Fire Ins. Co. v. Commissioner, 64 F.2d 763 (10th Cir. 1933).

221. More specifically, §§ 821-26 cover mutual insurance companies other than life insurance companies, certain marine insurance companies, and those fire or flood insurance companies which operate on the basis of perpetual policies or premium deposits. Sections 831-32 cover "insurance companies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies."

222. *See* H.R. REP. No. 1447, 85th Cong., 2d Sess. 42 (1962).

223. *See* pp. 1669-71 *infra*.

companies, as is evidenced by the relative abundance of tax-exempt municipal securities in their portfolios.[224] The principal reason for this greater severity in tax treatment is the treatment of all investment income and underwriting gain (other than a special deferred portion of mutual companies' underwriting gain) as taxable entity income. On the other hand, not only can regular underwriting losses offset investment income, but policyholder dividends can be deducted without limit, even against investment income.

The basic pattern of tax treatment of the two sorts of fire and casualty companies may best be understood by considering the broad outline of the Code's involved definitions and formulas. This outline will also show that the tax burden on stock companies and mutual companies identical in all ways save capital structure tends to be the same under a variety of simplifying assumptions—some of which are admittedly unrealistic.

A stock fire and casualty company's taxable income is defined[225] as its gross income less the many deductions (including one for policyholder dividends) listed in § 832(c). The "gross income" amount consists of gross investment income, underwriting income, gains from the sale of certain property, and certain other items.[226] The crucial term "underwriting income" is in turn defined[227] as the excess of premiums earned during the year over insurance losses and expenses incurred.[228] Although underwriting income as defined cannot be a negative number, the Code definitions are interconnected in a manner which allows underwriting losses to reduce investment income.[229]

As a formal matter, the statutory description of a *mutual* fire and

224. *See* R. ROBINSON & D. WRIGHTSMAN, *supra* note 3, at 50, 52 (figures for 1970).

225. § 832(a).

226. § 832(b)(1). Note that investment and underwriting income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

227. § 832(b)(3).

228. It may be helpful to view the taxing pattern applied to stock companies in three successively more detailed equations:

$$\begin{aligned} \text{SICTI} &= \text{GI} - \text{DC} && (1)\\ &= \text{GII} + \text{UI} + \text{GFS} - \text{DC} && (2)\\ &= \text{GII} + [\text{PE} - (\text{L} + \text{E})] + \text{GFS} - \text{DC} && (3) \end{aligned}$$

where *SICTI* means stock insurance company taxable income; *GI*, gross income; *DC*, the deductions listed in § 832(c); *GII*, gross investment income; *UI*, underwriting income; *GFS*, gains from the sale or disposition of property and items mentioned in § 832(b)(1)(C), (D), (E); *PE*, premiums earned; *L*, losses incurred; and *E*, expenses incurred.

229. *See* § 832(b)(3), (b)(5), (b)(6), (c)(1), (c)(4), (d).

casualty company's taxable income appears very different.[230] It is defined as the sum of three items (taxable investment income, statutory underwriting income, and "amounts required to be subtracted from the protection against loss account") less the sum of three other items (investment loss, statutory underwriting loss, and the "unused loss deduction").[231] For our purposes we can regard the income as consisting of investment income and modified underwriting income.

The investment income component is simple enough. "Taxable investment income" is defined[232] as gross investment income less the deductions listed in § 822(c). That section parallels the deductions enumerated in the general list of deductions for stock companies. Since § 822(c) relates to investment income, however, fewer deductions are listed—for example, policyholder dividends are not mentioned. If the deductions exceed the gross investment income there is an "investment loss."[233]

The approach to the underwriting component of income is considerably more complicated. It is designed to achieve some measure of equality of treatment between stock and mutual companies,[234] but is also the arena in which the special tax benefits for mutual companies are allowed to perform.

The strategy of the Code provisions[235] is to use the *total* net income of a hypothetical, comparable stock company as a base, and to allow the mutual company's actual net *investment* income to be subtracted against this base to yield its underwriting income. However, the underwriting income figure thus arrived at is *further* reduced by a special deduction for small mutual companies, if applicable, and by an addition to a special account which only mutual companies can set up—the "protection against loss account." This account is a bookkeeping receptacle into which the untaxed part of current underwriting gain is put.

In computing a mutual company's statutory underwriting income,

230. § 821(b). The tax pattern may be represented as follows:

$$MICTI = (TII + SUI + SPAL) - (IL + SUL + ULD)$$

where *MICTI* means mutual insurance company taxable income; *TII,* taxable investment income; *SUI,* statutory underwriting income; *SPAL,* amount required to be subtracted for the taxable year from the so-called protection against loss account; *IL,* investment loss; *SUL,* statutory underwriting loss; and *ULD,* unused loss deduction.

