[JOINT COMMITTEE PRINT]

MAJOR ISSUES IN THE TAXATION OF LIFE INSURANCE PRODUCTS, POLICYHOLDERS, AND COMPANIES

A STUDY

PREPARED BY THE STAFFS

OF THE

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AND

SENATE COMMITTEE ON FINANCE

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INTRODUCTION

This document is a study on the taxation of life insurance products, policyholders, and companies. It was prepared by the staffs of the Joint Committee on Taxation and Senate Committee on Finance in response to a request by Finance Committee Chairman, Robert Dole, in October 1982. (See Senator Dole's Press Release of October 8, 1982, requesting the staff study.)

The first part of the document is a summary of the study. The second part is a discussion of the taxation of life insurance products and policyholders. The third part is a discussion of the taxation of life insurance companies. In each of parts two and three, there is an overview followed by a discussion of specific areas of tax treatment, including background, present law, and issues.

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I. SUMMARY

A. The Business of Life Insurance

Life insurance provides protection from the economic loss due to the death of an individual. This protection is made affordable by spreading the risk of death among insured persons. The insurance company is a vehicle that pools its customers' premiums and administers the common fund from which individual losses are reimbursed.

A life insurance company is a hybrid organization. It is a service provider that sells insurance protection for a premium. It can also be seen as a financial intermediary, like a bank, that accumulates and invests the assets of others. In 1981, life insurance companies held $525.8 billion in assets, which were invested principally in corporate debt and government bonds, and in mortgages.

Unlike banks, insurance companies are organized and regulated exclusively under State law. Like thrift institutions, insurance companies may be stock or mutual organizations. Stock companies are similar to typical corporations owned by shareholders who receive profits through corporate dividends. Mutual companies are based on a cooperative concept and are owned by their policyholders, who share in the profits of the company. Since mutuals do not have a pool of capital contributed by stockholders, most mutual policies include "redundant premiums"; i.e., premiums in excess of what is necessary to cover the cost of the insurance. Mutuals often charge these premiums for "participating policies," which allow the policyholder a share in the surplus of the company through the distribution of policyholder dividends.

Although 93 percent of all insurance companies are stock companies, mutual companies are generally older and larger than the stock companies, and the market share and assets of the insurance industry are more or less divided evenly between the two groups.

Mutual and stock companies compete not only with one another for a share in the life insurance business, but also with banks and trust companies that administer qualified pension plans and with other tax-exempt insurance trusts.

The last major revision of the Federal tax laws governing insurance took place in 1959 (the "1959 Act"). The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") made certain changes in the taxation of life insurance companies and their products, although some of these changes were temporary "stopgap" rules applicable in 1982 and 1983.

B. Life Insurance Products and Their Tax Treatment

To understand the taxation of life insurance companies, a brief discussion of life insurance products and their taxation is neces-

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sary. Some life insurance contracts provide pure insurance protection. For example, a term insurance contract offers, for a set premium, insurance protection for the limited period of time set forth in the contract. The cost of a term insurance contract increases with a potential customer's age, since the premium price is based on the likelihood of death.

Other insurance contracts build up investment income ("cash surrender value" or "cash value") beyond the amount necessary to pay death benefits. Whole life policies allow lifetime insurance protection for a single or level premium that may be higher than the premium a younger person would pay for term insurance, but which will not increase with age. This is because the investment returns of these high premiums allow a buildup of cash value in the early years of the policy which reduces the amount of the insurance risk born by the company in later years when coverage is more costly.

In recent years, life insurance companies have been marketing flexible premium life insurance contracts (referred to as "universal life" or "adjustable life" contracts). These contracts are similar to traditional whole life policies, but typically permit the policyholder to change the amount and timing of the premiums and the size of the death benefit as the policyholder's needs change. These contracts may permit the policyholder to invest a substantial amount of cash in the insurance contract without a related increase in the amount of pure insurance protection offered by the contract.

These new policies offer taxpayers an opportunity to accumulate assets while deferring or avoiding entirely a tax on investment income. This is because a policyholder is not immediately taxed on increases in the cash value of an insurance policy.

Payments from a life insurance contract upon death are not subject to income taxation at all, and if a policyholder surrenders the insurance policy, any distribution from that policy is taxed only to the extent that it exceeds the aggregate premiums paid. Moreover, because State laws require that a policyholder be able to obtain the cash value of his policies, insurance contracts usually allow the policyholder to cash in his policy or to borrow against the policy at low rates of interest. Thus, although the policyholder has access to the cash value built up in his insurance contract, this amount is not immediately taxable to him, if it is taxable at all.

