In the

Supreme Court of the United States

UNITED STATES, Petitioner, v. CONSUMER LIFE INSURANCE COMPANY OF GEORGIA, Respondent,	)	No. 75-1221
FIRST RAILROAD & BANKING COMPANY OF GEORGIA, Petitioner, v. UNITED STATES, Respondent,	)	No. 75-1260
UNITED STATES, Petitioner, v. PENN SECURITY LIFE INSURANCE COMPANY, Respondent.	)	No. 75-1285

Washington, D.C.
December 6, 1976

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Washington, D. C.

Monday, December 6, 1976

The above-entitled matter came on for argument at 10:04 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice
JOHN P. STEVENS, Associate Justice

APPEARANCES:

STUART A. SMITH, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D. C., 20530, for the Petitioner United States.

JOHN B. JONES, JR., ESQ., Covington & Burling, 888 Sixteenth Street, N. W., Washington, D.C., 20006, for the Respondent Penn Security Life Insurance Company.

JAMES R. HARPER, ESQ., Johnson, Harper, Ward & Stanfield, 1526 Fulton National Bank Building, Atlanta, Georgia, 30303, for the Petitioner First Railroad and Banking Company of Georgia.

E. MICHAEL MASINTER, ESQ., Hansell, Post, Brandon & Dorsey, 3300 First National Bank Tower, Atlanta, Georgia, 30303, for the Respondent Consumer Life Insurance Company.

C O N T E N T S

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in Number 75-1221, United States against Consumer Life Insurance Company and the two other cases consolidated with that case.

Mr. Smith.

ORAL ARGUMENT OF STUART A. SMITH, ESQ.

ON BEHALF OF THE PETITIONER

MR. SMITH: Mr. Chief Justice, and may it please the Court:

These three Federal income tax cases are here on writs of certiorari from the United States Court of Claims and the United States Court of Appeals for the Fifth Circuit.

Two cases, Consumer Life and Penn Security, are from the Court of Claims and the First Railroad case is from the Fifth Circuit.

They present a common question: Whether these taxpayer insurance companies meet the definition of a life insurance company under the Internal Revenue Code.

Our tax system provides a marked preference for life insurance companies insofar as it grants them a narrow tax base.

The Court has previously considered the effect of that narrow tax base about ten years ago in the Atlas Life Insurance Company case.

Now, other stock insurance companies, such as those engaged in the sale of non-life insurance, such as cancelable accident and health or casualty insurance, are taxable on their total annual net income as any other corporation.

But life insurance companies have this preference, so it is to their decided advantage to qualify as a life insurance company.

But like most taxpayers -- that is, like most insurance companies, the taxpayers in these cases do not feel exclusively in either life or non-life insurance, but in a combination of those two types of insurance.

The Congress, since 1921, has provided a mathematical test in the statute designed to limit the preferential life insurance company tax treatment to those companies whose predominant business is the assumption of life insurance risks.

It is done so by -- in Section 801(a) of the Internal Revenue Code which represents, essentially, the same statute that has existed for some fifty-five years. Essentially, the statute provides that reserves are the appropriate measuring rod for determining whether an insurance company is a life insurance company.

The statute provides a fraction, the numerator of which is life insurance reserves, for purposes of this case, and the denominator of which is total reserves.

In order to be a life insurance company, to qualify for this preferential treatment, that fraction has to be more than 50%, so that your life insurance reserves have to be more than one-half of your total reserves.

QUESTION: That could be a matter of statutory definition of whatever the life insurance --

MR. SMITH: Exactly.

QUESTION: Basically, a life insurance company is an insurance company that -- more than half of whose business is life insurance measured by its reserves.

MR. SMITH: That is correct, Mr. Justice Stewart.

QUESTION: Is that it?

MR. SMITH: Now, the question in this case, in these cases, that is, focuses on the quantity of the denominator in the fraction, that is, total reserves.

These cases present the question as to whether certain cancelable accident and health insurance reserves, which are reserves on what is undisputably non-life business, are includable in these taxpayers' total reserves.

It is also undisputed that if it is includable -- these health and accident reserves are includable, as we submit -- these taxpayers fail to qualify as life insurance companies. If they are excluded, as the Court of Claims held and as the taxpayers submit, then they do qualify.

The case focuses on the effect of two different types of transactions which are presented in combination in all three cases.

For purposes of convenience, we have referred in our brief to these transactions as Treaty I and Treaty II. This is the nomenclature of the Consumer Life Insurance Company case which presents both of those types of reinsurance transactions.

Consumer, as I said, presents both kinds of transactions. Penn Security presents a Treaty I type arrangement and the First Railroad case presents only a Treaty II type arrangement.

We submit that the facts demonstrate with abundant clarity that the accident and health insurance business was attributable to the taxpayers so that the accident and health insurance reserves are includable in the total reserves of these taxpayers, so that their denominator is increased and the fraction falls below fifty percent.

The end result of our submission is that the Court of Claims was incorrect in holding that these companies qualify as life insurance companies and the Fifth Circuit was correct in holding that the taxpayer in that case did not qualify.

I think it probably would -- instead of stating the facts of each case, seriatim, since they are essentially similar, it probably would be helpful to put the facts before the Court in terms of the Treaty I and Treaty II generic type transactions, because, as I said, the arrangements in all three cases are essentially the same.

In the Treaty I type transaction, the taxpayer insurance companies, that is, Consumer Life and Penn Security, are subsidiaries of corporations engaged in the consumer loan business.

This accident and health insurance that we are involved with here is credit accident and health insurance because when these people borrow money from a consumer loan business they generally are encouraged by life insurance and accident and health insurance.

QUESTION: May I interrupt?

There is no question here about the term life insurance that a borrower takes out.

MR. SMITH: No, Justice Stewart. I think that was resolved in the Alinco case but that is life insurance and we are not disputing the correctness of that decision of the Court of Claims.

QUESTION: This is also term accident and health insurance, single premium, isn't it?

MR. SMITH: Exactly. That's what is involved here.

When the borrower, let us say, borrows $1,000, he is encouraged to purchase a life insurance contract which will pay off the outstanding loan balance. So it is decreasing term life insurance in the event he should die, or in the event that he should become disabled, the insurance is designed to continue to pay the loan payments during the period of his disability.

It is a single premium, as Mr. Justice Stewart indicated, that is paid in advance.

In most states, finance companies are prohibited to issue such credit life insurance. So, prior to the Treaty I type arrangements in these cases, the consumer finance companies essentially acted as sales agents for independent insurance companies. Usually they received a commission, which is a substantial commission, usually in the neighborhood of about 50%.

The Treaty I type arrangements were organized by the Consumer Finance Companies. They organized these taxpayer insurance companies as subsidiaries in order to command a larger percentage of the profits from this credit insurance business.

As the facts in Consumer Life Insurance indicate, at first, these newly formed insurance companies, these subsidiaries -- and in the case of Consumer Life it was the Consumer Life Company -- did not have sufficient capital to act as a direct insurer under the state law, under the state of the, you know, of the -- of incorporation of the Consumer Finance Company. So what it did was they acted as reinsurers rather than direct insurers.

Under Treaty I, the way the transaction worked was as follows: The independent insurance company issued the policy to the borrower and collected the premiums in full just as it had previously done before the taxpayer insurance company was organized.

The taxpayer, by contract, by reinsurance contract, which in the parlance of the industry is called a treaty, agreed to reinsure the risk and agreed to reimburse the independent insurer for all losses -- and I'm quoting -- "actually paid on both life policies and health and accident policies."

So, for purposes of this case, Consumer Life, that is, that's really one type case, there really is no dispute between the parties, although Consumer Life has argued to the contrary. But there really is no dispute that under the Treaty I type arrangement these taxpayer subsidiary insurance companies assume the entire insurance risk for this coverage, because they, by contract, agree to reimburse the independent insurer for all claims paid.

Penn Security doesn't contend to the contrary and Consumer Life, while they do dispute this assumption of risk, the Court of Claims found that they freely conceded that they assumed the risk below, and, as we point out in our brief, I don't think there really is any question that they did so concede and that they have assumed the risk by contract.