231. § 821(b).
232. § 822(a)(1).
233. § 822(a)(2).
234. *See* H.R. REP. No. 1447, *supra* note 222, at 42-43.
235. § 823(a)(1).

the statute in effect requires one to go through what is at first blush an absurd sequence of steps:

> (1) first compute what the gross income and general deductions of the mutual company would be *if it were a stock company;*
> (2) subtract from the gross income amount thus figured the mutual company's gross investment income, *as defined for mutual companies;*
> (3) subtract from the general deductions amount thus figured the mutual company's investment-related deductions, *as defined for mutual companies;*
> (4) the result of step (3) is subtracted from the result of step (2); and
> (5) the result of step (4) is reduced by a special deduction for small companies, if applicable, and by the permitted amount of the addition to the special protection against loss account.[236]

The use of a stock company's total income as the starting point in the computation of a mutual company's underwriting income might represent bizarre draftsmanship but is easy enough to understand. Absent the existence of special tax rates and special deductions for mutual companies, the result of this procedure would be to equalize the tax treatment of comparable stock and mutual companies. (By the same token, absent the special provision for mutuals, the two kinds of companies might be taxed under the same set of statutory provisions, instead of under two grotesquely interlocking regimes.) The special deduction in § 823(c) for certain small mutual companies can best be understood in the context of a discussion of other benefits for small mutual companies (subsection 2 below). Finally, the protection against loss account can be better understood by comparison to the "policyholders' surplus account" which life insurance companies establish and to the overall constraint on additions to bad debt reserves which is applied to thrift institutions.

If one accepts the official explanations found in the legislative his-

236. These steps can be recapitulated in a formula which more closely reflects the Code's actual grouping of the elements of the computation:

$$SUI = (GI - GII') - (DC - DC' + SD + APAL)$$

where *SUI* means statutory underwriting income; *GI*, gross income as defined for a comparable stock company; *GII'*, gross investment income as defined for the mutual company; *DC*, the total deductions allowed for a comparable stock company; *DC'*, the investment-related deductions as defined for the mutual company; *SD*, the special deduction given in § 823(c) for certain small mutual companies; and *APAL*, the deduction allowed by § 824(a) for additions to the so-called protection against loss account. If the calculation comes out negative, the result (which is not *expressed* as a negative number) is called a statutory underwriting loss (*SUL*). § 823(a)(2).

tory, to allow mutual but not stock fire and casualty companies to exclude some of their underwriting income from current taxation does not give mutuals an unwarranted or unfair special benefit. The basic idea behind the protection against loss account was to give mutual companies the functional equivalent of the cushion of equity capital which stock companies possess from their shareholders' tax-free contributions to capital, by allowing the tax-free build-up of a special account.[237] This functional substitute is somewhat misleadingly called the protection against loss account.

The legislative history is reminiscent of the reasoning behind the supergenerous deductions for "additions to bad debt reserves" which thrift institutions can take. As indicated previously, if these deductions are to be justified at all, the misleading terminology of "bad debt reserves" must be reconstrued as referring, not to an account geared to actual, realistic expectations of losses on loans, but to a functional substitute for equity capital. As in the case of thrift institutions, the congressional justification for the special benefit for mutual fire and casualty companies is not persuasive, because the additions to the protection against loss account in fact come out of income which is the result of operations, not from a one-shot infusion of capital.

The deduction for additions to the protection against loss account should also be compared to the deductions which life insurance companies take for additions to their policyholders' surplus accounts.[238] Both deductions result in some underwriting gain being currently untaxed, but the deduction available to life insurance companies is more permanent. *Any* life insurance company, whether stock or mutual in form, can escape current taxation of that half of its underwriting income added to the policyholders' surplus account. Mutual life insurance companies are never taxed on that half, and in practice stock companies are rarely later taxed. As seen earlier, the only possible rationale for this treatment is based on the purported difficulty of computing a life insurance company's underwriting income with certainty on an annual basis. By contrast, only *mutual* fire and casualty insurance companies can escape current taxation of some underwriting income by making additions to the protection against loss account. Furthermore, the deduction basically represents a five-year deferral of tax, rather than an escape from tax. The rationale for

237. *See* 3 *Hearings on President's 1961 Tax Recommendations Before House Comm. on Ways and Means*, 87th Cong., 1st Sess. 1949 (1962); H.R. REP. No. 1447, *supra* note 222, at 43.

238. *See* p. 1644 *supra*.

the account rests not on any computational difficulties but on an alleged desire to redress the supposed competitive disadvantages of mutual companies.

