In the

Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
PETITIONER,	)	
	)	
v.	)	
	)	No. 75-1771
STANDARD LIFE & ACCIDENT INSURANCE COMPANY.	)	
	)	
	)	
RESPONDENT.	)	
	)	

Washington, D. C.
March 30, 1977

Pages 1 thru 65

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COMMISSIONER OF INTERNAL REVENUE, :

Petitioner, :

v. : No. 75-1771

STANDARD LIFE & ACCIDENT INSURANCE COMPANY, :

Respondent. :

- x

Washington, D. C.

Wednesday, March 30, 1977

The above-entitled matter came on for argument at 10:05 a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM J. BRENNAN, JR., 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.

VESTER T. HUGHES, JR., Esq., 4300 First National Bank Building, Dallas, Texas 75202, for the respondent.

MATTHEW J. ZINN, Esq. 1730 Pennsylvania Avenue, N.W., Washington, D. C. 20006, for American Council of Life Insurance, as amicus curiae.

I N D E X

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in No. 75-1771, Commissioner of Internal Revenue against Standard Life & Accident.

Mr. Smith, you may proceed.

ORAL ARGUMENT OF STUART A. SMITH

ON BEHALF OF THE PETITIONER

MR. SMITH: Mr. Chief Justice, and may it please the Court: This Federal income tax case comes here on a writ of certiorari to the United States Court of Appeals for the Tenth Circuit. It presents a question of major fiscal importance involving the taxation of practically every life insurance company.

The tax statute that we will be dealing with this morning imposes a unique preferential system of taxation on life insurance companies. It recognizes that life insurance companies are required to add amounts of both premium income and investment income to an account called "Policyholder Reserves" in order to be able to have sufficient funds to meet future claims. What the statute does in brief is to permit a deduction from premium income for additions to reserve and to provide a computation by which investment income is broken down into two segments -- that is, the portion of investment income added to policyholder reserves is excluded from the tax base and the portion of investment income which is allocable to company surplus is subject to current tax.

The case involves a particular kind of premium, Called deferred and uncollected premiums, which I will shortly define. But suffice it to say at the outset that until the decision of the Court of Appeals in this case, four circuits, the Fourth, Fifth, Seventh, and Sixth, and the Tax Court had upheld the Commissioner's position that such premiums, that is, deferred and uncollected premiums, had to be consistently taken into account in computing three statutory categories -- assets, premium income (although the statute refers to it as gross amount of premiums), and reserves.

Here the Tenth Circuit has reached what we believe is an extraordinary and surprising result. It has held that these deferred and uncollected premiums are to be included in reserves but nevertheless excluded from the corresponding tax computations of assets and premium income. We believe the decision is unprecedented, and its unprecedented and peculiar quality is underscored by the fact that as the briefs disclose and the arguments this morning will doubtless confirm, the life insurance industry itself has disavowed the approach taken by the Court of Appeals.

Before I describe the facts of the case, I think it would be helpful and it would put the issue in proper focus if I set forth to the Court three elements before moving on, and they are --

QUESTION: Could I ask you, just so that I have it in my mind as I listen to the rest of the argument, do you understand that the State law was critical in the decision of the Court of Appeals?

MR. SMITH: Yes. I think the Court of Appeals decision turned in part on State law.

QUESTION: So if State law was different, they might have come out differently?

MR. SMITH: Possibly, although our position is --

QUESTION: Because you said a while ago this is a national issue and it affects every --

MR. SMITH: It is a national issue. I think the State law, the Oklahoma law, involved in this case is typical of the computational reserve modes in --

QUESTION: You think it is typical, then.

MR. SMITH: I think it is typical, yes.

I would like to set out three elements to the Court before describing the facts and the holdings of the lower court. I would like to define deferred and uncollected premiums. I would then like to describe the nature of the life insurance reserve, which is the central component of this tax computation, and the relationship of that reserve to premiums. And then I would like to describe in detail the mechanics of the tax statute.

Deferred and uncollected premiums are a particular kind of premiums used in selling life insurance. Now, a policyholder has the option to pay his premium in full as of the anniversary date or he can pay it in installments. If he pays it in installments, which are typically monthly, quarterly, or semi-annually, the amount which is due to be paid after the close of the calendar year, because insurance companies by statute are required to report their income on a calendar year, the amount which will come in after the calendar year but before the next anniversary date are called deferred premiums.

There is another kind of premium here called "due and uncollected premiums." And those premiums are amounts which the policyholder owes right now but for one reason or another has not paid. They are called premiums due and payable. They are also known as uncollected premiums.

QUESTION: When you say it is owed, it is not owed in the sense of a note at the bank, is it?

MR. SMITH: No, it is not, Mr. Chief Justice.

QUESTION: It reserves the option not to pay it at all.

MR. SMITH: Exactly. He can have his life insurance lapse. But what I am speaking of essentially is two types of premiums: those which your quarterly payment is not due yet, that is deferred premium, and then if the date passes when it should have been paid and isn't paid, that is known as an uncollected premium. And these two types are known in the aggregate as deferred and uncollected premiums.

QUESTION: Mr. Smith, let me just ask you a question on uncollected premiums. If a premium has been uncollected for, say, 45 days, there is a normal 30-day period during which he can pay, is it still classed as an uncollected premium, or are we only talking about on the year-end business those that were due just one month --

MR. SMITH: We are only talking about the -- right. Because I think after the grace period, which I will describe --

QUESTION: It would no longer be an uncollected premium.

MR. SMITH: It would no longer be an uncollected premium. I think the policy would lapse and then other mechanics would take over.

The question presented in this case involves the proper tax treatment under the current statute which came in in 1959 for these deferred and uncollected premiums under the two principal computations under the statute -- the computation for premium income, which is colloquially referred to as Phase II, and the computation of taxable investment income which is commonly referred to as Phase I.

Let me now turn, if I can, to the nature of the life insurance reserve and its relationship to premium.

The business of life insurance, I think we all know, is essentially the shifting of the risk of debt from the insured to the insurer for a price. And that consideration is called the premium. And the amount of the premium is calculated on a particular assumption, and that assumption is that the insurance company will set aside certain portions of its premiums that it receives and it will invest those premiums and those premiums will earn interest and the whole accumulated fund will be sufficient to meet claims of policyholders as they die.

Now, the gross premium is the amount that the policyholder actually pays. And that is divided in turn into two subordinate elements: the net valuation premium and another element called loading.

The net valuation premium is the amount computed under particular mortality and interest rate assumptions that the company assumes that it must take into account in order that these funds will accumulate a particular interest rate and that it will have a sufficient amount to pay claims as they arise. So the net valuation portion of any particular premium would be the amount that the company has to set aside and invest in order to meet the future claims.

QUESTION: Does that depend on state law, Mr. Smith?

MR. SMITH: Well, state law sets up, Mr. Justice Rehnquist, the minimum reserve valuation standard in order to make sure that insurance companies will be able to pay off their claims, and States might impose certain assumptions, or whatever. To that extent it does depend on state law.

QUESTION: Do most States impose minimum requirements of that sort?

MR. SMITH: Yes, because the States have an interest in making sure that when people pay premiums over a lifetime that they are not going to be faced with an insolvent insurance company which won't be able to pay off on their claims.

Now, the life insurance reserve is the amount that the company must set aside to meet its future claims. So the reserve is defined universally by the life insurance texts as the sum of these net valuation premiums taken in year by year plus the interest at the assumed rate minus the debt claims that are going to be paid out, and that is at any given point in time the amount that the company must have on hand, so to speak, or be set aside, as the tax statute refers to it, to meet future claims.

The loading element is the difference between the gross premium and the net valuation premium. It is, so to speak, analogous to a gross profit margin. If you buy something at 10 and sell it at 15, you would have to pay out certain expenses out of the 5, but that $5 would be a gross profit margin, which is designed to cover various costs that you have and also have a profit and also be able to pay dividends to your shareholders.

The life insurance texts, and this is significant, all define a life insurance reserve as derived from premiums. This is undisputed. And the tax statute, Section 801(b)(1)(B), uses the term in defining reserves as "amounts set aside to meet future claims." It is essential that there be this set aside notion that the company has the amounts to cover its reserve liabilities.