In exchange for the assumption of this risk under the Treaty I reinsurance arrangement, the taxpayers, Consumer Life and Penn Security, received substantial percentages of the commissions, much more substantial than they had, you know, when they were just -- when the taxpayers didn't exist and the finance companies were dealing with independent insurance companies.

In Consumer, the percentage was 90.5% of premiums and in Penn Security, it was 98% of premiums.

Under the Treaty I arrangement, the independent company, as I said, collected premiums in full. It also paid all claims under the policy, as any direct insurer would.

Each month, the independent company remitted to the taxpayer insurance companies their full share of the life insurance premiums that had been paid by the borrowers. But with respect to the accident and health insurance premiums, the independent company remitted these taxpayers only that portion of the premiums that was ratably allocable to the prior month's coverage.

So, for example, assume a $120 accident and health single premium that the borrower pays. That would mean, essentially, that the independent company would hold that $120 until the end of January and then on February 1st, or shortly thereafter, would pay over $10 a month in February which was allocable to January's coverage, and so forth.

In March, it would pay over another $10 which was allocable to February's coverage.

QUESTION: The way you describe it, the initial, or sometimes it is referred to as the direct insurer, it is essentially like a general agent in the field who receives a commission for initiating the business, whereas, the risk taking is by the reinsurer.

MR. SMITH: Essentially, that is our submission, Mr. Chief Justice, that, for purposes of Treaty I, the independent insurer is really nothing more than a commission agent because when the smoke cleared it only held its 9½% of premiums. Everything -- you know, it paid the claims out of this fund that was about to drop down, and essentially that the taxpayers agreed by contract to assume the risk and everything that was left over, less its commission, was paid over back to these taxpayer insurance companies.

QUESTION: Mr. Smith, you argued Foster Lumber here a few weeks ago, didn't you? And you prevailed by a narrowly divided vote over a strong dissent. It struck me there that the Government position was that we read the statute as written and don't make any allowance for equities or substance, or that sort of thing.

But here, it seems to me, the Government is talking out of the other side of its mouth and saying, in effect, while we can't read it quite the way its written, we've got to make sure that substance rather than form prevails.

MR. SMITH: I don't think so, Mr. Justice Rehnquist. The reason I don't think so is because I think that the statutory term, as I will develop at greater length in a few minutes, the statutory term "unearned premiums" in Section 801 C(2) does not, as the Court of Claims held, and these taxpayers submit, although I must say they submit it with varying degrees of differences among themselves.

We claim that the term "unearned premiums" refers to unearned premium reserves and not premium dollars and that the literal words of the statute, we think, support our submission here that the unearned premium reserves are attributable to these taxpayer insurance companies which were on the risk of this insurance.

I don't think that the positions in the two cases are inconsistent.

QUESTION: Would you have to take that position in view of your position in Foster Lumber?

MR. SMITH: Well, we try to be consistent, Mr. Justice Blackmun.

QUESTION: The Internal Revenue Service hasn't prided itself on consistency in the past --

(laughter)

QUESTION: -- and has conceded in briefs and in this Court. We are not being critical. A case is a case.

MR. SMITH: Surely, we would be consistent within a single term of this Court.

(laughter)

QUESTION: But you do consistently try to collect taxes.

MR. SMITH: Absolutely.

QUESTION: To follow up what Justice Rehnquist said, you would read the words "unearned premium" in the statute as saying unearned premium reserve. Is that right?

MR. SMITH: That is correct.

QUESTION: And you acknowledge the unearned premiums are in a different place than the unearned premium reserve.

MR. SMITH: The unearned premium dollars are in a different place.

QUESTION: But you say unearned premium --

MR. SMITH: I think, as we point out in our brief, and I'll be happy to go into it at greater length during my argument, I think that the words "unearned premiums" in the statute necessarily refer to unearned premium reserves. They can't refer to dollars. It just doesn't make any sense for the qualification of life insurance to turn on where particular dollars are located in an economy like ours where everything is put in terms of intangible bank claims. You know, claims on time deposits, or whatever.

I mean the physical location of the money, I don't think, makes any difference.

QUESTION: I think Congress omitted a word it is perfectly clear it intended to include. The word was --

MR. SMITH: I think I saw -- I think the structure, as I will point out --

QUESTION: Then you are, to a certain extent, asking us to change the language of the statute.

MR. SMITH: I am not asking you to change the language of the statute. I am asking you to be construe -- to be consistent with what I think is the appropriate --

QUESTION: Equitable way.

MR. SMITH: I think it is the correct way.

I'd like to turn now to a description of Treaty II before I go into our argument.

Under Treaty II, the roles of the taxpayer insurance companies and the independent company --

QUESTION: Let me just cover one other thing with you before you get into Treaty II.

In response to the Chief Justice, you said that the insurance company, the independent insurance company, is in the nature of a general agent performing a bookkeeping function. But isn't it correct that had they been merely a bookkeeper the reinsurer couldn't have qualified for the insurance coverage. Weren't they --

MR. SMITH: They had the status of a direct insurer, in that sense, yes. I think for state purposes they were a direct insurer, but I think that the substance of the arrangement was simply that they weren't insuring anything.

QUESTION: But did they not, by qualifying as an insurance company, provide something to the transaction which a general agent or a bookkeeper --

MR. SMITH: I think that's right.

QUESTION: -- If that were not true, they would not have been in the picture at all.

MR. SMITH: I think that's right. But, essentially, I would suggest that if the -- to use the analogy I used a few moments ago, had an insurance company taken unearned A&H, accident and health premiums, and put them in a time deposit in a bank and was not permitted to withdraw them except at stated intervals, I don't think anybody would say that the bank had the reserves on the insurance company.

I mean, essentially, I think that the function of this insurance company, this direct insurer, under the Treaty I arrangement, was little more than that. The functions it performed --

QUESTION: Mr. Smith, is that quite fair, because isn't the purpose of the state law to be sure that a company of a certain capital structure is able to assume the risks that all the policy holders rely on when they take out their insurance?

And isn't it performing a function in the whole risk-taking picture that is essential for a large company to perform?

MR. SMITH: I suppose it was performing a function under state law because, in this particular case, for example, in Consumer Life, Georgia had minimum capitalization requirements.

QUESTION: The purpose of those requirements is to be sure there is a company there with sufficient substance to assume these risks.

MR. SMITH: That's right. But I think it is common knowledge what happened in this case was that they shopped around for the minimum capitalization state, which was Arizona, and they set up this reinsurer.

I think, as a practical matter, the reinsurer contracted to take, you know, to bear the risk and it did bear the risk. And there really wasn't any way that the direct insurer was going to lose anything. You know, it was going to perform these functions which were --

QUESTION: In a way which would not have satisfied state law requirements without this other company in the picture.

MR. SMITH: That's right. Because the state law requirements of Georgia would insist that a company issuing insurance in Georgia have a, you know, a minimum capitalization.

And that was the direct insurer.

But we don't think that should make any difference for purposes of qualification for tax purposes.

QUESTION: The only purpose in my questioning was to test the importance of your point that they are nothing more than a bookkeeper. They also performed an essential function as a matter of state law, the independent company did.

MR. SMITH: I think that's right.

Now, to describe, briefly, what happened under the Treaty II arrangement, the roles of the taxpayer and the independent company were purportedly reversed. So the taxpayer becomes the direct insurer and the independent company, under this contract, is characterized as a reinsurer.

In the Consumer Life case, 80% of the accident and health business was purportedly reinsured with the independent company and in First Railroad it was 60% and then 70%.

Well, what kind of reinsurance really was this arrangement? The way it worked was the taxpayer paid these quarterly accident and health premiums to the independent insurer, keeping back a tentative commission of 50%.

The independent company then paid a quarterly rebate, or called it an experienced refund, and that rebate is equal to the premiums, less the 50% tentative commission, which had already been received, less a 3 or 4% commission -- well, 3% in Consumer Life -- and then less all claims paid.