This special tax treatment was granted to traditional life insurance contracts in acknowledgement of the social value of such insurance. Given the growth of nontraditional insurance contracts, TEFRA added guidelines that flexible premium life insurance contracts must meet in order to be treated as life insurance for tax purposes. To be treated as a life insurance contract for tax purposes, such contracts must meet one of two alternative tests. Under the first alternative, (1) the sum of the premiums paid under the contract at any time cannot exceed a specifically computed guideline premium limitation, and (2) the amounts payable upon the death of the insured cannot be less than a certain multiple of the contract's cash value as of the date of death. The first requirement is intended to prevent investment-motivated contributions of large cash amounts to the contract. The second requirement is intended to ensure that flexible premium contracts will offer a minimum

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amount of pure insurance protection at all times. The second alternative test limits the cash value of any insurance contract to the amount of premiums required to fund the death benefit under the contract. These provisions are temporary rules that apply to all such contracts issued before January 1, 1984.

An annuity contract can be considered a mirror of a life insurance contract. A fixed annuity contract is one in which the insurance company agrees to make specified payments during a fixed period in exchange for single or multiple premiums. A variable annuity is one in which the amount of each periodic income payment fluctuates on the basis of the investment return on the premium paid. Sometimes a set rate of return is guaranteed under the contract. Often the starting date of the annuity payments is deferred until a specific event (e.g., retirement).

The taxation of interest or other current earnings on a policyholder's investment in an annuity contract is deferred until annuity payments are actually, or deemed to be received. Amounts paid out under a contract before annuity payments begin are income only with respect to amounts in excess of the policyholder's investment in the contract (i.e., premiums). These rules make annuities an attractive investment.

TEFRA made two changes to the tax treatment of annuity contracts. First, a 5-percent penalty was imposed on certain distributions from the annuity contract. This penalty does not apply in certain circumstances, such as death or attainment of age 59-1/2. The penalty is designed to limit use of annuity contracts as an investment vehicle. The other change made by TEFRA is that partial surrenders or cash withdrawals made prior to the annuity starting date are income to the extent that the cash value of the contract exceeds the investment in the contract.

C. Taxation of Life Insurance Companies

A life insurance company, like a nonlife insurance company, is taxed at the normal corporate rates on its taxable income. However, the Code provides special accounting and other rules for defining taxable income that attempt to reflect a number of special characteristics of the life insurance industry.

First, an insurance company's taxable income reflects its dual role as a provider of insurance protection and a financial intermediary. The company earns underwriting income from its sale of insurance protection when it experiences "mortality gains" or "loading gains"; that is, if policyholders live longer than expected or if expenses are less than anticipated when the contract was priced. The company earns investment income as a financial intermediary when its return on invested assets exceeds amounts due to its policyholders. Second, insurance companies describe their business as unique because its major expenses (death benefit payments) occur long after the income relating to the expenses (premiums) is paid. The tax law permits insurance companies to take current deductions for additions to reserves that are built up in anticipation of the payment of future expenses for death benefits. Thus, an important issue becomes the method of computing appropriate reserves for tax purposes. Finally, the tax law has long reflected Congress'

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attempt to maintain a competitive balance between the stock and the mutual companies.

Under present law, life insurance company taxable income can be divided into three elements. These elements are referred to as "phases" in the literature, although that term is not used in the Internal Revenue Code. In general, the phases interrelate as follows. In Phase I, the investment income earned by the insurance company is computed, and the insurance company's share (as opposed to the policyholder's share) of that investment income is determined. In Phase II, the company's underwriting income is computed. If there is an underwriting loss, the company's share of its investment income is reduced by the loss; if there is an underwriting gain, 50 percent of that gain is added to the company's taxable investment income to become the company's total taxable income. Any tax on the remaining 50 percent of underwriting gain is deferred as "policyholders surplus" until distributions from this surplus are deemed made to shareholders in Phase III. These phases will be described in more detail below, with particular emphasis on the deductions and tax accounting methods that are intended to reflect the special characteristics of life insurance companies.

An insurer's taxable investment income determined in Phase I is split between the company's share of the investment income, which is taxed to the company, and the policyholders' share, which is not taxed. The deduction for the policyholders' share of investment income reflects in part the cash value of the insurance contracts owned by the policyholders and recognizes the insurer as a financial intermediary that holds these assets for its policyholders. This treatment of the policyholders' share is in some respects analogous to the treatment of banks and their depositors, with an important exception. Bank depositors are taxed on their investment income even if it is not distributed, but policyholders are not taxed on the policyholders' share credited to them on the books of the insurance company. Moreover, as explained above, no substitute form of tax is currently imposed on the increasing cash value in the policyholders' insurance contract. Thus, the policyholders' share of investment income escapes tax at both the company and the individual level.