So I think that it's fair to say that there is a direct and fundamental relationship between reserves and premiums. Indeed, the decisions of this Court, the early tax decisions of this Court, like McCoach v. Insurance Company of North America, New York Life Insurance Company v. Edwards, speak in these terms. They talk about amounts reserved from premiums. So I think that aspect of the case is fairly well undisputed.

Turning now to the particular details of the Life Insurance Company Income Tax Act of 1959 which the Court last considered in the Atlas Life Insurance Company case, this statute recognizes that life insurance companies, unlike the ordinary taxpayer, don't have unfettered discretion as to how to deal with their gross receipts, and they must set aside amounts. So it permits certain exclusions and deductions of amounts from two separate kinds of computation in order to cover the reserve liability.

This concept of reserve, which as I said is derived from premiums, is the central component of the statutory system.

And the statutory computations which are indeed complicated are essentially designed to measure the amounts the company has to add to its reserves and to exclude them from tax or to provide for deductions.

There are two primary categories of computations. There is a computation of taxable investment income, because, as I said, the company sets aside these amounts and they are going to earn interest and dividends on investments. Indeed, as the Court said in Atlas, they must invest because if they don't, they are not going to have enough under their assumptions to pay off claims.

Then there is a second category which the statute refers to as gain from operations, which is essentially income from all sources, including total taxable investment income plus also some other income the company has, for example, underwriting gains. In other words, the amount of premiums that it takes in less the amount of claims that it has to pay out.

Now, the statute imposes a tax on the company's taxable investment income plus one-half of the amount by which its total gain from operations, that is, the second category, exceeds its taxable investment income.

So essentially the whole statutory mechanics are designed to make these computations in order to determine what amounts have to be set aside from reserves and thereby excluded from tax.

Now, the Phase I computations, which we set forth in formula form, I think the most graphic way to understand it is to look at page 6 of our brief which sets forth a series of equations. Although they seem rather onerous, they are really not when we sort of strip it away from detail, because what you have essentially, you are trying to take the company's total investment income and break it down between the amounts that are allocable to reserves and thereby owned by the policyholders, so to speak, and should be free of tax, and the amounts that the company earns for itself which it doesn't have to set aside and it has to pay a tax on that.

So essentially, looking at page 6, we see essentially three formulas and then a variation of the third formula. But what essentially the statute prescribes is that the first thing that the company has to do is compute its earnings rate, and that simply is its investment income divided by its assets, and then it multiplies that earnings rate times its reserves and that yields its tax exclusion. And you can see that the third formula essentially substitutes for earnings rate its equivalent in the first formula, which is investment yield over assets. So you have a formula that is investment yield divided by assets times reserves equals the tax exclusion. And to restate the formula, it's essentially, you can see from the last way the equation is described that investment yield is multiplied by a fraction, the numerator of which is reserves and the denominator of which is assets.

One significant thing from this Phase I computation or expressions as we have set it out in the brief is that the amount of the exclusion, that is, the amount of the taxable investment income which is free of tax, is based upon a proportionate relationship of total reserves to total assets.

Now, the Phase II computation is a much more traditional net income computation which the Court is doubtless familiar with from other income tax cases. That is, it essentially says take in your gross amount of premiums and you subtract certain deductions. That statute is set out in 809 of the Code. Essentially, the unique deduction that the life insurance companies are entitled to is set out in section 809(d)(2), that is, it gets a deduction with additions to reserves, because that amount of the premium income is supposed to be set aside in order to meet policyholder claims.

I think with these sort of basics in mind I can now turn to the facts of this case and put the matter in clear focus. The respondent in this case is a life insurance Company in Oklahoma. It had deferred and uncollected premiums, as most life insurance companies do, and it also had due and unpaid or uncollected premiums, because it had a typical grace period of 31 days.

Now, there are certain things that the courts below set forth which are plain and undisputed. The policyholder, of course, as the Chief Justice pointed out, has no obligation to pay deferred or uncollected premiums, but -- and this is important -- respondent, the life insurance company, has no obligation to continue the insurance coverage beyond the point for which the premiums had been paid, because nonpayment of the premiums -- it's not like the note at the bank -- result in the lapse of the policy. The only thing the policyholder is going to get is his cash surrender value on an ordinary whole life policy.

QUESTION: Mr. Smith, what happens if I were to take out a $10,000 policy today to be paid quarterly and I pay the first quarterly installment and died tomorrow.

MR. SMITH: You pay the first quarterly installment and die tomorrow, Mr. Justice Powell, the company would pay off the $10,000, but State statutes permit it to deduct from that $10,000 the amount of the three quarters that you should have paid had you paid it at the beginning. So in effect the company never loses, it is always going to get its premium one way or another.

QUESTION: But the company would have to set up the full reserve today.

MR. SMITH: That is what I am about to get to. The company would indulge in the assumption that the full premium was paid in advance. That is a computational assumption that all life insurance companies --

QUESTION: But that is required by State law; it's not just a company assumption.

MR. SMITH: Right. It's a computational mode which is required by State law, but our essential position is that that is only one element of the statutory definition of reserve. The other element of the statutory definition in Section 801(b)(1)(B) is that there be an amount set aside to meet future claims.

I think the important thing about this case is that the reserve that it sets up, the full premium received assumption, so to speak, is simply that, an assumption. It's done as we point out in the brief and I will just describe in greater detail later, it's based on a historical financial reporting practice in which insurance companies for the last hundred years have been engaged in a full premium receipt assumption.

But the important thing is that there is nothing set aside, and the assumption, the fact that the company is making this assumption, doesn't upset its actual liability to the policyholders. It only is going to have to pay out with respect to covering for which it has received premiums.

QUESTION: Let's make another hypothetical a little more favorable to Mr. Justice Powell. He pays a $100,000 premium and pays the first quarter, $25,000, and doesn't die but lives. The policy lapses after the grace period, doesn't it?

MR. SMITH: The policy lapses after the grace period, that's right.

QUESTION: How does Internal Revenue treat the $75,000 premium which he has never paid?

MR. SMITH: It's not premium income. It wouldn't be premium income, and it wouldn't enter into the computation. Essentially that is the point. And this whole thing is an elaborate fiction. Essentially, the fact that the company engages in a full premium receipt assumption doesn't affect its actual liabilities. And our point simply is that if it is going to engage in this assumption, the Commissioner insists that it apply that assumption to the other elements of the statutory computation, that is, that it also consistently assume that it has these premiums for purposes of assets and gross amount of premiums.

QUESTION: Mr. Smith, is your answer to Mr. Justice Powell entirely correct? I understood you to say that when the reserve is set up on a deferred or uncollected premium, nothing is set aside. Of course, that is true in the sense that the premium itself has not been collected. There must be an offsetting asset on the balance sheet, must there not?

MR. SMITH: Yes. And as we point out in the brief, there is an offsetting net valuation of premium assets, but, you know, the insurance texts uniformly state that this is a fictional asset, this is a quasi-asset. That's the way the 1871 convention referred to it. And the fact that that goes on the balance sheet is simply a device that the companies use in order to ensure that they are projecting an accurate picture of their solvency, because otherwise they would have to commit real assets to cover these written up liabilities and it would impair their surplus.

QUESTION: I suppose if a policyholder dies, real assets will have to be used to pay the claim, won't they?

MR. SMITH: That is true, and that simply goes into the actuarial computations that a policyholder would die.

But the fundamental point is that these reserves, although they are written up on the full net valuation portion of the premium, they are not really reserves in a real sense, they are simply done that way to avoid the burdensome actuarial work of computing reserves on a policy-by-policy basis. In other words, if the company didn't do that, they would have to compute each reserve on a policy-by-policy basis. It's much easier for the companies to indulge in the assumption, "OK, we have received all the premiums as of the anniversary date." But once having done so, the Commissioner says that you have to engage in the corresponding consistent assumptions and take the full amount of the premiums into assets and gross amount of premiums.

QUESTION: In a sense they are an overstatement because the premium hasn't been paid, but aren't they as of the December 31 date an accurate statement of the contingent liability that the company has on outstanding policies?