And if the sum of these three things exceeded the losses under the insurance -- losses for the payment of insurance claims -- then those losses would be carried forward and the independent company would be able to charge it against the next quarter's experienced refund.

Now, in point of fact, in the Consumer case, the loss experienced was something like 18% of premiums paid, so there really was no way that the independent company was going to get more than its 3% commission or get less than its 3% commission.

In fact, in the Consumer Life case, the trial judge found, in the Court of Claims, that the likelihood that the loss experience would run so high that the 3% commission would be jeopardized was so remote as to be neglible, and that the parties knew this to be the fact.

QUESTION: Let me just interject here because I want to be sure you cover it.

What is -- Your conception of the independent company in Treaty I situation is kind of a bookkeeping function.

MR. SMITH: Yes.

QUESTION: In Treaty II, what is your conception of the contribution to the total arrangement which the independent company made?

MR. SMITH: It is also a bookkeeping function.

QUESTION: Well, why did they need them at all, if you are correct?

MR. SMITH: Why did they need them at all?

They needed them because -- What happened was after Consumer Life reached the maximum capitalization, it needed them because it could earn more profit, essentially.

QUESTION: Then if there were no reinsurance arrangement at all, why wouldn't they just completely cancel the reinsurance arrangement? If there really is no risk if they have to reinsure again. Why wouldn't they make more money by just taking them out of the picture completely.

MR. SMITH: I presume they could have done that, but --

QUESTION: You must have a theory as to why they didn't.

MR. SMITH: The theory has to be, essentially, that they did this in order to qualify as a life insurance company. Because if they issued this A&H insurance directly then there would be no question -- nobody would be here arguing -- that the reserves were not attributable to these taxpayers. And they would flunk the 50% test.

So they needed them, essentially, to say, "Well, look, we've put our A&H reserves somewhere else and we don't have them any more, so, therefore, we are a life insurance company."

QUESTION: That would explain why they would reinsure the A&H, but why would they reinsure the life?

MR. SMITH: They didn't.

QUESTION: They did not reinsure the life at all?

MR. SMITH: No.

QUESTION: The whole purpose of it is to qualify --

MR. SMITH: Right. In fact, what happened was, you know, in the Treaty I arrangement, they paid the life insurance premiums to the taxpayers right away. There was no delayed timing of that payment, because for their purposes they wanted to increase their life insurance reserves to qualify under the fraction.

QUESTION: One legitimate purpose of any business is the avoidance of taxes, isn't it?

MR. SMITH: Absolutely, Mr. Justice Rehnquist, I would not quarrel with that proposition, but I think that a transaction has to have some independent substance. And here, where you have a situation where these premiums are just being held back and paid on a monthly dribble -- I mean, that's really the only way to describe it -- I think that it sort of blinks at reality to say that this A&H business was not the taxpayers' business. Because they ran the risk, they got all the profits from it. There was no way that the other company could lose and the other company was not really insuring anything.

I mean, it was performing a function, but it was performing a function in the one case to qualify under state, you know, to qualify these transactions for state purposes.

In the other case, it was simply a bald-face attempt to qualify as a life insurance company under the statutory fractional formula.

In respect to the Treaty II arrangement, the Fifth Circuit correctly held, in our view, that there was no substance to this agreement as reinsurance and it was, essentially, the other company was simply earning a commission and doing a small set of tasks, receiving the payment, paying out the claim and getting no more than 3% and getting no less than 3%.

We agree that we don't think that's insurance.

Now, the proposition that we urge in these cases is a very simple one.

It is that for purposes of the Section 801(a) reserve ratio test, insurance reserves must follow the insurance risk, since, as I think is abundantly clear from the description of the facts, the taxpayers bore this accident and health insurance risk under both the Treaty I and Treaty II type arrangements, the accident and health insurance reserves are includable in their total reserve, that is the denominator of the statutory fraction, and they do not qualify as a life insurance company.

Now, we think the proposition that reserves must follow the risk can be demonstrated in three different ways.

First, we think the rule comports with the fundamental characteristics of insurance and the essential nature of what an insurance reserve is.

Second, we think that the language of the reserve ratio test of Section 801(a) and (c) supports our submission that reserves follow the risk.

And finally, we submit that the legislative history of the reserve ratio test, which dates back to 1921, supports our submission that the insurance reserves must follow the insurance risk.

With respect to the first point, I think it is fairly undisputed and this Court so recognized it about forty years ago in the LaGerce case, that the essense of insurance is risk shifting, and the essential characteristic of reinsurance is the transfer of risk from one company to another.

QUESTION: What would be your view, Mr. Smith, on a contract of risk-sharing, where, hypothetically, half of the risk was reinsured?

MR. SMITH: Well, then, I suppose half the reserves would be allocable to one and half to the other. But in this case, the risk was borne completely, Mr. Chief Justice, by the taxpayers.

QUESTION: But then the initial insurer, concerning which I inquired before, would be something more than a general agent, wouldn't he?

MR. SMITH: That's correct. To the extent that they bear the risk, reserves corresponding to that risk ought to be included in their total reserve.

When they don't bear any risk at all, as we submit these independent companies did, in these two different kinds of arrangements, I don't think that they ought to have those reserves chargeable to its -- to their total reserves.

QUESTION: Did you say that the reinsuring company would pay the claim? I think you did, under type II.

MR. SMITH: Under Type II, the way it seems to have worked, although the record is not entirely clear, the independent company paid the claim.

QUESTION: By independent, you mean the company that issued the policy?

MR. SMITH: Yes. In the Treaty II arrangement, the independent company is the purported reinsurer, although we would say it's not really a reinsurer at all.

But the company that was called the reinsurer under the Treaty II type arrangement, that is, the non-taxpayer would pay the claims. Essentially, what would happen is, you know, the taxpayer would issue the policy and --

QUESTION: The taxpayer is the company that qualifies as an insurance company.

MR. SMITH: Right. These taxpayers, here, whose qualification is at issue. They would issue the insurance policy and then pay out the premiums on a quarterly basis, but take back a tentative 50% commission. And then the independent company would pay out all the claims out of the remainder.

QUESTION: You put me off a bit when you say independent.

Could we speak in terms of the insurer and the reinsurer?

MR. SMITH: We could, Mr. Justice Powell, but my only hesitance to adopt that nomenclature is that we don't think that the Treaty II arrangement was reinsurance.

QUESTION: Well, your not going to influence --

QUESTION: Taxpayer.

MR. SMITH: Okay. Yes, the taxpayer and the other company.

QUESTION: What is the other company, the reinsurer?

MR. SMITH: The other company is called the reinsurer.

QUESTION: We are not going to decide the case on the basis of your nomenclature.

MR. SMITH: Exactly. Okay. The reinsurer paid out the claims.

QUESTION: The reinsurer pays out the claim. And how is it reimbursed by the insurance company?

MR. SMITH: It is reimbursed out of, essentially, it is reimbursed out of the claim -- out of the -- it reimburses itself. How is it reimbursed? It is reimbursed -- it pays these claims out of the premium dollars it has and then it pays back to the taxpayer what's left over. And if there should ever be any excess of losses over money left over which is, in these cases, almost impossible,and the parties apparently knew this to be the fact so the trial court in the Court of Claims found, then the taxpayer would pay it back out of the next quarter's premium dollars.

QUESTION: So, in that situation, the reimbursement would be delayed?

MR. SMITH: Yes. But, essentially, you know, there was no way that the independent company or, quote, "reinsurer," quote, could lose under the arrangement. It wasn't going to get more than 3% and it wasn't going to get less than 3%.

QUESTION: In the event of that delay, would interest be paid?

MR. SMITH: I don't know, but I would suggest that that simply -- that could be arranged between the parties in a way that -- it's just another bargaining point.

QUESTION: You regard the whole thing as a sham, as your brief states.

MR. SMITH: I think that's right. I mean it is not reinsurance.

QUESTION: Right. But is it also a sham where there is no parent subsidiary relationship and this is a contract of reinsurance negotiated at arm's length?