The actual amount allowable as an addition to the protection against loss account is given by § 824. Disregarding a complication,[239] the amount is the sum of (1) one percent of the losses incurred during the taxable year as determined under a Code paragraph[240] which defines losses incurred for stock companies and (2) 25 percent of the "underwriting gains" for the year. Underwriting gain is defined for this purpose as the statutory underwriting income computed without regard to the deductions or the additions to the protection against loss account.[241]

The conditions under which amounts added to the protection against loss account are ultimately included in taxable income are set forth in an elaborate list of required subtractions from the account. Unless the basic point of the protection against loss account is kept firmly in mind, the list will likely seem a random grouping of complex and arbitrary calculations. The account might best be thought of as the conceptual box into which one must throw that portion of the mutual company's underwriting income which is not currently taxed. Yet, since the aim is only to allow the company a tax-deferred build-up of an equity capital substitute of reasonable size, the box should not be of unlimited proportions. Similarly, losses in future years must not be allowed to create loss carryovers or carrybacks but must be offset first by the amounts in the box, which is designed precisely to provide for such future losses. Moreover, one might want to make certain that if amounts in the box are not actually used to absorb later underwriting losses within a reasonable period of time—for example, five years—they will be taken out of the box and put back into taxable income. Finally, one might want to prevent the company from using the box device to avoid a current tax on investment income, which Congress is chronically sure ought always to be taxed. The required subtractions listed in the Code simply implement all of these policies.[242]

239. § 824(a)(1)(c) provides for the addition of a certain amount if the "concentrated windstorm etc." premium percentage for the taxable year exceeds 40 percent. The term "concentrated windstorm etc." includes cyclones, hurricanes and similar natural phenomena, but does not include fires, explosions or riots. Treas. Reg. § 1.824-1 (a)(2)(ii)(b) (1963).

240. § 832(b)(5).

241. § 824(a)(1) (last sentence).

242. The statute, § 824(d)(1), requires that, after additions are made for the taxable year to the protection against loss account, five successive subtractions be made. First, if the amount of the addition just made to the account exceeds underwriting gain, the excess is subtracted. In other words, the box cannot be used to shield *investment* income

2. *Small Mutual Companies*

There are three provisions in the Code providing favorable treatment for small mutual fire and casualty companies. The applicability of the provisions is determined by an index of the size of a company's business. The index is based on what might be called a company's "gross amount," that is, the sum of its gross investment income, excepting capital gains, plus its premiums including assessments and deposits. The three provisions govern companies in three contiguous increasing size categories. A mutual company whose gross amount for the year does not exceed $150,000 is tax-exempt.[243] Companies in the middle group, with a gross amount greater than $150,000 but not greater than $500,000, are taxed only on their taxable investment income, at special rates.[244] Mutual companies with a gross amount between $500,000 and $1,100,000 are taxed on investment income and underwriting income, but in computing the latter they receive a small additional deduction (at most $6,000) that decreases with increasing

from current tax. One might compare the similar results for life insurance companies: with them, the deductible addition to the policyholders' surplus account can only be made if there is a positive underwriting income, that is, a positive result in the phase two computation. It follows that additions to the policyholders' surplus account cannot reduce phase one's taxable investment income. With mutual fire and casualty companies, the result is not automatic because of the more complicated formula for computing the addition to the protection against loss accounts—one percent of losses plus 25 percent of underwriting gain. This means, for example, that if the underwriting gain were zero and there were losses, an addition would be made in excess of underwriting income.

The second subtraction is obvious. If there is a total operating loss for a year—more exactly, if the sum of investment losses and statutory underwriting losses exceeds the sum of taxable investment income and statutory underwriting income—it is subtracted from the protection against loss account. Since the account is an accumulation of untaxed income designed to absorb future losses, when there ultimately is a net loss from the combined investment and underwriting aspects of the business, the account should then be debited and the amount taken into taxable income. The result brings the net loss up to zero taxable income, thus preventing the creation of loss carrybacks and loss carryovers.

The third subtraction, for unused loss carryovers, implements a similar theory. Such carryovers must eliminate the protection against loss account before they can reduce the tax on the current year's income.

The fourth subtraction is designed to prevent income previously added to the protection against loss account from escaping taxation for an unseemly period of time. The amount of the subtraction is determined by looking at the addition to the account for the fifth preceeding taxable year. If any of that addition still "remains" in the account, then the remaining amount (less one-half of the amount added to the account by virtue of the underwriting gains portion of the "one percent—25 percent" addition formula) is subtracted, thus increasing taxable income. Whether a prior year's addition "remains" in the account at any time is determined by a set of elaborate tracing rules governing subtraction.

The fifth subtraction is made if a specified ceiling on the size of the protection against loss account has been exceeded.

243. § 501(c)(15).