The amount of the policyholders' share of investment income is basically the additional amount that the insurance company is permitted to allocate to its reserves. A reserve recognizes a company's future liabilities to its policyholders. The size of the reserve depends in part on the interest and mortality assumptions used in calculating the present value of future benefits, premiums, and obligations.

Under the Internal Revenue Code, the reserves taken into account for tax purposes are generally those established under State law. Since States are generally concerned that an insurer have sufficient funds to pay all policyholder claims if liquidated, they generally require conservative interest and mortality assumptions that enlarge the size of the reserve.

The valuation method used by companies also affects the size and growth of the reserve. Two reserve valuation methods are generally prescribed by the States and used by companies. The "net level premium" method assumes that all sales commissions and administrative expenses of a contract are amortized over the life of that contract. The "preliminary term method" acknowledges the practical reality that such expenses are generally higher in the early years of the policy, and results in a lower level of reserves (and consequently a lower tax deduction) at the early stages of a policy's term. Although virtually all companies now use the preliminary term method, in 1959 many large companies used the net level premium method. Small insurers argued that it was unfair that large companies, which have higher levels of surplus, could take advantage of a higher reserve deduction, while the lack of statutory surplus would limit small companies to use of the preliminary term method. Recognizing that argument, section 818(c), enacted as part of the 1959 Act, allows insurers to use the preliminary term method for State minimum reserve compliance rules but use the net level premium method for tax purposes, pursuant to revaluation, of the State law reserves. This reserve revaluation may be computed under an "exact" method that produces exactly the same reserves as if the company actually used the net level premium method for State law purposes. The reserve revaluation may also be computed under an "approximate" method prescribed by section 818(c)(2). This "approximate" method has produced substantial tax savings for some companies. TEFRA reduced the tax saving that could be obtained by the approximate revaluation method, but did not eliminate it entirely.

The second phase of an insurance company's taxable income consists of the excess of one-half of the company's gain from all operations—-underwriting and investment functions—over its taxable investment income. This amount can generally be thought of as one-half of the company's underwriting income.

The Internal Revenue Code allows a deduction for policyholder dividends because such payments are not considered returns of profits to shareholders (and thus analogous to nondeductible corporate dividends), but are rather considered returns of excessive premiums charged to customers. Although stock companies sometimes do return excessive premiums to customers as policyholder dividends, they have argued that mutual companies are more likely to charge and return excessive premiums because the mutuals' policyholders are the true owners of the company and because these excessive premiums are in part a substitute for the capital acquired by the sale of stock. The stock companies argue further that they must maintain a larger surplus in order to retain funds equivalent to these excessive premiums. It is also argued that policyholder dividends are a distribution of more than customer rebates, that they are in part a distribution of the profits of the mutual company and should be taxable at the company level.

Under the 1959 Act, the amount of the policyholder dividend deduction and the amount of the special deduction were limited to the excess of gain from operations, if any, over the taxable investment income plus $250,000. An important purpose of this limit was to ensure that mutual companies do not entirely avoid tax liability by increasing their dividends to policyholders. In addition, the 1959 Act allowed special deductions for nonparticipating insurance, which is generally offered by stock companies, and for accident, health, and group life contracts. These special provisions were a re-

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sponse to the stock companies' concern that mutuals could lower their effective tax rates through the payment of policyholder dividends. Another rationale for this treatment is that the limit, in effect, imposes a "proxy" tax on the corporation in lieu of a tax imposed on the buildup of the cash value in the insured's policy comparable to a tax on interest. For taxable years 1982 and 1983, TEFRA revised this limitation. The limit is either a statutory dollar limit of $1 million, or the sum of (1) all policyholder dividends allocable to insured qualified pension plans, (2) $1 million, and (3) for mutual companies, 77-1/2 percent of the policyholder dividends other than dividends paid on qualified pension business, or, in the case of a stock company, 85 percent of the sum of such policyholder dividends and the special deduction for nonparticipating contracts. [1]

The third phase of an insurance company's taxable income is imposed only on the stock companies and is based on distributions from the so-called "policyholders surplus account," which is credited with one-half of the previous years' underwriting income deferred under Phase II. When the account exceeds certain limits, or if distributions to shareholders are deemed made, then the company pays a tax on the amount in the account. Since the limits are so high, and since any distributions to shareholders are deemed to be made first out of taxed income, this portion of the life insurance company tax is of little concern to insurers since it is rarely imposed.