MR. SMITH: Aren't they an accurate statement? No, I --

QUESTION: You can use the term in two senses, I suppose, one it's a measure of how much has been collected in the way of net valuation portion of premiums, and secondly, you can use it as a measure of the contingent liability on policies which are in force. And it is an accurate statement of the latter, is it not?

MR. SMITH: No, I don't think so, Mr. Justice Stevens. The insurance texts uniformly say it is not a real liability. The reason it's not a real liability is the fact that the state statutes, if you die after the first installment --

QUESTION: But if you die on the date the statement is prepared, it's a real liability to that extent, isn't it?

MR. SMITH: Well, no, because the state statutes permit the company to deduct the full amount, the other three quarters.

QUESTION: The risk includes the risk of death during the ensuing six months or so.

MR. SMITH: Exactly. And the insurance texts make that clear. It's not really a real liability.

QUESTION: In requiring the maintenance of certain ratios, particularly with respect to surplus, don't state regulatory commissions treat the reserves as a full liability?

MR. SMITH: It's written up as a liability, but the point is it's cancelled out by virtue of the fact of this quasi-asset which is not a real asset, because policyholders don't pay a net valuation premium, they pay the full premium. That is put on the left side of the balance sheet. And on the income statement, they have this elaborate --

QUESTION: But doesn't an insurance company have to maintain a ratio between its reserves and surplus?

MR. SMITH: It probably does for state law purposes, yes. So this fiction or assumption may be in the State reserve requirement, so to speak. But our essential point is that that has nothing to do with the tax computations.

QUESTION: Just fictions.

MR. SMITH: Just fiction, exactly.

Now, I think as the colloquy has indicated, what we are talking about here is computing your reserves on the assumption that the full annual premium has been paid as of the anniversary date, whether in fact this was the case. And that is what respondent did here. What it also did was to compute its reserves for Federal income tax purposes on the basis of the same assumption. So what it did was it included the net valuation portion of its deferred and uncollected premiums as if they were amounts set aside from premiums under section 801(b)(1) even though there was in fact no amounts set aside and it correspondingly increased reserves for purposes of the tax computation.

But respondent did not consistently apply that assumption in making the other required computations. For example, on its 1958 return it abandoned that assumption of full annual premium receipt in connection with computing its assets under section 805(b)(4). So essentially what it did was say, "We got these premiums, we will assume we got them in full for purposes of computing our reserves, but then I turn around and say that we did not get these premiums for purposes of computing its assets."

Now, the Commissioner of Internal Revenue on audit accepted respondent's full premium receipt assumption with respect to reserves, because pursuant to regulations which have been outstanding for 17 years and were promulgated in temporary form almost at the very outset of the 1959 Act, the Commissioner applied this full premium receipt assumption as well to the other tax computations of assets and gross amount of premiums.

Now, the Tax Court upheld the Commissioner on the authority of its prior unanimous review decision in the Bankers Union Life case, and it insisted on full inclusion at the gross amount of deferred and uncollected premiums in all the computations. The court of appeals reversed with one dissent. It held that the company was not required to include any portion of deferred and uncollected premiums in assets or gross amount of premiums. And it is significant not only has the life insurance industry itself disavowed this decision, but the decision of the court of appeals gave respondent the benefit of more favorable tax treatment than it itself claimed on its '59 and '61 returns, because it put its deferred and uncollected premiums in assets and in gross amount of premiums in '59 and '61 on a net valuation basis. It didn't exclude them entirely. And in so holding, as I said at the outset, the court of appeals rejected a uniform line of decisions of the Fourth Circuit and also invalidated the Treasury regulations.

Now, essentially this case involved whether and to what extent these deferred and uncollected premiums are taken into account for tax purposes in connection with these three major statutory elements -- reserves, assets, and gross amount of premium. There were several things I think that the foregoing discussion has demonstrated is undisputed. One, it is undisputed that the company does not have deferred and uncollected premiums on hand. It doesn't have any right to compel their payment from the insured, and that nonpayment of the policy results in lapse. And the company essentially insures, it doesn't do anything for nothing, it doesn't assume any insurance risk for periods for which premiums have not been paid, and essentially so given the direct relationship, fundamental relationship which the Court's decisions and the life insurance texts universally describe between reserves and premiums, it seems to be clear that actual life insurance reserves in a real sense are completely unaffected by deferred and uncollected premiums.

So in light of all of this it would seem, as we point out in our brief, that the treatment of deferred and uncollected premiums is a relatively simple matter. They don't exist, there is no premium , there is no liability, there is no set-aside within the meaning of 801(b)(1)(B), and it would seem that logic would dictate that they should be totally ignored for all purposes, and in fact the Treasury regulations provide, and that is our alternative position, and it's set out in section 801-4(f) of the regulations.

But essentially inclusion of deferred and uncollected premiums for purposes of all computation, as provided by our primary position, and which is also set forth in the regulations, we believe is grounded also on internal logic. Moreover, as we set out in detail and I alluded to earlier, it is traced to the historical practice of companies to assume the receipt of these deferred and uncollected premiums when computing its reserves.

As the Court may recall from our brief, the companies in 1871 got together at the first annual life insurance convention and they grappled with the problem of how to compute their reserves, what to do with these deferred and uncollected premiums. And since the actuarial work was then burdensome because it was before computers, it was then burdensome to compute reserves on a policy-by-policy basis, the reports said that the companies -- the companies said that they could indulge in this assumption of full premium receipt. In other words, that all the premiums were received as of the anniversary date of all the policies in force.

But in so providing for that financial reporting device, the report acknowledged that this assumption resulted in an overstatement of the company reserves, to the extent that the net valuation portion was deferred and uncollected premiums, because they haven't been paid and the company doesn't have any insurance liability.

So the convention had to deal with the problem since they had an overstatement on the right side of the balance sheet, what to do. I mean, it was an unbalanced balance sheet, and it would project an unfavorable picture of the company's solvency. So what the convention did was to devise some way of assuring that the balance sheet would be balanced, and the solution was to create a fictitious asset on the left side of the balance sheet, and that asset is called -- well, it's a fancy name -- premiums deferred and annuity considerations deferred and uncollected. But for these purposes the statute used "deferred and uncollected premiums." And that was an asset equal exactly in amount to the overstatement on the right side of the balance sheet.

Now, essentially what happened was the accounts balanced, and more importantly, the company didn't have to cover this overstatement with actual assets and thereby, as I said, impair its surplus.

QUESTION: Mr. Smith, do I correctly understand that this original decision by the industry, then, was to include the net valuation portion of the premium on the asset side?

MR. SMITH: That's right.

QUESTION: In other words, they took the position that the industry now takes?

MR. SMITH: They took the position that the industry now takes. But if I may digress just for a moment -- the logical exposition would have it come later -- but essentially this is a fictitious asset and in our view the error of the industry's position is that it actually believes, it is now believed in the fiction that there really is this net valuation premium or assets.

QUESTION: I wasn't trying to get to the merits, but I am correct, am I not, that apparently the industry's position has been consistent for about a hundred years.

MR. SMITH: Yes. But the important thing, Mr.

Justice Stevens, is that that industry position is purely for financial reporting purposes.

QUESTION: I understand.

MR. SMITH: And what we are involved with here is trying to grapple with the problem of how these deferred and uncollected premiums should be taken into account for tax purposes. I mean, it's one thing to set up an equation for solvency and it's another thing when you have to start figuring out what the ratio of total reserves to total assets is.

QUESTION: You speak of that as though these two things were quite alien and incompatible.

MR. SMITH: Oh, they are. They are, Mr. Chief Justice. And I think in fact the life insurance industry itself recognizes the incompatibility of their financial reporting conventions and the tax computations. Because about 10 years ago -- I think we set it out in our reply brief -- the Joint Committee on Blanks -- sort of a peculiar name; I suppose it means their forms -- met to try to figure out whether they could reach some reconciliation. And they finally concluded that it was impossible. They were basically dealing with -- you know, they had very different goals. One is the goal of measuring the amounts of income that are properly includable in the tax base, and the second thing is essentially to make sure that the company's solvency is accurately portrayed.