244. § 821(c). The special § 821(c) treatment does not apply to a mutual company which has a protection against loss account at the beginning of the taxable year. Otherwise, a very large company might use these special provisions in a year in which the gross amount of its business was abnormally small.

size.[245] Mutual companies whose gross amount equals or exceeds $1,100,000 are taxed on all their mutual insurance company taxable income at the "regular" rates set forth in § 821(a). The tax is roughly similar to the § 11 tax on ordinary corporations but may give mutual companies a slight advantage in the lower income levels over stock companies.

Why are there all these provisions for small mutual companies? The tax exempt treatment given to the smallest mutual companies traces back to the Revenue Act of 1916,[246] which added to the list of tax exempt organizations certain specified mutual insurance companies "of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses." In other words, the exemption originally covered local assessment-type companies. Assessment companies collect monies from their members *as needed* to pay out promised benefits. Unless the organization is very large, the payments a member must make may vary from year to year and are not predictable in advance. An ordinary insurance company collects periodic premiums which are based on actuarial projections of future payouts; one's premium payments are regular and (ignoring the possibility of dividends) relatively fixed. Assessment companies, in contrast, were based on a very rough insurance principle requiring little actuarial expertise, and were often "organized in the kitchen of the leading farmer of the community."[247] The local assessment companies were relieved from taxation on the theory that they were insignificant contributors to the tax coffers and that the burden of filing a tax return would weigh too heavily on them.[248] Many such companies were not required to make filings for state regulators and had no accountants. To prepare their returns, they might have had to hire an accountant, at a disportionate cost to their tax liability.[249] The very fact that the assessment companies were small and mutual, and could be viewed as "not-for-profit," also contributed to their special treatment.[250] Over time a dollar limit was substituted for the requirements of being "local" and of obtaining company in-

245. § 823(c). The amount of the § 823(c) deduction cannot exceed the statutory underwriting income computed without regard either to the § 823(c) deduction or to any deduction caused by an addition to the protection against loss account.

246. § 11(a) Tenth, ch. 463, 39 Stat. 767 (1916).

247. *Hearings on Revenue Revision, 1925 Before House Comm. on Ways and Means*, 69th Cong., 1st Sess. 258 (1925).

248. *Id. See also* H.R. REP. No. 922, 65th Cong., 1st Sess. 4 (1916).

249. *Hearings on Revenue Revision, 1925, supra* note 247, at 258.

250. *Id. See also* 2 *Hearings on Revenue Revision of 1942 Before House Comm. on Ways and Means*, 77th Cong., 2d Sess. 2327 (1942).

come from assessments.[251] The assessment requirement had proved particularly cumbersome for companies in those years when they made no assessments, because they did not qualify for special treatment in those years under a literal reading of the statute.[252]

The middle category of small mutual companies is principally a product of the shift in the tax base for mutual companies from a tax on investment income (the 1942 approach[253]) to a tax on investment and underwriting income (the 1962 approach[254]). The 1962 revision of the tax treatment of mutual companies subjected them to tax on their total income but continued to tax qualified smaller companies only on their investment income. The reasons given were similar to those given for the exemption for very small companies: many of the medium-small companies were of the assessment type and did not have to submit reports on underwriting income to state regulators.[255] Moreover, it was thought desirable to help "these small, often new, companies to maintain sufficient reserves so that they can obtain reinsurance at reasonable rates."[256]

The special deduction granted the largest small mutual companies may best be thought of as a transitional provision for small companies which are on their way to becoming larger and more heavily taxed.[257] The various special treatments given small mutual companies may result in only a small loss of revenue, but the number of companies affected is not insubstantial. At the 1962 Senate hearings, for example, it was stated that 80 percent of the 2,300 to 2,400 mutual fire and casualty companies had gross annual incomes below $75,000, and hence were in the very smallest class of mutual companies.[258]

3. *Stockholders and Policyholders of Fire and Casualty Insurance Companies*

The stockholders of stock fire and casualty companies are in general treated like other stockholders. Policyholders who in the course of their business purchase casualty insurance may deduct the premium

251. Revenue Act of 1926, § 231(11), ch. 27, 44 Stat. 9.
252. *See* 2 *Hearings on Revenue Revision of 1942, supra* note 250, at 2350.
253. INT. REV. CODE OF 1939, § 207, *as amended,* Revenue Act of 1942, ch. 619, § 165, 56 Stat. 798, 872.
254. § 821, *as amended,* Revenue Act of 1962, § f, 76 Stat. 989.
255. H.R. REP. No. 1447, 87th Cong., 2d Sess. 44 (1962); S. REP. No. 1881, 87th Cong., 2d Sess. 57 (1962).
256. S. REP. No. 1881, *supra* note 255, at 57.
257. H.R. REP. No. 1447, *supra* note 255, at 44; S. REP. No. 1881, *supra* note 255, at 57.
258. *Hearings on H.R. 10650 Before the Sen. Comm. on Finance,* 87th Cong., 2d Sess., pt. 2, at 1527 (1962).