MR. SMITH: When I use the word "sham," one tends to think, you know, that there is no substance and that there is sort of a tax avoidance motive, which I think is the case here, but I don't think it would matter whether it was negotiated at arm's length because we examine the figures and when you strip away all the technicality -- you know, all the contract provisions -- I think, for tax purposes, this was not -- reinsurance.

QUESTION: May I ask this question?

If it is a sham, what would be the business reason for an independent reinsurer to enter into a sham arrangement, just to be nice?

MR. SMITH: Earn a 3% commission, for doing a relatively small amount of work.

When we say sham, I don't want to -- I don't think that you have to go that far and knock out the agreement as some sort of sham. I think that, essentially, when we are talking about reinsurance, at page -- the Examiner's Handbook which was introduced in evidence in the First Railroad case -- at page 211 of that Appendix it defines reinsurance. It says, "The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the seeding insurer, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element, no credit whatsoever shall be allowed," etcetera, etcetera.

You know the insurance industry wouldn't recognize this as reinsurance and we don't think it is reinsurance. Insurance is taking on a risk. Reinsurance is transferring of a risk. There was no risk transferred in the Treaty II type arrangement.

QUESTION: But the state agencies do recognize it as reinsurance.

MR. SMITH: The state agency recognized it, but we don't think that really matters for purposes of Section 801(c)(2), as I think we pointed out in our reply brief. The regulations there say whatever is regarded -- whatever might be the case under local law. But the point of the matter is that the state agencies really approached this thing from an entirely different point of view.

Whether you believe they were smart people or not smart people, their essential purpose was to make sure that some company was solvent and that the policy holder was not going to lose. They weren't interested in --

QUESTION: On that very point, Mr. Smith, supposing in the Treaty II situation, the taxpayer became insolvent. That's, I suppose, theoretically possible, although, as you say, in the fact of the matter, it is unlikely to happen.

In that event, the risk would fall squarely on the reinsurer, would it not?

MR. SMITH: That is correct. And that is the only case --

QUESTION: Isn't there a second case? Supposing you had a very serious epidemic and an unpredictable number of claims accrued that were far above what anybody anticipated. Is it not possible that the reinsurer would assume that risk?

MR. SMITH: That is also correct.

QUESTION: So there are two risks that the reinsurer assumes that are both very unlikely but yet are risks --

MR. SMITH: I think that the case has to be examined in terms of what is likely. We are talking about claims of 18% or 22%.

QUESTION: So we look at the likelihood and probability rather than the literal language of the contracts and statute.

MR. SMITH: Yes. I think that is right.

I want to talk a little bit about what a reserve is, simply because I think that's critical to what this case is all about. An insurance reserve is not, as I think the Court of Claims held, and as one of the taxpayers here argues and the other taxpayers argue in sort of slight variation -- it is not anything one keeps in one's pocket. It is not an asset. It is simply a projected liability for, you know, a kind of unaccrued liability, for an event that might occur in the future and which an insurance company, basically, has to bear in mind.

QUESTION: Is the reserve -- A reserve is a liability. Does the balance sheet require that there be an offsetting asset for that liability?

MR. SMITH: I don't think so.

The way to look at this case is to say if an insurance company assumes a risk and has to know the reserve for this -- Let us say, it buys stock at $100 and the stock goes down to zero, and it has made a bad investment. Nobody would say that its reserves are depleted. It still has a reserve of $100. It just will have to use other assets to cover that reserve, but it still has a reserve.

The reserve is keyed to the liability, to the risk an insurance company assumes under a policy. There really is no matching principle, as such, when we talk about that the premium dollars have to follow the reserve. Essentially, what we are talking about is when the liability is assumed to the policyholder, that triggers the creation of the reserve.

And the fact that these premium dollars happen to be in another pocket, so to speak, you know, for a delayed reaction of about a month or so, shouldn't make a difference in this case, because it is not really physical location of an asset, because a reserve is not anything physical that you can sort of grab onto it. An insurance company doesn't segregate assets and say, "These are our reserve funds." There is no such thing as a reserve fund, as such. The reserve is the projected liability.

QUESTION: In the case of health and accident insurance, do you also have a reserve, the unearned premium, as distinguished from the reserve representing the risk on the claim?

MR. SMITH: Mr. Justice Powell, in health and accident insurance, there is no accepted table, the way there is in life insurance, to measure the risk.

As a result, the insurance parlance is to the effect that the unearned premiums equal the reserve, mathematically.

QUESTION: Is that the way it's recorded on the books?

MR. SMITH: That's the way it would be recorded on the books. But that doesn't mean, as I think we point out in our brief in greater detail, that the unearned premium dollars are the reserve. The reserve represents this projected liability to the policyholders.

QUESTION: To take your $120 example, you start out putting $120, if you had the entire right to the premium, on the reserve side of your balance sheet as a liability. Would you?

MR. SMITH: It is not really a balance sheet asset like a liability, but it would go in summary of operations, yes.

QUESTION: Well, a reserve is on the liability side of the balance sheet.

MR. SMITH: Yes, that's right.

QUESTION: And, at the end of the first month, that reserve would be reduced by one-twelfth.

MR. SMITH: That's right.

QUESTION: Now, that would be taken into income at that point, the one-twelfth of the premium.

MR. SMITH: Well, it would be sort of unrestricted, I suppose. You know, in that sense.

QUESTION: But it would be income --

MR. SMITH: Yes.

QUESTION: -- on which the taxpayer would pay a tax. Do you put anything on the asset side of the balance sheet to reflect the fact that you have earned one-twelfth of the premium?

MR. SMITH: I don't think so. The assets have always existed. It's just one insurance company and doesn't have any more assets.

QUESTION: Do you put a claim --

MR. SMITH: It has essentially reduced your liability.

QUESTION: What do you put on the asset side of the balance sheet at the beginning, $120?

MR. SMITH: At the beginning, I suppose it would be -- it would be put in as an asset of premiums received, I suppose. And then --

QUESTION: Before it is collected?

MR. SMITH: I see your point. Well, I think, as we point out in our brief, standard general accounting treatment for this kind of transaction is that it is an asset. It's, you know, the texts refer to it as funds held by seeding insurer or reinsurer, so to speak. So it is an asset. I don't really think there has to be this matching.

QUESTION: Carry on, Mr. Smith. I was just trying to visualize the balance sheet transactions indicated by what you are talking about, but I don't know that that is necessarily --

MR. SMITH: Yes. I think our essential point here is that the -- and I want to save the remaining time for rebuttal -- is that the unearned premiums referred to in the statute does not refer to the physical dollars, but refers to the reserve. And the reserve has to be attributable to the company that assumes the risk because the reserve represents this projected liability.

Since I think it is plain and it really can't be seriously disputed that these companies -- these taxpayer companies -- were all on the risk, I think that it is their business and I think that their insurance business necessarily has to be put in the denominator of total reserves.

QUESTION: What you ask us is to make two changes in the statute: One we add the word "reserve" to the word "premium," and then we attribute the reserve to the insurer.

MR. SMITH: I don't think those are changes in the statute, Mr. Justice --

QUESTION: Well, additions to the language that Congress --

MR. SMITH: I think when you look at the structure of the statute, it talks about, you know, there are three kinds of reserves: one, life insurance reserves, two, unearned premiums and unpaid losses not included in life insurance reserves, and three, all other insurance reserves required by law.

The first thing you notice is that one and three are plainly reserves. Unpaid losses, not included in life insurance reserves, also strike one as a reserve and, in fact it is a reserve. Unearned premiums, the insurance texts all refer to it as a reserve. I mean, it is a shorthand expression for a reserve.

I think that the calculation of accident and health insurance, casualty insurance, is put in terms of unearned premiums, and it's either unearned premiums or unearned premiums are reserves.

I don't think that, you know, Congress had to add that word "reserve." I think they were writing a statute for a very sophisticated industry that knew what it wanted and wanted to measure this, you know, make this qualification on the basis of reserves. I don't think these companies make it because they bore this risk under this casualty insurance. That's not life insurance and they flunked the 50% test.