The particular thing I was referring to is on page 23 of our reply brief where the committee concluded that "the basic objectives of the annual statement and of the tax return are so different in concept as to preclude revision of the annual statement blank solely to conform to tax accounting concepts."

QUESTION: It is one thing to recognize that careful business practice may lead to larger depreciation than the government would allow for tax purposes. It is quite another to say that these two things are totally separate compartments and have no relationship to one another. It is normal business practice. Do you suggest normal business practice is to be totally ignored in the taxing area?

MR. SMITH: No, I don't suggest that. I think the important thing here is that Congress has set out a very elaborate computational system for taxing life insurance company income, and they specifically relegated the industry financial reporting practice to a subordinate and interstitial role. I mean, they could have done it the other way, but they just didn't. And I think the important thing is that the goals of these two things are different. In one sense you try to just make sure that the books balance and that your state departments don't think you are insolvent. And in the other instance you are trying to do two things -- measure a proportionate amount of taxable investment income that has to be allocated to reserves, and these reserves are computed on the assumption of full premium payment. And our submission is that the denominator of that fraction, since the fraction is reserves over assets, similarly must be computed on the same assumption. You can't take a formula which has a fraction and compute the numerator one way and the denominator the other way and expect to reach a result which the fellow who made up the formula contemplated. I think that is really all there is to it.

Well, essentially our fundamental submission in this case is that a life insurance company can't first treat deferred and uncollected premiums as paid for purposes of its reserves, and when it increases its reserves it essentially decreases its tax liability, and then turn around and assert that they haven't been paid, the same premiums, for purposes of computing its assets and gross amount of premiums, the two statutory computations.

Now, I think the need for consistency in this area is graphically demonstrated, and probably more easily demonstrated, by reference to the Phase II, net income computation, because the Phase II net income computation says essentially, "OK, let's take all your gross amount of premiums and put them in income and then we will subtract out your additions to your reserves."

Now, the point of the matter is, as I said earlier, this is an overstatement of reserve. It's not really a reserve. But the Commissioner of Internal Revenue in his primary position on the regulations is willing to say to the life insurance industry, "OK, you have been doing it that way for a hundred years. We will acknowledge the fact that you want to indulge in this full premium receipt assumption. But essentially if you are going to get a deduction from income for reserves -- and that's what 809(d)(2) provides is a deduction -- then I think there would be no rational basis for saying that you could ignore the income on which the deduction is based. Essentially you have got to make the same assumptions in connection with computations of income and deductions.

And the same thing, I think, is true with respect to the Phase I computations. As I said earlier, that essentially multiplies your investment income times the fraction of reserves over assets. And if you are going to inflate your reserves at the expense of your assets, you are going to have essentially a distorted, you are going to have an inflated tax exclusion. And essentially it is going to be based on a set of inconsistent assumptions.

Essentially we think that is really where the court of appeals went awry, because it sort of assumed that the reserves were off to the side. Reserves are one thing and then we turn around and say the premiums really haven't been received. But the fact is that the computation of reserves is based on an assumption of full premium receipt, and therefore that same assumption, if the formula is going to have any meaning, has to be consistently applied to the other elements of the statutory equation.

QUESTION: Mr. Smith, just let me throw a thought out and be sure you address it in due course. Are you going to address the problem of what portion of the premium income is properly includable? In other words, is it the entire loading charge or just --

MR. SMITH: Yes, that's right. That's what I planned to turn to now, and I would actually like to save about 4 minutes for rebuttal.

Essentially -- I think that what I said indicates an imbalance. The Court of Appeals decision just makes no sense under the statute. There is another erroneous position advanced here, that of the American Council of Life Insurance. And they say essentially, "We agree that a certain amount of deferred and uncollected premiums have to be taken into account, but we think it really should only be the net valuation portion." Essentially what they are saying is, the assumption that they are willing to agree exists, is that the company receives the net valuation portion of the deferred and uncollected premiums, that is, the amount which, as I referred to earlier, is the fictional quasi-asset which is put on the left side of the balance sheet simply to balance the statement.

Now, as we point out in our reply brief, this completely mischaracterizes the full premium receipt assumption, because the assumption underlying the reserve computation is that the policyholders have paid the full amount of the premium and not some lesser amount. As I said earlier, policholders pay the full amount of premiums and not some lesser amount.

Essentially, their reliance on the NAIC balance sheet essentially, as I said earlier, kind of indulges in a belief that this is a real asset, and it isn't the real asset.

QUESTION: Mr. Smith, my question really related to how much of the loading would the government's position include in income on that assumption.

MR. SMITH: The whole thing.

QUESTION: What do you do about the Seventh Circuit case? I take it you still disagree with the position of the Seventh Circuit in its most recent case.

MR. SMITH: You mean the Federal Life Insurance Company case?

QUESTION: Yes.

MR. SMITH: Well, as we said in our reply brief, we don't think the question is presented in this case in the sense that there is no claim here. Those cases dealt with the narrow question whether a company could claim or accrue for Phase II purposes agent commissions and state premium taxes. There is no claim in this case. The Court strictly doesn't have to reach that question here because the taxpayers have never claimed --

QUESTION: But it will have to be reached before the litigation terminates, won't it?

MR. SMITH: Not this litigation. Ultimately it will have to be resolved.

Let me simply say in connection --

QUESTION: Would it have to be resolved in this litigation?

MR. SMITH: I don't think so, Mr. Justice Stevens.

QUESTION: Somebody is going to have to enter judgment for some amount of dollars, aren't they?

MR. SMITH: Yes, but the claim here is for a deduction for loading. And I think as the Seventh Circuit pointed out in that case, loading is an income item. The undifferentiated loading element is not an expense.

QUESTION: All loading certainly isn't income, is it? Mr. Smith?

MR. SMITH: Not all. There are elements of loading that are expenses. But the point that I am stressing is that the taxpayer in this case -- when I say that issue doesn't have to be resolved in this case, I am simply saying the Court doesn't have to address it because it was never raised in the Tax Court petition, wasn't raised in the court of appeals, and there really is no reason for the Court to reach it. There is no claim for the deduction.

QUESTION: Your basic position as I understand it is to advocate consistency in the practice of the insurance companies in accord with reality, and reality certainly is that loading includes substantial inevitable expenses.

MR. SMITH: I think there is substantial force to that contention. And let me simply say that we face now an unbroken line of decisions in three circuits -- the Seventh, the Eighth, and the Fifth. The Fifth and Seventh have sustained us on our major contention here, and it seems to me that the question of the propriety of those deductions in a case where they are properly raised is something that is now being reconsidered. Loading essentially is not an expense.

QUESTION: Is this correct in all events that what we are really talking about here is the year in which the tax will be paid on these --

MR. SMITH: Yes, it's a question of timing, but I mean --

QUESTION: Of course, it's advantageous to the taxpayer to postpone it. I understand that.

MR. SMITH: That's the name of the game in a sense, the timing of income.

I think, since there will be a lot of argument on the other side, I would prefer to reserve the rest of my time for rebuttal.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Smith. Mr. Hughes.

ORAL ARGUMENT OF VESTER T. HUGHES, JR.

ON BEHALF OF THE RESPONDENT

MR. HUGHES: Mr. Chief Justice, and may it please the Court: This is indeed a close case, but I don't think in the sense that one would understand a close case as it has been presented thus far.

It's a close case, I think, growing out of the problems that people have confused actuarial assumptions with accounting assumptions. Historically reserves have been a matter required to see what the solvency of a company is. One of the earlier Chief Justices of this Court in New York in 1905 and 1906 worked very hard to try to clear up insurance scandals, because people had paid money to life insurance companies and had not been paid upon death.

When the 1959 Act came along -- actually it applies to the year 1958 -- an attempt was made to change the general format that had been followed since 1921 in the taxation of life insurance companies. Since 1921 the format had been to tax investment income. The way the taxation of investment income had been worked was to apply a percentage, an arbitrary percentage at one period of time, and a percentage related to industry averages to reserves, to what we are talking about in the first part of this case, to the reserves of the company, to determine what earnings should be there to ensure that a policyholder would receive the face amount of his policy upon death. Once that amount had been calculated, earnings in excess of that amount were taxed at a given rate. But as Mr. Smith pointed out, in 1958 -- actually bill was signed by President Eisenhower in 1959, but it does apply to 1958 and years after that time -- the determination was made to take a total income approach in two stages, actually in three stages. The third stage is not in question here.