payment as an ordinary and necessary business expense.[259] As a corollary, any actual casualty losses covered by the insurance would not be deductible,[260] but neither would the insurance proceeds be income.[261] Nonbusiness policyholders—for example, an individual purchasing fire insurance on his home—are taxed similarly, except that the premium payments are nondeductible, because they are viewed as personal expenses.[262] The wealthy individual may therefore have an incentive to be a self-insurer; since a casualty loss not covered by insurance is deductible, the after-tax cost of a casualty loss may be less than the cost of buying insurance protection from a commercial insurer.[263]

C. *Deviations from Full Integration*

There is no integration of the tax on stock fire and casualty companies with the individual tax on their stockholders, just as there is generally no integration with respect to elite suppliers of capital who are shareholders. Nor is there integration with respect to the public suppliers of capital, the policyholders, because the law consistently treats even mutual company policyholders as purchasers of insurance protection rather than as capital suppliers. Admittedly, this categorization of policyholders as customers rather than capital suppliers is not senseless.

To be sure, most of the types of public suppliers of capital discussed in this article can be construed, with varying degrees of plausibility, as something "more" than capital suppliers. Thus, savings accountholders in banks and thrift institutions might be said to purchase FDIC or comparable insurance; mutual fund and REIT shareholders purchase the benefits of diversification; and, more substantially, life insurance policyholders purchase life insurance protection. In all these cases, however, the savings/investing element remains large, and the individuals benefit significantly from the entity's investment operations. In the case of property and liability insurance, the capital-

259. *See* § 162(a).
260. § 165(a).
261. The proceeds might, however, produce capital gain or ordinary loss under § 1231 if the proceeds exceeded or were less than the adjusted basis of the destroyed property used in the trade or business.
262. *See* § 262 (disallowance of personal, living and family expenses except where otherwise provided in ch. 1). Note that for collection of proceeds upon a fire, § 1231 produces a possibility of gain or loss if proceeds exceed or are less than basis.
263. By contrast, medical insurance premiums are deductible as medical expenses. § 213(a)(1), (e)(1)(C). Correlatively, amounts received through accident or health insurance for personal injuries or sickness are not included in gross income, unless they are attributable to contributions by an employer that were not included in the beneficiary employee's income. § 105(a).

supplying function of policyholders might be thought so negligible that entity income allocable to the policyholders ought to be disregarded when computing their income.

In general, then, fire and casualty companies might be said to be taxed according to a bizarrely presented but basically conventional pattern: they are taxed in effect like ordinary corporations, apart from special provisions to benefit mutual companies, and the policyholders are treated principally as customers, even in the case of mutual companies. Because of the peculiar historical evolution of the relationship between the tax law's treatment of stock and mutual fire and casualty companies, however, the Code expresses this simple objective in a bizarre network of statutory language. In line with the suggestions made about life insurance companies, the law ought in principle to give greater recognition to the role of policyholders as capital suppliers. Thus, it could stipulate a limit on the extent to which policyholder dividends may reduce entity income, and then integrate the tax on entity income so computed with the tax on the policyholder. Practical difficulties with this proposal are discussed in the concluding section.

VI. Qualified Pension Plans: A Pattern of Overriding Policies

Qualified pension trusts, and to a lesser extent qualified pension plans administered by life insurance companies, have been among the fastest growing types of investment funds.[264] Part of this growth can be explained by their tax advantages. An employer's contributions to a qualified pension trust are immediately deductible by the employer as a business expense,[265] but are not immediately taxed as compensation income to the employee-beneficiary of the trust.[266] Investment earnings of a qualified pension trust are exempt from federal income tax.[267] The pension fund can therefore accumulate over the years on a tax-free basis, in a manner similar to the build-up of policy reserves attributable to life insurance policies. Since 1959, substantially the same exemption from tax available to pension trusts has

264. Between 1959 and 1973, the total financial assets of private pension funds increased from about $34 billion to about $133 billion, 1974 FLOW OF FUNDS, *supra* note 3, at 35. Of the institutions discussed in this article, only the assets of savings and loan associations increased a greater number of times during this period.

265. § 404(a). Of course, there are limits as to permissible amounts.

266. *Cf.* § 402(b) (beneficiary of nonexempt trust is currently taxed on employer contributions to trust).