QUESTION: Mr. Smith, I do want to ask one other question because, under your theory, the unearned premium reserves on the accident and health business remains with the taxpayer because it ultimately takes the risk, as you analyze it, whereas, the unearned premium dollars would be with the re-insurer, in the Treaty II situation.

Would you say that there is an unearned premium reserve matching the unearned premium dollars in the reinsurer as well as in the taxpayer? In other words, is the reserve in two places at once?

MR. SMITH: It possibly could be. For state-county purposes --

QUESTION: No, no. For Federal tax purposes, assuming that the reinsurer was also a company --

MR. SMITH: No. The Internal Revenue would never put a reserve in both places. It would either be in one or the other and we say it is with the taxpayer.

QUESTION: Even if it was the difference between qualifying as a life company for the reinsurer?

MR. SMITH: I think that we -- You know, our rule that the reserves follow the risk -- We would, obviously, you know, possibly, lose some cases under this rule. We would not inconsistently put reserves in a place where the risk was just to disqualify a company.

QUESTION: But the fact that you say the risk is in the taxpayer does not necessarily negate the possibility that it is also in the reinsurer.

MR. SMITH: There may be slight risk, as you pointed out, with insolvency, and so forth and so on, but that's a negligible risk and we don't require attribution of the reserve.

QUESTION: What if the risk were just a little more probable in the other company? There is a legal risk under the terms of the contract and they also have the premium dollars. Would that ever require them to be considered also have --

MR. SMITH: That could be sort of, you know, there is a type of reinsurance known as excess loss reinsurance which probably could be calculated. There might be a small fraction of a reserve left for the other side, you know, with the independent companies, for tax purposes.

But I think when we are talking about what happened in the Treaty II case, the risk was negligible and I think the reserve belongs to the company that realistically bore the risk, here the taxpayers, and they have to include that in their total reserve.

QUESTION: So the issue really turns on a kind of finding of fact as to which company, realistically, takes the greater share of the risk --

MR. SMITH: And we think in both cases --

QUESTION: -- rather than the terms of the contract.

MR. SMITH: And we think in both cases, First Railroad and Consumer, the findings of fact, you know, even the District Court in First Railroad which held against the Government, acknowledged that it was almost remote and negligible that the other company bore any risk.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Jones.

ORAL ARGUMENT OF JOHN B. JONES, JR., ESQ.

FOR THE RESPONDENT

MR. JONES: Mr. Chief Justice, and may it please the Court:

I am counsel for Penn Security in No. 1285.

Just to remind the Court, our case presents solely a Treaty I situation, because I think must of what Mr. Smith has just said has no bearing on a Treaty I situation.

I will be followed by Mr. Harper for the First Railroad. He will be representing a taxpayer with a Treaty II situation. Mr. Masinter will conclude and his case includes both the Treaty I and the Treaty II issues.

I am sure the Court is aware, from its questions, what the statutory test says and that Penn Security meets the statutory test in terms of reserves which it has on its books and which it reports to state authorities and which they have approved.

I think it is also -- I've heard nothing suggested by the Government that there is any way you can read the Code or the regulation which would suggest to you that some other reserves may be attributed.

Rather, as I see, the reserves follow the risk test which has been expounded here this morning, it is sort of a touchstone which is offered by the Government to better carry out the statutory purpose. And the argument is really whether that new touchstone test can be reconciled with the statute and the regulations.

QUESTION: In your situation, Penn Security, is there any privity between the insured person, policyholder and the beneficiary, on the one hand, and the reinsurer?

MR. JONES: No.

QUESTION: The privity is between the initial insurer and the insured and stops there.

MR. JONES: That is correct.

Of course, the initial insurer is also not related to the reinsurer, in our case. No relationship between them at all. It is an outside company.

We feel that applying this test to Penn Security shows that it is a very unwise grasp on the statute. Penn Security which meets the statutory reserve test, actually reinsures more life risks than accident and health risks. That arises because they never sell accident and health without life. They sometimes sell life without accident and health.

In terms of what it cost them to carry the insurance, we have findings in our case that it requires the company, in order to meet the claims under the policies, it will cost them more to meet their life claims than to meet their accident and health claims.

Penn Security has no interest in the reserve funds which are held by this independent outside insurer. There is no way in the world that you can use the word "shifting" in talking about the reserves applied to this Treaty I situation. Those funds come in from the policyholders to the direct insurer and the question is on accident and health insurance when they come over to the direct insurance company.

In fact, the eccentricities of the Government rule are shown here by the fact that we do qualify for 1965, no matter what this Court says here.

Indeed, we have some arguments which are in our brief, that maybe I'll get to, which show why, even if they attribute here, we'd still qualify as a life insurance company.

And we don't think that fifteen years after the event this kind of game should be played with somebody who is in clear compliance with the statute.

Perhaps, if this had been adopted as a regulation at an earlier date, a case could be made for it.

Now, the Government does not, despite the use of the word "sham" earlier, does not have any element of sham in our reinsurance agreement. This is an outside company which reinsures and, indeed, if they sham, we are not in the case and we don't get the income. It is only the reinsurance which gets it in the income.

The Government makes much of the point that under this reinsurance agreement all of the risk shifts to Penn Security. But that, I suppose, is always true -- Excuse me, that is not always true, but the normal pattern of reinsurance, an insurance company would like to get rid of all risk under a policy. It is quite natural that if it reinsures, it will be taken off the policies entirely. It does not want to have the residual risk of the catastrophe which was mentioned here earlier.

Reinsurance has been around a long time. These arguments the Government now proposes would throw a great monkey wrench into the reinsurance business, if every time you reinsured 100%, you had to talk about shifting the reserves.

We submit and we think one of the key elements that tells the Government that it's really trying to make new law here is this Revenue Ruling 7508. That's a life insurance case and it isn't directly involved here, but you will see there that where the direct insurer actually paid over the income on the retaining funds to the reinsurer -- so it is a stronger case. It is sort of like Economy Finance -- Where it did that, they still did not require attribution of the reserves there. And, as we pointed out in our brief, there is a regulation which would have given them license to.

We think this is an ad hoc argument to try, as a last gaff, to get at these credit life insurance companies.

The terms of the reinsurance treaties -- at least in this Treaty I situation -- are an arm's length deal between the reinsuring company and the direct insurer. The direct insurer has to make terms that will let him keep in the business by paying the right amount to the reinsurer. If he gets too greedy, then they will go somewhere else. So there is free bargaining.

I don't believe there can be suggested any reason why, once you go into this reinsurance business, you should not be allowed to cast it in terms which qualify you for the taxation which Congress has specified for life insurance companies.

As Mr. Smith stated earlier, it is not argued here that somehow Credit Life doesn't fit within the 1959 statute and that is settled by the Alinco case and by the Superior Life case in the lower court.

Some focus is made, and rightly so, on the manner in which the premiums of accident and health are paid. They are done on an as-earned basis, while life is done on a -- paid over directly.

This is a term reached by the party. It has several effects. One which will be discussed more by my following counsel is what that does on the ability of the insuring company to sell more insurance.

It is important to them to have their reserves adjusted, as has always been the case, on the handling of reinsurance.

There is a tax impact and that is what brings us here. But between the parties, this is perhaps the most important term of the deal. If you look at the accident and health insurance, and you can work this out on paper and pencil, if you have A&H policies that last three years, and you get your premium in advance from the insured and you keep that money and you only have to pay it out -- one-thirty-sixth for each month -- you will find that the calculation builds up a fund one and one-half times the annual premium rate.

That one and one-half times the annual premium rate belongs to the direct insurer and he can invest that, and if his rate of investment is, say, 5%, you will see that 5% on one and one-half times the annual rate is a great deal more than 2% commission which appears on the face of the contract.

So, I submit to the Court that this provision for retaining the reserves on accident and health is one of the most important provisions between the parties. It has tremendous economic substance and could certainly not be disregarded under any standards that we have seen in the past.