D. Principal Issues

General

The general rule for income taxation of corporations is a tax at a rate of 46 percent on income. Many corporations pay income tax effective rates of less than that because of various special provisions which have been added to the Internal Revenue Code to provide incentives for certain types of activities. The life insurance industry has benefited from a determination that certain behavior should be encouraged—economic protection against untimely death or against unexpectedly long life, provisions for retirement via qualified pension plans and deferred annuities, and economic protection in cases of disability or illness.

Many of the tax incentives to further these social policies benefit consumers directly by lowering the taxes they otherwise would pay. In addition to special tax treatment for life insurance payments made on account of death or in the form of an annuity, the Internal Revenue Code provides additional benefits to help people to save in order to purchase life insurance or annuity benefits in the future.

A threshold issue presented is how great an incentive, at the consumer level, is appropriate and necessary to encourage socially desirable goals. A second issue is how to define adequately the products which are to be encouraged. When TEFRA was considered in

[1] The $1 million amount is ratably reduced when the policyholder dividends and special deductions of an insurer reach $4 million, and eliminated entirely when the sum exceeds $8 million.

1982, there was concern that some products were being sold primarily as investment vehicles rather than protection against dying too soon or living too long. The result was the guidelines for flexible premium life insurance and limitations on early withdrawals from deferred annuities. Further efforts at product definition may be appropriate. For example, at what point is a high premium justified to provide life insurance, and when is a portion of the premium merely a method to sell tax-sheltered investment earnings?

Once Congress is satisfied that it is providing sufficient tax incentives to consumers for adequately defined products, the next issue is whether the true income base of the insurance companies themselves is accurately derived by reference to the life insurance company provisions of the Internal Revenue Code and, to the extent that deductions do not reflect accurately the real costs of providing products or services, whether there are additional social policies which justify deviation from the general rules.

Probably the most important issue in determining a life insurance company's income is the treatment of reserve liabilities. As discussed above, life insurance companies are allowed to deduct additions to reserves representing the liability to pay claims in the future. This treatment allows the deduction of amounts at an earlier time than other corporations are allowed under normal accrual accounting rules. Although this treatment in concept may be sound, the determination of the proper method for calculation of the reserves is difficult. Under present law, life insurance companies have substantial latitude in choosing among several reserving formulae acceptable to the States in which they conduct their business. This is due, in part, to an interest of the State insurance departments to encourage conservative business practices to ensure solvency of the companies.

However, the tax laws generally allow deduction of business expenses if they are both ordinary and necessary. It may be argued that, under this standard, only the minimum reserves required by State law should be deductible since all that is "necessary" to be established as a reserve is the minimum amount required by State law.

Even if one accepts that a reserve method allowed for State regulatory purposes should be deductible for Federal income tax purposes, there remains the question of whether a life insurance company should be allowed to restate its State law reserves for tax purposes in a manner to accelerate deductions. Present law allows companies to do this by revaluing reserves established for State law purposes on a "preliminary term" basis to a "net level premium" basis for tax purposes.

This revaluation may be made either by recalculating the reserves on an exact basis or by using a simplified, approximate formula set forth in the Internal Revenue Code. The approximate revaluation formula has been criticized by the General Accounting Office and others as being significantly more generous than a revaluation by an exact recalculation of reserves.

In addition to the reserve issue, there are other special deductions for certain accident and health insurance contracts, group life insurance contracts, and certain nonparticipating (nondividend-paying) contracts, as well as for certain policyholder dividends for which the economic justification is unclear, although the provisions undoubtedly have an impact on the competitive balance between stock and mutual companies, as well as on the aggregate tax liability of the life insurance industry.

Balance between stock and mutual companies

Since mutual companies do not have a separate class of stockholders, any gains not anticipated in the calculation of the price of products, from better than expected investment or underwriting experience, will benefit policyholders. However, because stock life insurance companies have separate policyholders and shareholders, any difference in the tax treatment to a company of returns to policyholders and returns to stockholders could cause a competitive advantage to either stock or mutual companies.

This competitive problem is usually discussed in the context of what portion of policyholder dividends should be deductible to a mutual company as a business expense and what portion, if any, is analogous to a stockholder dividend as a return on invested capital to be paid out of after-tax earnings. This problem is often referred to as the "ownership differential" issue.

Although many mutual companies reject the notion that any policyholder dividend should be taxable to the company, stock companies have argued that, unless some portion of a mutual company's policyholder dividends is treated as stockholder dividends, stock companies may not be able to compete effectively with mutual companies.

If one accepts the concept that some portion of policyholder dividends should be paid out of after-tax earnings, a method of arriving at that portion must be derived. One method of accomplishing this is to compute a return on equity (the excess of assets over liabilities) for mutual companies approximating the return on equity of similar stock companies. The amount of policyholder dividends equal to this return on equity would not be deductible to the mutual company in computing its taxable income.