267. Indeed, the trust itself is exempt from taxation. §§ 501(a), 401(a).

in effect been granted to qualified pension plans administered by life insurance companies.[268]

The tax treatment of the ultimate payment of pension benefits from the fund depends on the method of distribution. Previously, a lump sum distribution resulted in a capital gain to the employee of the excess amount of benefits over past contributions.[269] With the Pension Reform Act of 1974,[270] the lump sum distribution produces ordinary income, but special averaging rules are provided.[271] Distributions of pension benefits other than lump sum distributions are in general taxed like annuity payments: taxable gain and return of capital elements are both pro rated over the payout period.[272]

Although the tax law governing qualified pension plans is extremely complex, from the standpoint of the theme of this article they present a very simple pattern. Since there is no federal income tax at all on the income generated by these plans, there is no need to consider whether the intermediary-level tax is integrated with the personal-level tax. Moreover, it seems clear that Congress's decision to exempt the investment earnings of these plans from current taxation was deliberately made, on the theory that the tax law ought to give unique treatment to these plans in order to encourage provision for retirement. In the face of this overriding nontax policy determination, it would be futile to object that pension plans are given an unfair special advantage as compared to other financial intermediaries.

Conclusion: A Program for Reform

The preceding analyses suggest certain changes in existing law. Depending on the intermediary, the changes affect one or more steps in the process of computing and taxing financial intermediary income according to the model of fullest feasible integration of the intermediary-level tax and the tax on public suppliers of capital. Those steps include the computation of income earned by the intermediary, the taxation of distributed income, the taxation of undistributed but

268. *See* § 805(a)(2), (d). In computing policy and other contract liability requirements —for which the company gets a deduction—unadjusted pension plan reserves are multiplied by the *current* earnings rate. The effect is to give the company a deduction for virtually all investment earnings allocable to pension plan accounts.

269. § 402(a)(2), *as amended,* Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, § 4(c), 76 Stat. 825.

270. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829.

271. § 402(e), *as amended,* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2005(a), 88 Stat. 987.

272. § 402(a)(1).

allocated income, the taxation of undistributed and unallocated income, and basis adjustments.

Regulated investment companies and real estate investment trusts should continue computing their income as they now do. Currently distributed income should be taxed as it now is, but consideration should be given to withholding a part of the shareholders' tax at the entity level. All of the undistributed income of both types of intermediaries should be taxed as the undistributed capital gain income of regulated investment companies is—that is, according to the standard Carter Commission method of integration. Such a change would eliminate the need for the 90 percent current distribution requirement, which uselessly restricts the investment and growth strategies open to these socially desirable investment vehicles.

When computing their income, both banks and thrift institutions should be required to limit their allowable additions to bad debt reserves on the basis of a moving average experience formula. The alternative computational methods should be abolished over a transitional period. The interest income earned by depositors at these institutions may be considered currently distributed to them whether or not it is withdrawn.[273] It is therefore correctly taxed to the depositors and deductible by the institution. One administrative change meriting serious consideration would be the withholding of the depositors' tax by the institution. The Carter Commission technique of permitting the corporation to allocate currently undistributed income to the shareholders, thereby allowing the income to be taxed at their (often lower) rates, would indicate that banks and thrift institutions should be permitted to allocate undistributed income to their public suppliers of capital (the depositors)[274]; however, current practices do

273. Interest earned on time deposits presents a technical problem: though at any given time the depositor may have earned a given amount of interest, under current regulations he will have to forfeit some of the interest if he demands withdrawal of his funds before the stipulated maturity date. This problem can be resolved by treating all interest earned at the end of the time depositor's taxable year as distributed to him and allowing him to claim a deduction in a subsequent year for the amount of any forfeiture of interest caused by early withdrawal.

274. One problem not dealt with in the text is whether the *character* of the income computed at the entity level ought to flow through to depositors. Should a bank, for example, be able to allocate its undistributed capital gain income as such to its depositors, who would then be taxed on it at capital gains rates, just as regulated investment companies may allocate undistributed capital gains to their shareholders? The same question can be raised about insurance companies. The problem apparently is not urgent in the case of banks and life insurance companies, since a relatively small proportion of their income is capital gains. Banks' gains on sales of debt securities are treated as ordinary gains, and life insurance companies, though treated more conventionally on sales of debt securities, in fact have relatively small capital gains because they tend to hold securities for interest income. The problem is more important for fire and casualty companies, which frequently trade stocks and bonds.

not admit of meaningful allocation. Because of interest rate ceilings, institutions which already credit to savings accounts the maximum interest allowed by law probably could not commit additional funds to *particular* depositors, even those at mutual thrift institutions. In the absence of such a commitment any claim that an allocation had been made would be hollow. I must therefore conclude that the present tax treatment of distributed and undistributed income of these institutions ought to continue in its present form. I do hope, however, that at some point the interest ceilings on savings deposits will be lifted and innovative banks allowed to offer participating deposit accounts which would give certain classes of depositors a share in earnings. Depending on the nature of such earnings, the question of requiring or permitting allocation of income as part of an integration scheme would then need reevaluation.