Our position is that this reserve follows the risk has no authority under the statute. It is to be contrasted with Section 482 which does give the Commissioner license to do that. We think it runs to the extent the Code speaks at all on the subject of attribution of reserves. It goes the other way in Section 820. It is not involved here, but it seems a little odd that if the rule were, as the Government claims here, that the reserves follow the risk, that Section 820 would be written just the way it is.

We find that the Government's attempt here runs afoul of four regulations requirements. One, that the premium -- in order to create an unearned premium reserve, the premiums must be paid in advance. That's one of the requirements. The second is that it must be actually held. The third has to do -- there are two aspects to it -- with being required by state law. And finally, whether if you do go to an attribution of this, you really want to use the gross A&H premium.

Now, in terms of paid in advance, we don't have any dispute that that language in the regulations applies.

The Government suggests in its reply brief that this is satisfied as to Penn Security by the fact that the insured paid their premiums in advance to the direct insurer.

Well, I think that is an extraordinary stretching of language.

Those premiums which were paid in advance had no relation to any liability of Penn Security.

Its liability to the direct insurer arose only when the premiums were paid monthly by the direct insurer to Penn Security. If the direct insurer did not pay those amounts, there would be no liability in Penn Security.

And if you are looking in terms of the regulations, the insurance risk which is referred to in the regulation, about paid in advance, very clearly refers to the reinsurance risk which is assumed by Penn Security, not the risk which the direct insurer assumed.

Now, we come to the language which says that the reserves must be actually held, and that is discussed quite a bit in the brief.

The Government says reserves are sometimes described, in colloquial manner, as funds set aside, but that's not the appropriate interpretation, and we've heard that this morning, that they should be treated as liabilities.

We agree that if you look through the insurance texts around the country, you can find some terms which speak this way, but we think that the very use of the words "actually held" in the regulations meant that the -- in drafting the terms of the regulations, it was not suggested that anything other than funds actually held would be involved.

In other words, they adopted what has been described as a colloquial description and insisted on it.

If additional authority is needed, we would suggest that the Court look at Revenue Ruling 67180, which makes it very clear that the IRS has continued to apply under the 1959 Act all those early cases which talked about funding and reserve, Maryland Casualty being one of the leading cases.

I would also point out the Atlas Life case which was mentioned here earlier this morning. Atlas Life makes it very clear that they are talking about a funding of a reserve.

And, indeed, if you don't fund a reserve, you are going to get in a very difficult situation where you create a liability that will be a very distorted picture of the company's position unless some assets are brought in.

Let's just go back to the statutory language. Even if we concede that somehow you can hold a liability, as opposed to holding an asset, within the meaning of the regulation, what about the word, "actually." If the word, "actually," means anything, it must mean that the company actually holds it, not that the Commissioner of Internal Revenue can come along ten years later and create a liability that you didn't have.

We would think that the word, "actually," even if he is right about what it means, reserves or funded or not, the word, "actually," alone is enough to keep the Government from proceeding on this case.

There are two aspects to being required by state law. One of them arises under 801(c)(2) where the Government correctly points out you can read the statute and regulations as not requiring Government approval under (c)(2).

But we don't really conclude as the Government does that here, alone, among all the rules of insurance taxation in this very complicated section of the Code, in this one place, Congress intended the Commissioner of the Internal Revenue to have a free hand to go around and make rules which improve on what the state authorities have done and give him a chance to make a better tax law than what would come from following the state regulations. That is just too contrary to the rest of the Code.

We would submit to the Court that a better reading is to say that the difference in language about state requirements is to accommodate the decision in National Protective Insurance Company which is cited in the briefs. There the taxpayer held a brief which was at least arguably not required by state authority and that case held that it should be included in the reserve. We can see removing the requirement that it be required by state law, in order to say if, in fact, you have a reserve, you are going to have to include it in the computation, whether or not it is required by state law.

But it is a far cry to go from that to say that this particular language choice gives the Commissioner power to do his own creating of reserves.

As is apparent from our briefs and discussion, there is a difference between gross and net premiums. Accident and health insurance is judged on the basis of -- traditionally in the industry on gross premiums, and that includes the morbidity risk which, I would beg to differ with Government counsel, is just as well established as mortality risk, plus expenses, plus profit.

In the type of insurance we are talking about here, the risk of carrying the insurance is only one-third. And if you are going to attribute the risk, if that's what the Government is really after, then I think you should depart from the statutory adoption of the industry practice and only attribute that part of the risk which corresponds to the mortality risk in life insurance, because then, as we have demonstrated here, it would be seen by this company as a life insurance company by that method, as well.

The point is that if you depart from the statute, then it seems to me you are not bound by the fact that states, for many purposes, require using gross premium. One particular reason that would apply here is that the direct insurer has the obligation to refund the premiums in the event the insurance is canceled. That is one of the reasons for maintaining the gross reserve.

Here, in our case, Penn Security is not -- Once that policy is canceled, Penn Security never sees it and the refund comes from the direct insurer. So there would be a very strong reason, if you are really looking for improving on the statutory test, to use net premiums in this situation.

Just let me conclude and remind the Court just how predominantly this company is an insurance company, because of the fact that it meets the 50% test, it sold more life insurance than accident and health, had more life risks than accident and health risks and those reserves which are being attributed to it are clearly held by the direct insurer as an important part of the arrangement which was made.

Thank you.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Jones.

Mr. Harper.

ORAL ARGUMENT OF JAMES R. HARPER, ESQ.

FOR THE PETITIONER

MR. HARPER: Mr. Chief Justice, and may it please the Court:

The Government is correct in pointing out that the Government provided a mathematical test, a ratio, but I believe it is subject to criticism for not pointing out to you that the Congress has also passed a statutory framework for the analysis of these problems.

Not only has the Congress enacted law, but the Treasury, itself, has explained many of the terms.

Without proceeding to the more orderly part of my discussion, I would like to point out that it is quite painful to me that the Government would come in and tell you that the statute said unearned premiums and meant reserves, because I point out to you, in Section 801(3)(e), the Treasury, itself, defines unearned premiums. Unearned premiums are those amounts which will cover the cost of carrying the insurance risk.

Now, if it is, in fact, a liability, I don't see how it is going to cover the insurance risk.

I think they have avoided their own regulations and tried to ignore them.

I will point out many other differences, but before I do, I would like to discuss, for a moment, risks.

It was pointed out by Mr. Justice Stevens that there are two risks. I'd like to point out a third. There is a distinct third risk and that is in having too small an insurance base to adequately determine premiums.

For example, in our case, here, there was evidence that a number of the agents had loss experiences that were above the 96%.

I point out to you that one of the risks is that you do not have a broad enough base to have a determinable premium.

Let's talk for a moment about premiums, and may I distinguish, because it must be done -- May I distinguish the risks of life insurance and the risks of accident and health?

It has, over the many years, been clear that the life of a group of people was predictable, the mortality tables would so advise you -- not as to one individual man -- but that death is a predictable thing.

The amount of a reserve for life insurance becomes an obligation because each day that inevitable death approaches, the risk then is greater as time passes and man gets older.

It is entirely the opposite for accident and health. Every month you get by, I think, we are all happy, "Well, we made another month and we are not sick. I'm glad I'm not like old George."

Every month that's true of the accident and health insurance business. This is a risk not predictable upon the basis of actuarial certainty, a risk which is so indeterminant that the law requires that the entire unearned premium be set aside at the moment of sale.

When you sell life insurance, you can look at the premium you've got, look at the mortality table, and you have earned some income at that moment.

In the case of accident and health, not so.

QUESTION: Mr. Harper, is it critical to your position that there be a difference in the predictability of the morbidity risk as opposed to the mortality risk?

MR. HARPER: No, I think not, only insofar as the reasons which would justify the undertaking. For example --

QUESTION: Is the rate charged for the life insurance in this credit business different, depending on age of the borrower? I thought it was all term insurance.

MR. HARPER: It is all term insurance.

QUESTION: And the rates vary with the age of the borrower?

MR. HARPER: It does not vary with the age. However --

QUESTION: Well, how does your argument about mortality, and all, play in because, as far as we are concerned --

MR. HARPER: Well, it plays in here, very definitely, because you cannot take any portion of this accident and health risk insurance into income. It is reserved and set aside.