An alternative approach would be to allow a full deduction for policyholder dividends but to impose an addition to a mutual company's tax base computed by determining the difference between the return on equity for stock companies and for mutual companies (after policyholder dividends) and multiplying this difference in rate of return by each mutual company's equity base.

Another alternative, incorporated into the temporary rules enacted as part of TEFRA, would be to provide for a specified percentage of deductible policyholder dividends and interest credited in excess of the amount guaranteed under the terms of the contract or policy with the customer. Under the TEFRA provisions, stock companies were allowed to deduct a minimum of 85 percent of policyholder dividends paid while mutual companies were allowed to deduct 77-1/2 percent of policyholder dividends. The 7-1/2 percent differential was intended to reflect the return-on-equity concept as a part of the dividends paid by a mutual company to its policyholders.

Probably the most important point is that, whatever approach is taken on this issue, the goal is primarily to provide a mechanism for competitive balance between stock and mutual companies which will be dynamic enough to adjust to changes in the industry over time.

Treatment of affiliated businesses

To the extent that extraordinary tax treatment is accorded to a life insurance company through various provisions designed to reflect the special nature of the business or to provide competitive balance within the industry or with other financial intermediaries, substantial pressure is placed on the definition of a life insurance company. Also, to the extent that the special life insurance company tax rules create either an incentive or disincentive to carry out certain business activities within a life insurance company or within an affiliated company, the specific rules relating to consolidation of tax returns become very important. For instance, if a certain type of business activity is unrelated to life insurance activities, would the operation of the business within a life insurance company cause the company not to meet the definitional requirements of a life insurance company? If so, how would operation of this unrelated business in an affiliated company be treated if the life insurance company and the nonlife insurance affiliate filed a consolidated return? Similarly, if a certain type of insurance product could be sold either in a life insurance company or a nonlife insurance company, would there be any difference in tax impact depending on which type of company offers the product?

A related question involves the treatment of a life insurance subsidiary of a mutual company. Should the subsidiary be treated as a stock or mutual company?

Other issues

In addition to product definition and income definition, competitive balance within the industry, and treatment of affiliated groups of corporations including life insurance companies, there are several additional issues, such as the need to address concerns of small insurance companies and the competitive balance with other financial intermediaries, which must be considered in analyzing any proposed change in the taxation of life insurance companies.

II. TAXATION OF LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

A. Overview

Historically, life insurance products have offered policyholders insurance protection and a vehicle for savings. For example, under whole life insurance, the buildup of cash value through premium charges that exceed the cost of insurance in the early years of the policy and the investment earnings on the cash buildup contribute generally to the reduction of overall insurance costs in later years of the policy. This inside buildup or subsidy to the cost of insurance traditionally has not been taxed to the policyholder unless the contract is surrendered prior to maturity, and then, only to the extent the cash surrender value exceeds the aggregate premiums and other consideration paid. One reason for this treatment might be that before a taxpayer may enjoy this buildup he must surrender a valuable right, the right to future insurance protection at a guaranteed cost.

Recently, this characteristic of tax deferral, which could be viewed as a reward for savings, has been emphasized and marketed as a way to shelter income from tax. Also, products have been designed to offer savings rates that are competitive with other financial institutions, in a general effort to attract the taxpayer's savings dollar, albeit also to encourage the use of such savings to purchase and reduce the cost of insurance. Against this background, the question that must be addressed is: to what extent should taxpayers, as owners of insurance products, be allowed to defer taxation on current investment earnings or use before-tax investment earnings to reduce the cost of their insurance protection?

One answer to this question may be to allow an unlimited amount of deferral or use of investment earnings to reduce the cost of insurance. This policy would be justified by treating a taxpayer's investment in a life insurance contract in the same manner as his other major long-term investments which typically include his home and his retirement savings. The Congress has generally adopted mechanisms through which the inside buildup of value with respect to housing and retirement savings may escape current tax. It could, therefore, be seen as logical to provide the same treatment for life insurance accumulations. In addition, the social benefits derived by the nation from having its population adequately insured and by the long-term investments made by insurance companies might further justify deferral of tax on the inside buildup.

A contrary approach would be to treat the savings element of an insurance contract in the same manner as bank savings. The comparison of the savings element in insurance with a passbook account or certificate of deposit may lead one to conclude that the entire inside buildup should be taxed currently to the policyholders.