The investment income approach of the past was reiterated. That's Phase I. The definitions of reserves that had obtained since 1871 were left intact. The committee reports indicated there was no intention to change this. The early case, the Herold case, a district court case in New Jersey, Herold v. Prudential Life, had exactly this question before it in 1917. This Court said, yes, premiums arising from the liability on policies with respect to which there are deferred and uncollected premiums will be taken in full, Will be accounted in full. It's a liability. But the income not received will not be so taken.

The government has argued here today, and it's a fact that four circuits have gone against us on the basic assumptions here and that we are here today because the Tenth Circuit determined that the item deferred and uncollected premiums are not income, are not assets, but policies with respect to which the liability is determined actuarily on an annual basis will be taken into account in full, that is, the reserves with respect to such policies will be taken into account in full.

The government didn't quite answer the Chief Justice's question on what would happen if Mr. Justice Powell had taken out the $100,000 life insurance annual premium policy and the first $25,000 was paid in the last quarter of the year. So $75,000 remains unpaid. It's not due. It will be due quarterly, the remaining $75,000.

Now, the liability for the policy is the full liability when it's taken out. If Justice Powell were to die in the meantime, the government's position is that at that year end, Standard Life would have had $75,000 of income, although of course what it really had was a loss. That is presupposing the death after year end and before the payment of the second premium.

QUESTION: Mr. Hughes, wouldn't you concede that there is at least a superficial plausability to the government's approach that if a figure goes into the numerator, it ought to go into the denominator, too?

MR. HUGHES: Mr. Justice Rehnquist, I would say that the word "superficial" is right, it is more optical than real. And that is part of the reason I wanted to go into the history. What has happened here is actuarial assumptions are used to determine, to underpin, to cause one to decide what the liabilities are going to be. The State set up those minimum liabilities. Once a company has set up a reserve, it cannot reduce that reserve without permission of the State Insurance Commissioner.

Now, those are the reserves that were used from 1921 forward until the 1959 Companies Act. The reserves haven't changed. Those included liabilities, reserve liabilities with respect to policies, the premiums of which would be paid later or were in the grace period.

Now, superficially you would say, then, why don't you have plug figures that go on either side? That first computation is an actuarial computation that relates to the liability of the company. That's fixed. That's fixed by state law.

The next computation we are trying to make is what investment income has this company realized with which to discharge its obligations? Now, it is a little difficult to say that something it does not have produces any income at all or in the alternative, when it is defined, it says assets excludes from the definition of assets assets used in the life insurance business. So 805 under two theories might not take into account premiums, deferred and uncollected.

Further, he would say then, what about the situation of the income side, which was very properly raised, the Phase II part? But in the example we have given, if the government approach is followed, then we have $75,000 additional income which we did not get in the year ending, with respect of which the policy was taken out. Even though we did not get that income, we would never get that income, the policy liability with respect to which the $25,000 was generated did in fact occur.

QUESTION: Mr. Hughes, on that assumption wouldn't the $75,000 premium be deducted from the payoff, and therefore you would have received the income.

MR. HUGHES: We would receive it in the next year.

QUESTION: Well.

MR. HUGHES: And that's the timing matter. This Court has often said that timing depends on accounting concepts. That's why I wanted to differentiate between actuarial concepts and accounting concepts. In the early case of Burnet v. Sanford & Brooks, you recall, the dredging contract expenses had been realized in earlier years, and when the taxpayer wanted to match those earlier deductions against the later income, this Court said no, it's on an annual basis.

QUESTION: Mr. Hughes, maybe I am not following you, but suppose you are on a calendar year basis and the death occurs on the 30th of March. Why do you say the $75,000 comes in a later taxable year, as I understood you to say?

MR. HUGHES: All right, sir, let's take some specific examples on dates here.

QUESTION: I have given you one.

MR. HUGHES: All right, sir, but we would have had two premiums due on March 30 because -- well, if we assume the first premium was paid December 31 --

QUESTION: Well, January 1. Let's keep it in the calendar year and you are on a calendar year basis.

MR. HUGHES: If it all happens within the same calendar year, Justice Blackmun, then there is no question, because it will come in the income.

The entire question here --

QUESTION: I think you confuse when you speak of two taxable years and it isn't necessarily so.

MR. HUGHES: Mr. Justice, I believe that this may be one of the problems with the case, then, because deferred and uncollected premiums refer only to premiums which on December 31-- all life insurance companies are on a calendar year -- refers only to premiums that on December 31 are going to be paid in the next year if the policy remains in force. In other words, if there is a quarterly paid policy and on November 1 the first premium is paid, what we are talking about are the three premiums that then will be paid February 1 and May 1 and in the remaining quarters.

It is only when the premium payments are split over year end and that there is a question here. And let me suggest that the Court might consider that when this matter was first considered in the Western National case by the Tax Court, Judge Drennan, Chief Judge of the Tax Court at that time, speaking for the Tax Court, held exactly what the Tenth Circuit held in Standard Life. There was a reargument of the case in '69, and the Tax Court changed to the view that the American Council of Life Insurance is going to propound today, and indeed the view which we think is the alternative view that the Court could reach.

If strict accrual accounting is followed, then premiums deferred and uncollected are neither income nor assets. If this Court determines that Congress intended that there be an overlay on accrual accounting resulting from the section 818(a), which refers to the National Association of Insurance Commissioners, then the position of the industry is supportable. The way that comes about is to say that there is a modification, a modification, of accrual accounting insofar as the accounting that is incident, that has been fostered ever since 1951 when there was first promulgated an approach of operations income for life insurance company. Prior to that time all you were talking about was balance sheets. But once there was an income item, the net valuation portion of the premium would be included as an income item.

And that's what the Tax Court held, and that's what the Tax Court continued to hold. But the circuits then, as the cases would go up, would say, "No so. We are going to follow a gross income approach." And I think it is by saying what is a act is not a fact, or what is not a fact is a fact, that the courts have come up with the situation we have today where we first have the vour courts saying you use gross income, and as Mr. Justice Stevens pointed out in Federal and the earlier Fifth Circuit case of Great Commonwealth what had happened was that is not quite fair. The expenses incident to the collection of that premium, the same thing that gives rise to the fantasy in the first place,is also a proper deduction from it. So agents' commissions were allowed.

The next stage was a logical extension of that Particular proposition. State premium taxes would also serve to be a reduction, because if the premium was collected, the premium tax would be due. If the premium was not collected, the premium tax would not be due.. But under all accrual accounting, all accrual accounting theory, there is no basis for saying that that income has been realized.

Now, there is a basis for saying that 818, where it refers to the National Association of Insurance Commissioners, is an overlay which would take you back to the alternate position.

The government has made a great deal of the argument of consistency, and Mr. Justice Rehnquist noted this, that at least prime facie it has a lot of appeal. But part of that appeal goes to assuming that there is a simple equation. In Phase I, for example, it's either the investment yield of the year in question or the average of the preceding five years. So it's already out of balance if it's the average of the five years. The reserve figure is not merely the state reserve figure, it's adjusted reserves. Congress explicitly stated that it was going to follow the state reserving process except in a number of instances which were carefully delineated. The first of these is deficiency reserves and pension reserves. Deficiency reserve is the kind of reserve set up if the premium is not enough to take care of the net valuation portion. The stated reason for that exception is that a number of companies in 1958 and 1959 had large deficiency reserves that would flow back into income. And the then Secretary of the Treasury, Robert Anderson, in his presentation to Congress said that it was not deemed fair to cause income to be generated in that fashion.

The next is reserve strengthening. Reserve strengthening occurs when a company determines that it is going to increase voluntarily the amount of reserves held. Now, Congress put a limitation on this, as indeed you would anticipate, because if a company could happily decide it had unneeded surplus funds at the end of the year and strengthen reserves and thus have that kind of impact on the year in question and perhaps eliminate its tax, then this might become a vehicle for avoidance that would not be tolerable to the revenues.