You earn money when you sell life insurance. There is no money earned when accident and health insurance is sold.

QUESTION: As each month passes, it earns, doesn't it?

MR. HARPER: It is earned in a pro rata amount.

QUESTION: Pro rata amount, yes.

Aren't the morbidity tables just about as reliable as the mortality tables?

MR. HARPER: I think these are different names for the same -- as I understood it --

This is just the reciprocal -- It does not predict the risk of going to the hospital, for example, or being disabled.

I must point out another reason actually held -- I think it was actually covered in the preceding statement -- But let me point out that the problem of state authority is to be sure that there are funds there to pay the insured when he is entitled to indemnification.

We then find that there is a clear requirement first that the amount be actually held. That means that there must be a funded reserve.

There are two types of reserves. There are those reserves that a bond holder might insist upon, merely earmarking a portion of surplus. But if that bond holder wants to be certain that bonds are going to be paid at the appointed time, he requires that funds be allocated.

We know the term "sinking fund." I say that's what they wanted here. When the state authorities set out the requirement of actually held, they did mean that it was a funded reserve. We submit that premiums were the fund.

In the regulations, which they have ignored completely, there is the very interesting requirement of Section 1805(b). Reserve required by law means those reserves which are reported on the annual statement. This annual statement goes to the state authorities. They don't just want a funded reserve. They want it reported to the state as to what the reserve is.

There are some differences here between the parties, but I would like to point out that, at the time these people in Georgia undertook to go into accident and health insurance, they went into it because of a clamor of their agents to have a single policy, a single insurance company that would cover it.

They also undertook it with what we describe as minimum capital. But let me point out to you that minimum capital, under our statute, was $400,000. By the time they undertook the accident and health insurance business, the insurance reserves, or what we know as the surplus funds, were well over $400,000. And by this agreement, we brought into play and into risk reserves that were well over $400,000 in the reinsuring company. It was real. It was real in that --

QUESTION: Let me just interrupt because there is something running through my mind I am not sure I understand.

You have a Treaty II situation, is that correct? Your client is the direct insurer and you reinsure the A&H business but not the life business. Is that correct?

MR. HARPER: Our company originally acted as a --

QUESTION: Is that correct?

MR. HARPER: -- reinsurance business for life insurance.

QUESTION: With respect to the years in issue, is it correct that you reinsure the accident and health business and not the life business?

MR.HARPER: I think that's correct. I would not be certain.

QUESTION: Is there a business reason for that, other than favorable tax consequences?

MR. HARPER: There is a business reason in that we need a broader base. Although we had over $400,000 in reserves, the authorities who testified and the college professor who testified recognized that the ability to take on new business was limited to those who had policy premiums --

QUESTION: Jow what was it that broadened your base?

The reinsurance of the A&H business. Did that broaden your base?

MR. HARPER: It did broaden the base.

QUESTION: Why wouldn't it have broadened it even more to reinsure the life business, as well?

MR. HARPER: Well, of course, the life business is a little more profitable, among other things. Credit life is a much better deal than accident and health, and I think that that was undertaken for business reasons, to make more money.

I think it was also undertaken, probably, because of tax reasons.

I'd like to point out, though, that we took it --

QUESTION: In other words, on the A&H business, your primary motivation was to broaden the base at the sacrifice of some profit. In the life business, you were more interested in making profit and not interested in broadening your base.

MR. HARPER: Well, this made it possible to broaden -- or to sell more insurance across-the-board, very definitely. And it was very critical to broaden the base because you have to set premiums. It has to be a reliable standard. We want to make some money.

The big thing about reinsurance, and they fail to note this -- the biggest thing about reinsurance is that it tends to stabilize results. The actuary who testified in our case testified that the basic purpose is really to spread the fluctuation of a company's earnings, to sort of level out their claims experience. And this is the kind of a transaction that would have been undertaken with third parties just as quickly as it would have been undertaken by people with enough money in Georgia to bear the reinsurance risks.

Now, there are sound reasons for it. The Government complains that there was a carry-over provision. But this, too, spreads fluctuation from year to year. It tends to insulate you from shock losses, from catastrophic amounts which could wipe you out.

I'd like to point out that, to some extent, this risk test must depend on hindsight. It is easy for Mr. Smith to say there is not much risk of insolvency, but insurance companies do go insolvent. This very company, here, after it went into accident and health -- and Exhibit 23 will show it --- there were four years in which they lost money.

When they increased their sales by three-fold, they then began to realize a profit on accident and health. They had to go into accident and health in order to meet the clamor of their agents.

I think I must develop, to some extent, the business purpose. I would like to go back to the rules of this Court and particularly to the Helvering v. Gregory case which we quote all the time. Everybody says you don't have to arrange your affairs to pay the most tax.

Mr. Justice Hand went on to say that the underlying presumption is plain, that the Act was undertaken for reasons germane to the business. We do not proceed upon any business purpose here that was not germane to and did not forward the insurance business.

The reinsurer was required, and Judge Roney said: "The reinsurer is required to commit its assets to reserve status for reinsurance purposes and to pay tax on the reserve for tax purposes."

They bore all the legal consequences of the required reserves. They reported the reserves as required by law and there was no exception taken to it. The reinsured bore none of these risks.

The statement of requirement has an economic impact --

MR. CHIEF JUSTICE BURGER: You are now getting into your colleague's time, Mr. Harper.

MR. HARPER: I am not through, but I quit.

(laughter)

MR. CHIEF JUSTICE BURGER: Unless he wants to yield his time to you which --

MR. HARPER: I am sure he doesn't.

MR. CHIEF JUSTICE BURGER: Mr. Masinter.

ORAL ARGUMENT OF E. MICHAEL MASINTER, ESQ.

ON BEHALF OF THE RESPONDENT

MR. MASINTER: Mr. Chief Justice, and may it please the Court:

I am counsel for Respondent Consumer Life Insurance Company.

In this case, the Government seeks to reverse the holding of the Court of Claims and asked this Court to hold that certain unearned premium reserves, relating to accident and health insurance, should be attributed, or imputed may actually be a better word, to Respondent, reserves which Respondent did not hold but were held by an unrelated insurance company, reserves which Respondent was not required to maintain pursuant to state law or state regulatory purposes, reserves which Respondent was not required to maintain pursuant to standard accounting and actuarial principles applicable to this industry.

This case involves both the Treaty I and the Treaty II situations. In the Treaty I situation, American Bankers Life Insurance Company was the unrelated company and it wrote the insurance and Respondent was the reinsurer.

In the Treaty II situation, Respondent was the insurer and the unrelated company was the reinsurer.

The facts are uncontroverted that the reserves were actually held by American Bankers, the unrelated company, and that American Bankers earned the investment income on these reserves and included these reserves in their reports for state reporting purposes.

Both Respondent and American Bankers were subject to regular triennial examinations by the state authorites of Arizona, Georgia, Florida, and other states. During the years at issue, none of these state insurance commissions required either Respondent or American Bankers to change their method of reporting these reserves.

As all the counsel seem to agree, the central issue here is the definition of reserves as set forth in Section 801 of the Code, as to which we believe there are two overriding principles.

Firstly, that the test for qualification as a life insurance company is clearly set forth in the Code as the reserve ratio test. That is, to qualify as a life insurance company, a company's life insurance reserves must comprise more than 50% of its total reserves.

And, secondly, the Congressional intent is clear that state law shall control in matters relating to the substantive definition of insurance companies.

Nevertheless, in the face of these clear principles, the Government seeks attribution of these reserves on a very novel theory. This theory is that reserves follow the risk, a theory which we would submit goes beyond the clear wording of the statute and the intent of Congress, because this theory maintains that the legal definition of reserves is: Who bears the ultimate insurance risk?

The terms "reserve," "total reserves," and "reserves required by law," are all used in the statute, but the statute does not define them technically.

However, the cases in this Court have consistently held -- and this goes back to the Maryland Casualty case -- that these terms are deemed to have a technical meaning, that is to say, a meaning consistent with that used by the state law, by the state regulatory authorities, and a meaning consistent with the common and prudent business practice in the insurance industry.