A third response to the question may be to limit the amount of tax-deferral or pre-tax use of investment earnings. For example, earnings up to a certain defined rate might continue to enjoy tax-deferral, while earnings in excess of that rate would be taxed currently. At the same time, if a product was designed to give the policyholder the benefit of higher investment earnings through the distribution of policyholder dividends, interest in excess of that guaranteed for the life of the contract, or premium adjustments, some tax could be imposed on the current earnings on the policyholder's investment in the life insurance product.

A fourth response may be to limit the amount of a taxpayer's investment in a life insurance product that earns tax-deferred investment income. This might require limits and penalties similar to those used in retirement plans.

Finally, tax-deferral and pre-tax use of earnings combined with insurance might be allowed only for certain defined products. This would require definitions of a life insurance contract and an annuity contract for tax purposes. A minimum amount of pure insurance might be required at all times under the contract. Further, a ceiling on the maximum amount of tax-deferred savings might be provided. In addition, the cash value of the contract might be required to follow a pattern of certain traditional insurance products that have not been heavily investment oriented.

The temporary guidelines for flexible premium life insurance could be viewed as a response by Congress to the recent trend of marketing life insurance products as shelters for increased investment earnings. Limitations were placed on products like universal life insurance, requiring that a minimum amount of insurance protection must co-exist with the policyholder's cash value investment. A similar response to marketing trends also can be seen in the current provisions for taxing annuity contracts. A 5-percent penalty on distributions made within 10 years of a contribution to a deferred annuity and the cash withdrawal rules might be viewed as being patterned after rules for IRAs and Keoghs. The effect of these provisions is to restrict tax-deferral to certain qualifying products or to limit tax-free accumulation of investment earnings to certain products used for long-term savings. These provisions, however, do not alter the tax treatment of these products for the companies.

B. Insurance Products

1. Background

A whole life insurance contract can be thought of as consisting of two separate elements: the first, pure insurance protection; the second, an investment in a type of tax-deferred savings plan. Traditionally, the savings element has been used in part to pre-fund, on a tax-deferred basis, the insurance portion and level out the annual premium payments over the term of a policy. Life insurance products offered today continue to reflect these two elements. However, in recent years years a number of factors have encouraged life in-

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surance companies to invent new products that reflect different combinations of these elements and compete effectively with money market and other financial investments.

The first factor is the availability of new financial products. In the past few years, the range of financial products in which individuals can invest has expanded significantly. As a result of deregulation in certain sectors of the financial industry, and mergers and expansion across financial markets, the financial services industry has become very competitive with new products being offered by both traditional financial intermediaries and new entities.

The second factor is the availability of high rates of return on short-term investments. During the past few years, high rates of interest on certain short-term and other debt obligations during peak inflationary periods encouraged investors to move their funds rapidly among alternative investments. During this period, many insurance policyholders borrowed the cash value of their insurance products (pursuant to loan rights contained in such products) and transferred funds from low-yield insurance policies to instruments yielding higher returns, such as money market funds and Treasury bills. In what might be characterized as self-defense, insurance companies have constructed insurance-savings combinations that could compete in the money markets.

a. Elements of traditional life insurance products

Traditionally, the primary purpose of insurance has been to protect the insured against a loss that would require a substantial cash payment or would reduce or deprive a family of its income source. Generally, individuals have purchased life insurance to acquire protection rather than to acquire an investment vehicle. There have been four major types of these traditional life insurance products—term insurance, whole life insurance, endowment insurance, and fixed annuities.[2]

Term insurance

Term insurance is a contract that furnishes life insurance protection for a limited number of years, a benefit being payable only if death occurs during the stipulated term, and nothing being paid in case of survival. Such contracts may be issued for a period as short as one year (e.g., traditional term contracts), or may provide protection for a longer period such as the life expectancy of an individual with premiums being level throughout the period (e.g., term-for-life contracts). Although these contracts are strictly protection contracts, the leveling of a premium over a long period of years produces a small cash value that increases to a point and then declines to zero at the termination of the contract.

In most term contracts, the face amount of the policy (the amount payable upon death) remains unchanged during the period of protection. However, the face amount may decline year by year from a given initial amount of insurance to zero, or increase from an initial amount to some higher amount, at the end of the term of

[2] Noncancellable accident and health insurance, because of the long-term nature of the rate commitments, might also be considered a traditional life insurance product despite the fact that it is casualty insurance.

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the contract; this is known as "decreasing" or "increasing" term insurance.

In a yearly renewable term contract, the insurance element is the face amount of the policy and there is no investment element. In a term-for-years contract with level premiums, the insurance element is the difference between the face amount and the cash value. The investment portion of this contract is the cash value that accumulates at interest to be liquidated to support increased insurance costs during the latter part of the term.