Life insurance companies should be required to include all their annual underwriting income as well as all their annual net investment income in the computation of their income for tax purposes. This implies that the present scheme for taxing only one-half of underwriting gains, the phase three tax on stock life insurance companies, and related provisions should be abolished. Treatment of life insurance companies' investment income is most clearly in need of revision, since much of it is not currently taxed. Whatever the details of such a reform, it ought to implement one basic principle: roughly the same amount currently deducted by the company as an addition to policy reserves must be currently treated as income to particular policyholders. Once this basic principle is implemented, there will be no need to put a maximum limit on the amount of investment income which a company can allocate to its policy reserves (or to policyholders in some other way). The statutory standard, to be specified from time to time by Treasury regulations, might be that a company could allocate all of its investment income if it could

In resolving this question, I think one must consider what theory might justify the flow-through of capital gains of investment companies. Perhaps the idea is that the investment company stands as a surrogate for the individual investors who supply capital to it and that these individual investors cannot themselves be properly classified as dealers in securities for tax purposes. If that is the theory, one might attempt to distinguish some of the other institutions, *e.g.*, commercial banks, on the ground that those institutions are not primarily surrogates for individual investment portfolios, but are instead providers of services, *e.g.*, the safekeeping of money. In view of the stress placed in this article on the role of depositors as suppliers of capital, however, such an argument seems unpersuasive. As a theoretical matter, then, flow-through of capital gains should be available to all public suppliers of capital to financial intermediaries, or to none. The real question is whether it is practicable ' attempt to achieve a flow-through treatment of capital gains in the case of all financial intermediaries.

show "with reasonable certainty" that the income had been "committed" or "dedicated" to particular policyholders. Pressure would thus be taken off the formula for distinguishing between the company's share and the policyholders' share of investment income—a formula which, as was seen, is difficult to specify in a way that is nonarbitrary and simultaneously meets criteria of realism and fairness among kinds of companies. This formula is now the dividing line between taxable and nontaxable income; if the basic principle stated above were implemented, the formula would at most be the dividing line between income taxed at the policyholders' rates and unallocated income taxed at a flat entity rate.

To be sure, the costs of achieving an *exact* implementation of the basic principle of equating company deductions from investment income with policyholders' taxable investment income may be excessive. For various reasons, some methods of allocating *to particular policyholders* whatever investment income is not to be taxed at a flat entity rate as residual (undistributed and unallocated) income may be simpler than others. Goode's analysis,[275] which basically accepts the separate entity tax on life insurance companies and seeks principally to tax the policyholders' accumulated savings, focuses on policy reserves as the amount analogous to a depositor's deposit. Yet he is forced by practical considerations to propose a reform expressed in terms of cash surrender values as the measure of those accumulated savings. (As stated previously, cash surrender values are usually slightly lower than policy reserves by roughly the amount of certain initial expenses not yet amortized.) Following his analysis,[276] the law could feasibly use cash surrender value as the measure of the accumulated savings element of a policy, and apply annually against current cash surrender value an interest rate which would be, (1) in the case of nonparticipating policies, the contractually assumed rate, which cannot be exceeded, and (2) in the case of participating policies, the company's average earned rate, or, since mutual companies do not attempt to distribute all earned surplus to policyholders, some high fraction, such as nine-tenths, of the earned rate.[277] The companies would prob-

275. Goode, *Policyholders' Interest Income From Life Insurance Under the Income Tax*, 16 VAND. L. REV. 33 (1962).

276. *Id.* at 50-52.

277. An alternative suggestion might be to tax each policyholder on the amount of interest credited each year by the company to his policy. Companies do not usually credit interest to particular policies, however, and to require them to do so would be burdensome. It is far simpler to multiply the company's earned rate of interest on all assets times a figure, such as cash surrender value, that is meaningful in relation to a particular policy.

Another possibility would be to employ on an annual basis the Code's present rule

ably have to compute the amount of income thus regarded as allocated and notify the policyholders. They might also be required to withhold at least part of the policyholders' individual tax liabilities.

Underwriting gain will continue to pose a problem which, in view of the mixed role of policyholders as customers and capital suppliers, is capable of no solution free of conceptual tension. Perhaps the best the tax law can do is to compromise the viewpoints. Congress could specify a certain portion (fixed by a percentage figure or some formula) of current underwriting gain that is capable of being reduced by current policyholder dividends. (Once all investment income is taxed either to the company or policyholders, it is plausible to regard policyholder dividends as coming out of underwriting gain). The specified portion should probably be small, and Congress should put the burden on the industry to come forward with arguments for the propriety of giving greater weight to the view that the dividends are mere price adjustments. To the extent that the dividends come out of the specified portion of underwriting gain, they would be deductible by the company and nontaxable to the policyholders. To the extent that the dividends exceed the specified portion, they would be treated as taxable dividends to the policyholders. Because of the integration ideal, they would also be deductible by the company. For administrative simplicity, all the various ways of definitely crediting a dividend to a policyholder would count as "distributions." There would probably be no room left for "undistributed but allocated" underwriting gain. All policyholder dividends in excess of the specified portion would be treated in an integrated manner and the company would have no option. Finally, all undistributed underwriting gain would be taxed to the company at a flat rate.