Nonetheless, the Government argues, that state law is irrelevant, and the Government also says today that the state insurance regulatory authorities don't care about these reserves as they are before the Court in the cases today.

We would suggest that the state regulatory authorities, who have the primary responsibility for looking for the safety of the policyholders and, therefore, looking for the safety and importance of the solvency of these companies, would not respond very favorably to the Government's comments.

Now, the reserve ratio test, in Section 801, has been in the Code for a long time. It was originally enacted in 1921. The present statutory definition was enacted as part of the Revenue Act of 1942, and during this long history never has there been one suggestion, in any case, or in the legislative history before Congress that the test should be reserves follow the risk.

Another thing that is important is that the cases have always used the term, "funds held." In fact, the Treasury's own regulations require that funds must be held.

In the present case, it is important to note that in both Treaty I and Treaty II situations the accident and health reserves covered by these reinsurance treaties were not held by Respondent. Pursuant to the terms of the treaties themselves and pursuant to the requirements of state law, these unearned premiums did not constitute the assets of Respondent on its balance sheet. Therefore, there was no requirement that it maintain the corresponding reserve.

The court below placed very heavy emphasis on the requirement of the statutory provisions of the states of Georgia and Arizona, in recognition, we would submit, of the clear Congressional intent that state law must apply in matters relating to substantive definitions of insurance companies.

The Government's argument in this case today ignores the requirements of the state law as interpreted by the regulatory authorities of both Georgia and Arizona.

The Court of Claims stressed the generally accepted principle that where a statute is ambiguous or doubtful, and in the absence of judicial authority to the contrary, the uniform and consistent interpretation of that statute by the regulatory body charged with the responsibility of administering the statute, is entitled to great weight.

This principle is clearly applicable in the present case, and this Court should give great weight to the fact that the state regulatory authorities of both Arizona and Georgia made no change in the reporting of the reserves of Respondent.

This was the case even after there were two triennial examinations during the taxable years in issue. This was the case when special attention was given to these reinsurance treaties and the reserves by the examiner from the state of Arizona.

Even after these two examinations and this special attention was given, no change was made in the reporting of the reserves by Respondent.

Therefore, we would submit that a departure from such a time-honored principle, as we have referred to, is not warranted by the facts in this case.

As each of these consolidated cases clearly indicate, we are swallowed up in a sea of complex terms and equally complex contractual arrangements which are perplexing to lawyers and laymen alike.

The depth of this complexity, it seems to me, demonstrates even more clearly the Congressional wisdom of leaving substantive definitions to the state regulatory authorities who have a vested interest in regulating the industry and who have the necessary training and expertise to comprehend these complex reinsurance arrangements.

Indeed --

QUESTION: Counsel, could I just interrupt on one factual question?

Does the record tell us in the Treaty II situation who does the administration, who actually pays the claim? The reinsurer or the direct insurer?

MR. MASINTER: Your Honor, I believe, under the terms of the contract, the claim would have to actually be paid by the direct insurer, because the contract provides that the reinsurer shall reimburse the direct insurer.

Other than the contract, I don't think there is any specific evidence on that point.

I would have to go further and explain that it is common and customary in this industry for a company like American Bankers, for example, to assist in maintaining the books and the records because it is clear that they do have the staff and the machinery and the computers, and that type of thing, whereas the companies like Consumer do not have the adequate personnel to perform the record-keeping.

We would submit, Your Honor, that these complex reinsurance arrangements are the results of highly creative people, actuaries and businessmen alike, and that once their efforts have come together to produce a complex and sophisticated reinsurance arrangement such as we have in these cases today, that the Federal income tax consequences should flow from the regulatory interpretation of these arrangements and not otherwise.

We think it is very important that Federal income tax consequences look to the substantive law of the state. This is clearly the most efficient and effective method of imposing our Federal income tax system on this industry and will permit a greater certainty in the planning of the tax and financial affairs of these companies.

The Government has argued on brief that the issues and the cases dealing with the issue of substance versus form should be applicable in this case.

The Government cannot be heard to say that these issues are applicable here. These treaties cannot be disregarded for lack of economic substance or business purpose.

The court below clearly found that these reinsurance treaties had a business purpose, but moreover and more importantly, this theory should have no application to the reinsurance transaction in this case.

Out of the multitude of cases that have dealt with the question of substance versus form, for this Court and other lower Federal courts, one very clear common thread or common principle has developed, the principle conceived by Judge Learned Hand in his dissent in the case of Gilbert v. Commissioner and which was followed by this Court in the Knetsch case.

Judge Hand's test was if the taxpayer enters into a transaction that does not appreciably effect his beneficial interest, except to reduce his tax, the law will disregard it.

Stated conversely, this test would recognize business transactions for tax purposes if they were treated consistently for material non-tax purposes.

Furthermore, we would submit that this test would have the effect of recognizing for tax purposes transactions between unrelated parties dealing at arm's length, except transactions which have no economic purpose apart from tax aids, as clearly was the situation in the Knetcht case.

Since the transactions in the present case possessed material business motives apart from tax deferrment motives, the appreciable effect test, as applied to the facts in this case, would compel a result that these reinsurance transactions should not be disregarded for lack of economic substance or business purpose.

In this case, we see a factual situation where the Respondent and an unrelated insurance company carefully arranged their business relationship in a sophisticated business-like manner, totally in compliance with state law and state regulatory law and totally in compliance with the income tax statute when it was permitted to qualify as a life insurance company.

The challenge, it would seem to me, if any is to be made, to this reinsurance arrangement which is so common in the credit insurance industry, properly lies in the Congress, where statutory provisions may be studied with care and precision and where statutes may be written to apply in a consistent fashion to the entire industry.

A result that we would submit is paramount in this complex area of the law.

Sophisticated business arrangements that have been in effect for many years in a particular industry, as is the case here, should not be overturned on the basis of legal theories which find no support in the case law, the legislative history or in fact among the regulatory bodies who have the responsibility for regulating the industry and to whom the Federal taxing law looks for substantive guidance.

We would strongly urge this Court to affirm the decision of the Court of Claims.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Smith, you have about two minutes left.

REBUTTAL ORAL ARGUMENT OF STUART A. SMITH, ESQ.

ON BEHALF OF THE PETITIONER

MR. SMITH: Yes. I just have a few points to make, Mr. Chief Justice.

Counsel for Penn Security, Mr. Jones, attempted to characterize that Treaty I arrangement as one in which the company, that is the taxpayer, assumed the risk as it received the premiums on a monthly basis.

I think if the Court examines the agreement which is set forth at page 40A of the Appendix, Article 2 contradicts that assertion. It says, "The liability of taxpayer on all reinsurances shall begin simultaneously with that of Pilot Life" -- that's the other company -- "and in no event shall the reinsurance of taxpayer be in force and binding unless the policy issued by Pilot Life is in force."

I think it is plain that the purport of this agreement was that at the very beginning, once the policyholder paid the premium, Penn Security and Consumer Life in the Treaty I arrangement were on the risk.

And if they were on the risk, they had to project that liability and they have to -- those insurance reserves are includable in its total reserves.

I would think that the tax law and the insurance law is not that primitive that it cannot recognize that these contractual assumptions of risk, in exchange for a receipt of premiums which are going to drop down to these taxpayers, should not be attributed to it, as its accident and health insurance business has to be includable in the total reserves, the denominator of the statutory fraction.

I have one last point to make and that is with respect to business purpose. There has been a lot of talk this morning, from counsel for the taxpayers, about that there were business purposes to these agreements, that they were very sophisticated. That may well be the case, but there was no insurance purpose to these Treaty II arrangements.

The risk in the Treaty II arrangement stayed with the taxpayers. In the Treaty I arrangement it was real reinsurance that was assumed by the taxpayers.

That, to us, means that it was insurance business, accident and health insurance, which has to be attributed to the taxpayers.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

(Whereupon, at 11:34 o'clock, a.m., the case in the above-entitled matter was submitted.)