THE FEDERAL INCOME TAX IN ITS RELATION TO LIFE INSURANCE COMPANIES

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In the debates upon the proposed income tax law which took place in the House of Representatives on the sixth and seventh days of this month (May, 1913) the points most discussed were not, as might have been expected, the advisability of an income tax nor the general scheme of rates and deductions. The one question upon which there seemed to be the most divergence of opinion and which received more attention in the debates than any other was the effect of the law upon mutual life insurance companies. The question is important as there are some 6,000,000 policy-holders in such companies who would be directly affected by any tax upon the corporate income. A large number of petitions, letters and memorials in favor of the entire exemption of mutual life insurance companies were presented. The chief argument advanced in favor of such exemption was that mutual life insurance companies should be placed in the same category as mutual savings banks and fraternal insurance companies which are exempted. The answer to this was that the mutual companies made large profits which should be treated as income and that the corporation tax law, which is now practically merged in the federal income tax law, had provided for a tax on such profits. The contention in favor of total exemption did not appeal to the majority of the House, but there was another question which gave rise to a great deal of animated discussion and is likely to be a subject of controversy when the bill reaches the Senate, viz:

ARE POLICY DIVIDENDS INCOME?

The varying views which arose as to whether the so-called dividends returned to policyholders by mutual life insurance companies should be treated as a deduction from gross income may be classified under three heads:

1st. That such "dividends" should be deducted on the ground that they were simply returns of overcharges.

2nd. That the whole of the dividends paid to policyholders should be included in income, on the ground that they represent profits.

3rd. That so much of the dividends as represented return of premium payment should be deducted; but so much as represented net earnings or profit should be taxed.

The first and second contentions are clearly untenable, as the following analysis of the account with an ordinary policy in a mutual life company will show:

Age 38, 20 Payment Life, $2,500, issued 1904. Gross premium $100.85, Net premium $79.35, Loading $21.50. American Experience Mortality Table with 3% interest. Illustration of Dividend Account at end of 9th year, in 1913.

Dr.

To Loading	$ 21.50
" Mortality, as per table	21.95
" Reserve, 9th terminal	602.08
" Dividend	24.28
	$669.81

Cr.

By Reserve 8th terminal	$526.50
" 9th premium paid	100.85
" Interest on Reserve 3%	18.18
" *Salvage on Loading*	8.89
" *Salvage on Mortality, 24%*	5.28
" *Surplus interest on reserve 1.6%*	9.70
" *Interest on Loading salvage 4.6%*	.41
	$669.81

It will be seen from the above (which is an actual, not an assumed case) that the last four items on the credit side exactly equal the amount of the dividend on the debit side and constitute the elements of which it is composed. If we consider these elements separately it will appear that:

1st. *Salvage on loading* (for expenses) is not earnings or profit, but simply a return of principal or capital. The company, out of abundant caution, required the payment of a larger premium than was necessary, it being understood, however, that if the expenses proved less than had been estimated then the surplus would be returned. This is not income to the company because it is refunded. It is not income to the policyholder because (although wrongly termed a dividend) it is a mere refund of money temporarily advanced by him to the company.

If the *policyholder* were permitted to deduct the amount of premium paid on his life insurance in the first instance as a legitimate business expense, then of course, in the administration of the income tax, it would be necessary to treat this refund as income to *him*. Although it is called a "salvage" it is, strictly speaking, not an amount saved. To illustrate: A man making a trip to New York might provide himself with $100 for traveling expenses and upon his return find that he had spent only $75. It does not follow that he has saved $25. He did not expect to spend $100 and only took the extra $25 to provide for emergencies. In like manner it might be said that the mutual insurance company did not expect to spend the whole amount of the premium required. It "loaded" it enough to provide for any extraordinary expenses which might occur and then returned the amount not used.