So in order to take care of that, Congress said this takes effect in the next year in the Phase I computation. In the Phase II computation, it followed the general accounting practice of a 10-year period of taking it into account as a deduction. And it's, of course, there that the increase in reserves are taken into account in Phase II. I don't believe that was clear in the government's argument. It's not the amount of reserves that you get a deduction for, it's the increase in reserves. And the contrary is true, of course, if you make money and there is a decrease in reserves, you have income from the reserve computation in Phase II. So it depends on whether your reserves are going up or your reserves are going down.

The third variation in arriving at this adjusted reserves that Congress saw fit to put into effect is what is known as the 818(c) election. The 818(c) election says that a company that computes its reserves on a preliminary term basis has the option of treating the deduction as level for Phase II purposes. This means this was of particular benefit to new and growing companies because it meant that in their first year of a policy where many times the commissions will exceed the premium, they did not have to establish a reserve. But then in the succeeding years, they would take into account, as, for example, on a 20-year pay, they would take into account the reserve computations for the succeeding 19 years for state law purposes, but for Federal income tax purposes it was for a 20-year period.

Finally, Congress said, in what was called the 10-for-1 rule, popularly known as the "Menge Formula" -- Mr. Menge was a distinguished actuary, president of Lincoln National Life -- that we need to take into account what earnings actually occur. We need to see what happens, in fact, to one of these companies. If they are assuming a rate of interest of 3 percent, what is their investment yield -- 4 percent, 5 percent, 2 percent? -- and adjust their reserves accordingly. Simply stated, the Menge Formula would have the effect if, for example, the interest assumption were 3 percent, the actual return were 4 percent, it meant that the earnings were better than anticipated. So you would reduce by 10 percent reserves. You wouldn't have 100 percent of the reserve figure, you would have only 90 percent. Contrariwise, if the earnings were 2 percent instead of the 3 percent assumption, it meant that you should have had more reserves, at least in a taxing sense, if you are going to cover what is necessary to pay off the policies. Therefore, it would be 110 percent.

Now, I submit that these four adjustments to reserves decimate entirely any notion that you can plug figures in in equation fashion, that there is some symmetry, that there is some balance. I am very tempted to go a little outside the law for jurisprudence at this point to suggest that maybe Professor Emerson was right when he said foolish consistency is the hobgobblin of little minds, and I think that that may well be the case here in a consistency argument, because they aren't the same thing. In assets we are trying to determine what assets are there that generate income, that give rise to earnings. And as has been said in the earlier questions and been noted by the earlier questions, solvency is terribly important, terribly important to the Federal government as well as to the State governments.

I call the Court's attention in this regard to the very interesting exchanges that were on the floor, and I think they are best stated perhaps in the amicus brief on pages 16 and 17, when the matter was being discussed, and in response to various questions, Mr. Mills, in response to questions from Mr. Simpson, who was minority leader, and others:

"The committee has no intention of placing jurisdiction of the management of insurance company reserves within the hands of the Commissioner of Internal Revenue."

"We are trying to preserve as best we can in this bill the management of the industry in the hands of the State regulatory agencies and not to change in any way that situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or anyone else in Washington the regulatory authority."

"We are not saying that a company may not accumulate reserves if the State regulatory body tells it to accumulate reserves. We are not levying a tax on the accumulation of those reserves."

The inviolate character of reserves as determined for State law purposes, modified, however, by the four exceptions which Congress spelled out very carefully, it seems to me, causes the conclusion that the only result that really can be supported in terms of the legislative history is that the reserves as stated for State law purposes, as modified by the four specific exceptions that Congress enacted and enacted very carefully, must stand.

I was amazed and maybe mildly appalled at the government's suggestion in its reply brief that both the Commissioner's primary and alternative positions represent different but equally valid methods of dealing with the overstatement of reserves caused by the inclusion of the net valuation portion of deferred and uncollected premiums in reserves.

QUESTION: What page were you on there?

MR. HUGHES: Page 5, sir.

That simply is not true. The tax results are remarkably different. If they are equally acceptable, something is wrong somewhere. Furthermore, there is no way that you can go back to the legislative history and support the government's alternative position.

QUESTION: You would agree they are equally valid, wouldn't you? You would say neither of them are valid.

MR. HUGHES: No, I wouldn't agree that they are equally valid. I think there is more invalidity in the alternative than there is in the primary, because all that happens in the prime position is that consistent accounting principles are applied to a fantasy. And I don't think the fantasy is necessary. You know, this Court has said that such fantasy isn't necessary in the past on many occasions, in the Schlude case, where there were prepayment of dance lesson amounts and the people were going to have to give the services later. But there was no deduction. The same thing in the American Automobile case, the deduction and the income items do not have to be matched. They do not have to be matched. And whether it is the deduction first or the income first. Burnet v. Sanford & Brooks, a classic case from this Court many years ago, the taxpayer was out of luck. His deductions had run out, and when he got his money later, it was taxed.

Now the government has this feel that somehow or another Congress did not mean what it said. In 818 it says "accrual method of accounting shall be applied." Some way they say, they say under all known accrual methods of accounting there is no income because the taxpayer has no right to the premiums, may or may not collect them. All that happens to the policyholder is that his policy is cancelled.

QUESTION: On that point I wish you would pursue for me the hypothetical question I put to Mr. Smith about Justice Powell's $100,000 premium. He has paid the first quarter and does not die, but lives, but declines to pay the second quarter, just lets the policy lapse. Now, what happens with respect to that $75,000 of unpaid premium?

MR. HUGHES: Mr. Chief Justice --

QUESTION: Before you start, would you reduce that premium to $100, please?

(Laughter.)

MR. HUGHES: With the Chief Justice's permission, I will reduce it to $100.

QUESTION: Mr. Smith wouldn't agree to that. He wants a larger tax.

MR. HUGHES: But the novelty of the government's position shows up there, because under the taxpayer's position, assuming that Justice Powell survives, the $75 would come into income in the succeeding year if paid. Under the government's position, the $100 would come into income and the $75 would never be paid.

QUESTION: Mr. Smith disagreed. He said there would never be any tax levied on that.

MR. HUGHES: Oh, under the government's primary position, at the end of the year the deferred and uncollected -- and under the position of the four circuits -- the gross premiums, not the net premiums, except as modified then by Federal and Great Commonwealth, but the gross premiums would be taxed in year one. Assume this policy was taken out in 1976, under the government's position the entire $100 would be included in income and there would be no deductions attached to that $100 in income under Phase II and no reduction in assets under Phase I.

What it boils down to is the very bizarre position that if a year premium is paid in advance because on that basis the taxpayer at least gets the deductions incident to it, the taxpayer is better off than if it isn't paid, because he may or may not get it in the succeeding year. It's a very, very bizarre result. And I submit it comes about by reason of the Tax Court's having had its second thought. I think that initial Tax Court opinion is worthy of consideration in Western National, because it is very much like the Tenth Circuit. It took a number of years of dealing with imagination and fantasy and the Alice in Wonderland world of taxation of life insurance companies and language like this that goes all through the opinions to come back to the point that the Tenth Circuit was right, and it was right in the same way the Tax Court was right in its initial opinion.

Now, our second position is that at least the industry position is correct, and that would come about depending on a reading-- now, I have difficulty reading 818 this way -- but on a reading of 818, to go back into the preceding paragraphs, if you will look at the government's brief in the appendix, I guess it is on page 19A, "All computations entering into the determination of the taxes imposed by this part shall be made--

"(1) under an accrual method of accounting."

If we stop there and nothing else was said, the taxpayer clearly wins, there is no income, there are no assets. But then at the end there is a paragraph that says, "Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for the purposes of the annual statement approved by the National Association of Insurance Commissioners."

Now, if that means that accrual accounting is modified to the extent of the annual statement procedures, the net valuation portion of the premium would be included in assets and be included in income. If what this paragraph or sentence really means is rather that the taxpayer, if he is, for example, accruing discount on a bond, he must do it in the same way that he accrues for annual statement purposes. If that is what it means and you apply it to strict accrual accounting, the Tenth Circuit is right and the 16 judges of the Tax Court were right the first time they considered the matter.