Whole life insurance

A whole life insurance contract provides for the payment of the face value upon death of the insured, regardless of when it may occur. Such protection may be purchased under an ordinary life contract, or a limited-payment life contract.

Under an ordinary life contract, premiums are to be paid throughout the insured's lifetime. In the early years, the annual level premium is in excess of the amount required to pay the current cost of the insurance protection. The balance that is retained by the company as a reserve, at interest, creates a cash value which reduces the insurance that is required in later years when the annual level premium would no longer be sufficient to cover the annual cost of insurance in the face amount. The cash value accumulation continues until reaching the face value of the policy at maturity (typically age 100).

Under the limited-payment life contract, the face value of the policy is not payable until death, but premiums are charged for a limited number of years only, after which the policy becomes paid up for its full amount. The premium under such a contract may be larger than the aggregate amount paid during the same period under an ordinary life contract so that the company can carry the policy to maturity without further charges. The extreme case is the single premium whole-life policy. The insurance element in this type of policy is the difference between the face amount and the cash value. The cash value that accumulates at interest to maturity of the contract is the investment element in the policy. This savings or investment feature is characteristic of all permanent plans of insurance.

Such a contract can be viewed as providing decreasing term insurance and an increasing investment. The investment portion of the contract, which is the cash value that accumulates at interest, is available to the insured at any time after the first few years through surrender or a loan upon the policy. At any time, the sum of the accumulated savings fund and the decreasing term insurance will always equal the face of the contract. The decreasing term insurance component may be viewed as that portion of the policy that the policyholder intended to save if he had lived, but that was not saved because of premature death.

Endowment contracts

An endowment insurance contract provides not only for the payment of the face amount upon the death of the insured during a fixed term of years, but also the payment of the full face amount at the end of the term if the insured is living.

Such a contract can be viewed as term insurance and pure endowment. That is, endowment insurance is essentially a savings plan (to accumulate a specific sum over a period of time) with insurance to protect that plan against premature death.

Fixed annuities

In a fixed annuity contract, the insurance company agrees, for a cash consideration (in single or multiple premiums), to make specified payments during a fixed period or for the duration of a designated life or lives. A deferred annuity is an annuity contract under which the periodic payments begin only after a specified period after purchase has expired. It has two phases: an accumulation phase and a payout phase. An immediate annuity is an annuity contract under which periodic payments are to begin immediately upon purchase. An immediate annuity has no accumulation phase. It has only a payout phase.

Most annuity contracts contain a refund feature stated either in terms of a guaranteed number of annuity payments whether the annuitant lives or dies, or in terms of a refund of the purchase price (or some portion thereof) in the event of the annuitant's early death (prior to the annuity starting date).

When the number and amount of future annuity payments are based on a contingency (e.g., the life of the annuitant), the contract contains an insurance element. Prior to maturity, a deferred annuity contract is an investment contract for the accumulation of a principal sum to be applied to provide periodic payments after the annuity starting date. After the annuity starting date, payments may be a liquidation of the accumulation amount together with interest (fixed term annuity), or of the accumulation amount together with interest and mortality experience (life annuity).

b. Modern life insurance products as investments

In general

Generally, the concept of a balanced portfolio requires a balancing of risks, current income (interest or dividends) and capital appreciation. An investor seeking to maintain such a portfolio would mix assets so that the risks of loss of capital value or reduced income in some assets are offset by gains in others.

Recent approaches to financial analysis and portfolio management have considered various forms of insurance as portfolio assets that can provide a hedge against nonportfolio losses that might otherwise result in liquidation of portfolio assets. Annual premium payments thus become part of that year's saving, and even though the nominal value of the portfolio is not increased through the purchase of insurance, the long-term stability of the value of the portfolio is enhanced.

Many insurance products now also provide savings elements and tax deferrals that warrant consideration as portfolio investments. Life insurance premium payments that are greater than the amount necessary for current insurance protection are savings and build up the cash value of the policy through interest accruals, which are not included in gross income. The resulting tax deferral is a valuable attribute and may provide an investor with a higher rate of return than he would derive from a taxable investment after payment of taxes.

Unlike traditional contracts which guarantee small amounts of tax-free investment buildup over extended periods at fixed interest rates, these new products have given investors access to tax deferral on relatively high yields over shorter periods. To a large extent, these new products arose from the need of stock companies to compete effectively with the traditional products of mutual companies which also carry with them the ability to pay out high yields as policyholder dividends. For nonparticipating policies, additional tax-free buildup is being returned to the policyholder through mechanisms that allow for a larger cash value of the policy without any additional cost or through reduction of the current premium. Such mechanisms allow for the purchase of these contracts with pre-tax dollars.