One remaining issue is the usefulness of giving each policyholder a basis in his policy similar to that of a share of stock. If a policyholder had such a basis, the Carter Commission method could be followed to its logical conclusion by treating the excess of proceeds received on the insured's death over the basis of the policy as income to the policyholder, his estate (if he were the insured), or the beneficiary (the constructive donee of the policy). Following the Carter Commission model, if the policyholder had been taxed over the years on

for policy surrenders, which is that the excess of cash surrender value over premiums paid is taxable income. Any excess of the increase for a given year in a policy's cash surrender value over the premiums paid would then be taxable income. This strategy would make the same error that the existing Code treatment does, for it would in effect allow personal expenses for insurance protection to be offset against interest income.

investment income credited to his reserves and on policyholder dividends not received in the form of cash, his basis would have been adjusted upwards by these amounts. Consequently, any gain on death would be due to (1) past undistributed and unallocated entity income, (2) his dying earlier than predicted, or both. The former source of gain has already been taxed once, and given integration as a goal the entity tax paid on it should now be allowed to the individual taxpayer as a credit. The latter kind of gain would in the aggregate be balanced by roughly comparable individual losses from policyholders who outlive their life expectancies. Consistently treating life insurance policies in a manner similar to the treatment of shares of stock under the Carter Commission method would probably have small revenue consequences as compared to the present exemption-of-death-proceeds rule, and would be administratively costly. Additionally, an individual probably does not purchase a policy expecting to die early and thus cash in his investment which is favorably taxed relative to other investments; therefore the present rule probably leads to little misallocation of resources. The present tax-exempt treatment of proceeds paid upon death might be kept for these reasons. A policy cashed in before death should also produce no tax upon surrender or maturity if the rule of currently taxing all interest earnings is followed. Interest at the company's earnings rate will have been credited and taxed to policyholders on the basis of yearly cash surrender values, so that the cash value upon surrender will merely represent two nontaxable amounts: previously taxed interest earnings, and portions of past premium payments that went into a quasi-savings account. Thus, no basis need be assigned a policy because of the possibility of surrender.

Stock and mutual fire and casualty insurance companies ought to compute their income similarly; the protection against loss account should therefore be abolished. Because the traditional rationale is still valid, small mutual companies may continue to receive favorable tax treatment. On principle, the treatment of the investment and underwriting income of a fire and casualty company ought to be similar to that of life insurance company income, although the greater dominance of the customer role of their policyholders might be given recognition by allowing a greater proportion of underwriting gain to be reduced by policyholder dividends. Excess policyholder dividends would be taxed as outlined above. Any crediting of investment

income to policyholders that is definite enough to count as an allocation could probably be classified as a policyholder dividend.

In practice, a company might find it exceedingly costly to allocate all investment income among many thousands of policyholders who are associated with it for only a short time. To be sure, when a company credits a noncash policyholder dividend to a particular policyholder it has made the allocation, but to require it to withhold a tax on such dividends and to comply with the paperwork duties of a withholding system would be to impose great costs on it. The company could of course be given an incentive to make allocations. Under the Carter Commission method the tax which it pays in the first instance is at or near the highest individual tax rate, so that the allocations to policyholders would amount in effect to giving out tax refunds to those policyholders not in the highest brackets. A company would therefore find it profitable to make the allocations if it could advertise its doing so and get enough new business to recoup its additional paperwork costs. But to say this is not to say that the procedure would be socially desirable.

The ultimate question is not whether individual companies might find it practicable to implement an integration program but whether the social benefits of the program would outweigh the real social costs involved in its implementation. In the case of fire and casualty companies, the costs would appear to be higher than in the case of other intermediaries and, in view of the greater dominance of the customer role played by their policyholders, the benefits less clear. It may be the better part of prudence not to attempt to impose such a program until some estimate can be made of the benefits to be achieved and the costs that will be created.

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Glenn M. Reiter, *Municipal Employee Residency Requirements and Equal Protection*

Charles G. Buschman, *Preserving Scenic Areas: The Adirondack Land Use Program*

Peter R. Jarvis, *In re* Leasing Consultants, Inc.: *The Double Perfection Rule for Security Assignments of True Leases*

Ellen A. Kandoian, *Due Process in the Allocation of Scarce Lifesaving Medical Resources*

Judith A. Miller, *Judicial Review of the Facts in Informal Rulemaking: A Proposed Standard*

Philip C. Bobbitt, Book Review: *Strategies of Abolition*