2nd. *"Salvage on Mortality"* is not profit or earnings if refunded to the policyholder and should not therefore be treated as income. The insurance companies very wisely provide for a heavier mortality than actually occurs. It is realized that war, pestilence, floods, earthquakes or other far-reaching catastrophies might at any time produce an excessive mortality which the company must be prepared to meet. But when the year has ended and it is found that the number of deaths has actually been less than the mortality tables provide for, then there is a considerable sum of over-paid premium which, in the case of a mutual company, can be safely refunded to the policyholder. The premiums which grant the insured participation in the profits, are always loaded, the "loading" amounting usually to a fixed percentage of the net premium.

3rd. *Surplus interest on reserve.* The "terminal reserve" is defined by the Wisconsin law as the "reserve at the end of the policy year, and is the sum sufficient, with the premiums coming due, to provide for the future expense and mortality charges and mature the policy according to its terms, all computed upon the *expense charges* assumed, the table of *mortality* adopted and the *rate of interest* assumed." The interest required on the reserve in Wisconsin is 3%; but in the case of the policy mentioned above as an example the interest actually earned was 4.6% so that, at this point, we reach something which is clearly earnings, profit, or income and should be taxed as such whether it is retained by the company, or in the case given, is returned to the policyholder. As a matter of convenience it is much simpler and easier to collect the tax on the aggregate sum in the hands of the company than to follow it into the hands of the policyholders. In the policy account given above, moneys which have been paid in by the person insured and used as reserve have earned more than was needed for purposes of insurance and the surplus earning is refunded.

4th. *Interest on loading salvage.* As in the last case above this amount is clearly income. In the example given the policyholder practically loaned the company $8.89 for one year at 4.6 per cent and received the amount back with 41 cents interest.

The example above illustrates the important principle so often overlooked in the discussion of this subject, that capital utilized in insurance may at the same time be employed in the production of wealth. It is often claimed that premiums paid for life insurance are not an investment, but that statement is clearly incorrect in the case of participating policies.

It may be, and usually is true that the primary object of insurance is provision for the future; but this involves certain forms of investment which almost invariably yield more income than is absolutely needed for insurance purposes. In the example given above the policyholder paid a premium of $100.86, of which sum it was found that $14.17 was not needed and it was therefore returned. There were also surplus interest earnings to the amount of $10.11 which were not required and were therefore paid over to the policyholder.

In the case of a stock company with non-participating policies, there would be no refund and the surplus interest earnings would be applied to dividends on the stock and increase of reserves and surplus.

EFFECT OF THE TAX ON THE POLICYHOLDER

It is estimated that the average life insurance policy is for an amount between $2,000 and $2,500, and the example given above refers to a $2,500 policy with earnings perhaps a little greater than the average. The effect of the proposed income tax upon the policyholder would be that the company would be required to pay a one per cent tax on the net earnings, ($10.11) or ten cents, and the amount of loading refunded the next year might be reduced to that extent. It will thus be seen that the burden of the tax, so far as small policyholders are concerned, will not be very heavy.

Considerable confusion has arisen in the public mind as to how the tax on insurance companies is to be assessed and collected. It is suggested that the policyholder who does not have $4,000 of income ought not to be called upon to pay the tax nor to make an affidavit as to his income.

While the law is not quite as clear on this point as might be wished, its general purpose seems to be to treat insurance companies exactly as other corporations are treated. They can deduct from gross income all sums paid as losses, all expenses and all sums necessarily applied to reserves. Upon the net income or earnings a tax of one per cent is levied. It is assumed for the purpose of income taxation that the policyholder in a mutual insurance company stands in the same relation to the company that a stockholder in any ordinary business corporation does to the company in which he holds stock. The question of whether he has an income of $4,000 or not is not raised. The government looks to the corporation for its tax and is not concerned whether the men who compose the company are stockholders or policyholders. That the *policyholder* is not required to make a return of the income derived from dividends would seem quite clear from that portion of paragraph D of the law which reades:

"Persons liable only for the normal income tax shall not be required to make return of the income derived from dividends on the capital stock, *or from the net earnings * * * of insurance companies taxable upon their net income as hereinafter provided.*"

It is precisely *because* the policyholder is not