Because of the importance of this case, the life insurance industry have ceded time in argument to the American Council for the argument of their position. I feel this is only fair. Standard is a small company. We believe our principal and primary position is right. We believe the Tenth Circuit is right. But we also believe that it's in the Court's interest and in the interest of proper resolution of this matter to hear from the Council.

But before that happens, I would like to respond to one matter Mr. Justice Stevens raised. Were this Court to decide that there should be a netting of agents' commissions and of premium taxes, we believe that is covered in this case. We believe that it is comprehended in the general category of what loading is intended for. From the record, from what is contained in this record, the computations on an approximate basis of those two figures can be made. I asked the company actuary and accountant to make those computations, so we believe it is properly in issue. As indicated by the preceding argument, I don't believe that it is the proper result, but we do believe that that matter has been raised.

QUESTION: Mr. Hughes, before you sit down, on the Court's time rather than your colleague's, may I ask this question: The agent's commission is included in the load element of the premium, is it not?

MR. HUGHES: Your Honor, it is, not on a per se basis, but the load in any given year, the commission could be greater than the load or less than the load. To take it into account, yes, sir.

QUESTION: Yes. That's an expense to the company. I realize that these commissions vary. What is an average commission on the first year's premium, a new policy written by an agent? What is the range?

MR. HUGHES: Mr. Justice, I don't know the answer to that, but I can tell you that a small company trying to put much business on the books may pay more than the first year premium in commission, whereas a more established company which really has agents available to it and has a better sales mechanism will not pay anything like that. I will be happy to submit to the Court and to government's counsel at lunch --

QUESTION: Just in a rough estimate, it would be 70, 80 percent?

MR. HUGHES: Yes, Mr. Justice, but it could be higher than that. It could be in excess of 100 percent.

QUESTION: A small company, you mentioned, could put itself in a position where its surplus is wholly inadequate to meet the business if it wrote too much insurance on the basis you have indicated.

MR. HUGHES: Yes, indeed, and that's why that 818(c) net level election might be made so they can take their tax deductions on a different basis. That was Congress' third exception to the reserves for the benefit of small companies.

QUESTION: A large established company, the loading plus the commission itself in the first year means that there is no net income to the insurer in the first year.

MR. HUGHES: There is no net income for annual statement purposes. There is net income under the government's position.

QUESTION: I was speaking of real income, not taxable income.

MR. HUGHES: That's right.

QUESTION: Very well.

(Laughter.)

MR. CHIEF JUSTICE BURGER: Mr. Zinn.

ORAL ARGUMENT OF MATTHEW J. ZINN ON BEHALF
OF THE AMERICAN COUNCIL OF LIFE INSURANCE,
AS AMICUS CURIAE

MR. ZINN: Mr. Chief Justice, and may it please the Court: The American Council of Life Insurance wishes to express its appreciation to Mr. Hughes for ceding a portion of his time to the Council so that the views of the industry may be presented to this Court.

As the Court is aware, the Council occupies the middle ground between the primary position of the government in this case and the primary position of the taxpayer. Our view is that only the net valuation portion of deferred and uncollected premiums is properly included in assets and income and that there is no basis for reducing reserves on account of deferred and uncollected premiums.

In the few minutes available to me, I would like to outline for the Court the four considerations which we believe should guide decision in this case.

The first of these relates to reserves. Much of the ground has already been covered, and I will simply sum up. Reserves have been handled the way we say they should be handled since 1871, long before there was an income tax. The precise issue that is raised here was raised and decided adversely to the government in 1918, and the government didn't prosecute an appeal of that case. More significant, in 1921 the then Bureau of Internal Revenue acquiesced in the 1918 decision. From 1921 to 1951 everyone proceeded on the understanding that reserves were not to be reduced on account of deferred and uncollected premiums. In 1959 Congress looked at reserves very carefully, and as Mr. Hughes points out, it make four specific exceptions to the rule of State law applicable to reserves, but it made no exception for deferred and uncollected premiums. Indeed, in the government's own regulation which it relies upon to reduce reserves, section 1.801-4, which appears on page 19A of the appendix to the government's brief, the caption of that regulation is "Adjustment to Life Insurance Reserves." And in the body of that regulation, it is stated that if assets and income are not stated the way the government says they should be stated, then we will reduce your life insurance reserves.

The point I am trying to make is that the government's own regulation in force for 17 years presupposes that there is to be no reduction in reserves on account of deferred and uncollected premiums. As far as the regulation itself, we think we have covered it adequately in our brief. There is not a word in the legislative history which authorizes a regulation of this sort, and while Mr. Smith has objected to our characterization of the regulation as strong-arm and pernicious, he has not objected to the characterization of it being unique. I know of no other situation in the tax law where the government says if you don't report one item the way we say you should report it, we will take something away from You that you are otherwise entitled to.

So much for reserves. Let me turn to my second point. Mr. Justice Rehnquist asked a question about consistency, why is it that we don't do the numerator and denominator the same way. My answer is because the Code says so, Mr. Justice Rehnquist. The reserve computation is determined under section 801. The method of accounting applicable to assets and income is determined under section 818. Section 818 is also set out on page 19A of the appendix to the government's brief, and if the Court will turn to it, it will see that insofar as relevant here, we are talking about section 818(a)(1) which refers to the accrual method of accounting, and we are talking about in the flush language at the end of that provision the NAIC method of accounting.

Now, what the government is asking this Court to do, we think, is to read an additional sentence into section 818(a) that is not there which would say, in effect, in applying this provision, or notwithstanding the foregoing provisions, it shall be assumed that deferred and uncollected premiums have been received in cash. Now, if that sentence was in there, I don't think we would be here now. But it's not in there. The government, it seems to us, is taking a position exactly contrary to the position it took in the Foster Lumber case. There it told the Court, "Don't read in additional words into section 172, the net operating loss provision. Read the Code the way it was written," the government told this court.

Now, we think if that was the standard that was applicable in the Foster Lumber case, which involved the somewhat complicated provisions of net operating loss and capital gain, a fortiori that standard should apply in the interpretation of the arcane life insurance company taxing provisions.

QUESTION: Of course, the government prevailed in the Foster Lumber didn't it?

MR. ZINN: Yes. And that's exactly our point. The government prevailed and the Court didn't read the language in.

And we think that, as I say, regardless of the differences in that case, this is an a fortiori case, given the more difficult provisions that are involved here.

This brings me to my third point, and that is how we choose between the accrual method of accounting that is specified in section 818 and the NAIC method. The lower courts have simply read out of section 818(a) the last sentence of that provision. They have looked at it, and they have said, well, it's accrual, and they have either held for the Standard Life position here, because as Mr. Hughes has pointed out, if you apply strict accrual accounting, the judgment of the court below should be affirmed, or if they had read in the assumption sentence that the government tells us should be read into this provision, they have held that it is accruable, which is also right. If the amount was received in cash, under the accrual method it's read in.

QUESTION: Just precisely what sentence were you referring to in 818 that the government is reading out?

MR. ZINN: The government is reading in, not reading out.

QUESTION: You just said that they were reading out.

MR. ZINN: No. The courts below in interpreting 818(a) have read out the last sentence, the "except" sentence, which refers to the NAIC position. They have either said, as the court below did, under strict accrual accounting, with no government sentence in there, what the Tenth Circuit said here, nothing is includable in assets or income. Or they have said that the accrual language of the statute simply takes precedence over the NAIC reference in the last paragraph.

Now, we think that this provision should be interpreted in a way to give play to both provisions, and I would like to suggest to the Court the way in which we think this should be done. We think that the two-step process should be applied. The first step is to determine whether a particular item of income or expense is to be accounted for currently under the accrual method specified in 818(a)(1). If it is to be accounted for currently under the accrual method, we think that is the end of the inquiry. That overrides the "except" language at the end of section 818(a). If, on the other hand, as in this case, accrual accounting does not require an item of income or expense to be taken into account, then it seems to us that it's appropriate to go forward and see if that item is to be accounted for currently under the NAIC method of accounting, the result in this case would be to adopt the NAIC method of accounting that we urge upon the Court. In this way we believe both sentences of the statutory provision can be given meaning without reading one or the other out.

Finally, let me deal briefly with consistency, and let me reduce the numbers we used before to just $1 if I may, Mr. Justice Powell. What the government is saying here essentially in the Phase I computation is this: If you add a dollar to the numerator of the fraction, a dollar to the denominator of the fraction, in most situations that is going to increase the fraction and increase the exclusion. That is our position, add a dollar to each. So the government says add a dollar to the numerator, but add $1.25 to the denominator because that is the gross premium. It says we should do this because we want to maintain the proportional relationship.

The difficulty with the government's position is that it is not uncommon for 80 or 90 percent of that 25 cents of loading to consist of expenses, and what we are talking about here is a problem as familiar to this Court as any in the tax law where you cut off the accounting cycle. If you cut the accounting cycle off after the receipt of the $1.25 but before the payment of the expenses, that is going to produce a result that is disproportionately high, both under the fraction and in the Phase II computation, because you will have the same imbalance there. The $1.25 will come into income currently, but the, let's say, 20 cents won't come into expense until the subsequent period.

Now, our solution to the problem of adding a dollar to the numerator and a dollar to the denominator is not a perfect solution. I suppose the perfect solution would be add a dollar to the numerator and let's say $1.05 to the denominator, if that is what you are really going to have left after you pay the expense. But in this area I don't think we can strive for perfection. I think the method that we urge upon the Court comes closest to that. The government's method, on the other hand, overstates income in the Phase II computation by not allowing for expenses and overstates it in Phase I by not reducing the assets by the amounts that would be paid out in recognition of these expenses.

There have been references this morning to the Great Commonwealth line of cases, and we think those cases were correctly decided. But we think they don't nearly go far enough. With one exception they have been limited to the Phase II computation and have not been carried over into Phase I. We think they should be. The government truly seeks proportionality, and it seems to us that assets ought to be reduced on the assumption that the expenses were paid in cash. If we are going to assume we received the premiums in cash, we see no reason why it is not equally fair and reasonable to assume the payment of expenses in cash.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Zinn.

You have about 2 minutes left, Mr. Smith.

REBUTTAL ARGUMENT OF STUART A. SMITH ON

BEHALF OF THE PETITIONER

MR. SMITH: I will quickly just make a few points.

I think the taxpayer's position and the industry's position on the question of reserves stem from the notion that if State law says it's OK to write up the reserves this way, well, that is the end of the matter. The point is simply that this Court in its decision in New York Life Insurance Company v. Edwards specifically rejected a contention like that. It said the fact that a State official calls something a reserve doesn't mean it's a life insurance reserve, that it's a reserve from premium. And the Federal statute, the definition, 801(b)(1)(B), uses the term "set aside." And you have got to have something to set aside. If there is nothing to set aside, there is no reserve.

Our position simply is that the Commissioner is willing to accept the assumption of full premium payment, but the taxpayer can't simply say, "OK, we will accept it for purposes of reserves but not accept it for purposes of assets and premium income."

I want to say something about the difference between the Phase I and Phase II computation in response to something Mr. Zinn just said, which I think is important. And that is there is no warrant, no matter how the Great Commonwealth loading line of cases is ultimately resolved on expenses, there is absolutely no warrant in the statute for providing for an offset from assets for any expenses at all. And the reason is simply this: The statute talks about assets. It doesn't provide for any deductions. If a life insurance company has a building which it paid $1 million for, and that building is mortgaged for $500,000, that building goes in the asset computation as $1 million and not at something else. And simply to put the matter another way, if a life insurance company has accrued expenses which in fact it is allowed to take deductions for on the Phase II computation, those deductions don't reduce its assets until it actually pays them out. And our position here is simply that there is no deduction for any expenses from assets in the Phase I computation until there is an actual disbursement from the life insurance company's assets.

QUESTION: Mr. Smith, you argued Foster Lumber?

MR. SMITH: I did.

QUESTION: Not once, but twice.

MR. SMITH: That's true.

QUESTION: Do you have any comment to Mr. Zinn's reference to Foster Lumber?

MR. SMITH: Yes, I do, Mr. Justice Blackmun. I don't think that we are reading language in statutes or reading language out of statutes. These statutes are complex, and we are satisfied with the way they are written. The point is simply this: Section 818 says all computations entering into the determination of taxes imposed by this part shall be made under an accrual method of accounting.

I think we are all agreed that these things are not accruable items on any side of the balance sheet. And if we talking about perfection, the perfect solution is the alternative position that is set forth in our regulations, the whole thing is simply ignored. But the Commissioner has gone along with the life insurance companies indulging in the assumption for purposes of reserves, and we believe that it necessarily has to -- that imposes a condition that those computations be made consistently.

I think the point of the NAIC method, I think the important thing about it is that final flush language begins, "Except as provided in the preceding sentence," and you first got to get over the accrual hurdle. And if the life insurance companies are going to "accrue", that is, recognize full premium receipts and get deductions for increases in reserve and increase the numerator of the fraction and increase the inclusion, they correspondingly have to make the same accrual type assumption in its denominator of the fraction and for purposes of including the full amount of deferred and uncollected premiums in the statutory Phase II category "gross amount of premium."

QUESTION: Mr. Smith, may I just ask this one on this very point. That is not an answer to Mr. Zinn's argument that you first look at the accrual and see that it does not come within the normal accrual accounting, and then if it doesn't, you are then within the "except" language and now you must look at the NAIC. What is your response to that?

MR. SMITH: Yes, but I think if you carry Mr. Zinn's initial premise, you land right in the alternative regulation because none of these things were accruable items. They are not liabilities.

QUESTION: You land right into the NAIC --

MR. SMITH: No, I don't think so.

QUESTION: Why don't you? That is the question.

MR. SMITH: I think you don't land in the NAIC point because essentially the insurance texts uniformly provide, and there has been no refutation from the other side on that point, that these are not liabilities, they are overstatements. So the first thing, they are simply not accruable liabilities. Because essentially the insurance company doesn't bear any risk for periods which have not been covered. So you don't have any liability. You don't have any premiums. You don't have any assets. So you land in the alternative position. And that's essentially what we are talking about.

QUESTION: Does one ever land in the "except" sentence?

MR. SMITH: I think you will land in the "except" sentence to the extent that the NAIC method is recognized in the statute.

That leads me to the last point I want to make, which is, you know, we are talking about these expenses. The important thing is the NAIC method has a deduction for loading to offset the overstatement. But the Seventh Circuit said that loading is simply not an expense. I think the important thing for us is to look at the statute. Congress was aware of the NAIC method and it didn't provide for a deduction for loading. The important thing is first to look at the statute, and to the extent that the NAIC method is not inconsistent with an accrual method of accounting, I think that can supply guidance here.

MR. CHIEF JUSTICE BURGER: Mr. Smith, you are going over old ground now.

MR. SMITH: I am sorry.

QUESTION: Mr. Smith, I would like to ask you -- this may be old or new -- is this a relatively new position of the Commissioner?

MR. SMITH: Absolutely not.

QUESTION: How long has it been going on?

MR. SMITH: For about 18 years. Since the 1959 Act. Then the regulations came out in temporary form in 1960. So essentially the industry and the government have been grappling --

QUESTION: Have there been proposals for amending the revenue laws to change the Commissioner's practice?

MR. SMITH: Absolutely not, not that I am aware of. Until the Tenth Circuit's decision in this case, both Mr. Hughes' position and the industry's position were uniformly rejected by four courts of appeals --

QUESTION: You think this position, you could say, has been going on or has been -- it may have been challenged all this time, but it has been the Commissioner's position for 20 years, or not?

MR. SMITH: Well, since 1959-60, so about 18 years.

QUESTION: Of course, as long as the courts were going your way --

MR. SMITH: We were happy. That is true.

QUESTION: -- you didn't need to worry about this.

MR. SMITH: Although we submit that this Court should reverse the judgment below.

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

[Whereupon, at 11:43 a.m., the arguments in the above-entitled matter were concluded.]