Flexible premium life insurance

One of the new products which allows investors to obtain high tax-deferred yields on their investment is flexible premium life insurance, sometimes referred to as universal life insurance. Under these policies, the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates which may change from time to time above a floor rate guaranteed in the contract.

The death benefit under such a contract, typically, may be one of two options: (1) a face amount or, if greater, the contract's cash value at the time of the insured is death plus a specified amount of death benefit (a corridor of pure insurance protection); or (2) the contract's cash value at death plus a level specified amount of death benefit (a corridor of pure insurance protection).

In a flexible premium life insurance policy, the investment element is the cash value that accumulates at interest, which interest may be adjusted above a minimum guaranteed rate to reflect anticipated earnings of the company. The insurance element of the policy is the difference between the prescribed death benefit and the cash value.

Variable life insurance

A variable life insurance policy is one under which the benefits relate to the value of assets behind the contract at the time the benefit is paid. Generally, the death benefit varies with the unit value of the underlying investment account. Under most contracts, however, the death benefit cannot decline below a minimum guaranteed death benefit that is equal to the initial death benefit payable under the contract.

As in the case of a variable annuity contract (discussed below), premiums from a variable life insurance contract purchase units in a segregated investment account managed by the insurance company. Variable life insurance is a security subject to the Securities Act of 1933.

Variable annuities

An annuity contract in which the amount of each periodic income payment may fluctuate is called a variable annuity. The fluctuation may be related to the market value of certain securities, a cost-of-living index, or some other variable factor.

During the accumulation phase of such a contract, premiums are invested in units of a segregated investment account (similar to the purchase of units in a mutual fund). The cash value of the contract will fluctuate with the increase or decrease in unit value associated with the segregated investment account. At the annuity starting date, the accumulated total number of units credited to the contract are used to fund income payments. Instead of providing for payments of a fixed number of dollars, the variable annuity provides for the payment each month or year of the current value of a fixed number of annuity units. Thus, the dollar amount of each payment depends on the dollar value of an annuity unit when the payment is made. Although the company may assume a mortality risk under a variable annuity for life, the annuitant assumes the entire investment risk. Variable annuities are securities subject to the Securities Act of 1933.

The investment component of a variable annuity contract can be viewed as a product of a regulated investment company (mutual fund, money market fund, etc.). Generally, as in the case of investors that acquire investment company products, contract holders of variable annuities bear the investment risk. As stated above, a variable annuity for life also contains an insurance element.

2. Present Law

Historically, Federal tax laws have permitted a tax-free accumulation of amounts necessary to fund the insurance protection of life insurance products. Thus, companies have been allowed deductions for increases in reserves and policyholders have not been taxed on increases in cash values. Generally, distributions of cash value on surrender of a policy have been subject to income tax only if they exceed the aggregate premiums and consideration paid, and death benefits have not been subject to income tax at all. Under current law, consideration paid for the contract is not reduced by the cost of pure insurance consumed while the policy was in force. Annuity contracts have also been permitted tax-free accumulations; however, these accumulations have been taxable when distributed.

Death benefits

Generally, amounts received under a life insurance contract by reason of the death of the insured are not subject to income taxation.[3] An exception to this rule applies in the case of the proceeds on flexible premium insurance contracts which fail at any time during the duration of the policy to meet either of two statutory guidelines.

A flexible premium life insurance contract is a life insurance contract which provides for the payment of one or more premiums

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[3] Proceeds are subject to the estate tax, however, if the decedent possessed any incidence of ownership in the policy at his death.

that are not fixed by the company as to both timing and amount. Thus, under such a contract, the insurance company may fix the timing of the premium payments but not the amount, the amount of the premiums but not the timing, or neither the timing nor the amount of the premiums.

As stated above, proceeds of a flexible premium insurance contract will be included in income if either of two statutory guidelines are not satisfied at any time during the duration of the policy. These guidelines which were enacted on a temporary basis in TEFRA require that a minimum insurance feature coexist with the savings feature of a contract. The first guideline test provides that two requirements must be met at all times: (1) the sum of the premiums paid under the contract at any time cannot exceed certain amounts (the "guideline premium limitation"); and (2) the amounts payable on the death of the insured cannot be less than a certain multiple of the contract's cash value as of the date of death. For purposes of applying the first requirement, the sum of the premiums paid includes premiums for any additional qualified benefits as well as the primary death benefit.

The premium limitation in the first test is intended to prevent investment-motivated contributions of large cash amounts to the contract. The second requirement provides a restriction on the death benefits in order to insure that flexible premium contracts offer at least a minimum amount of pure insurance protection at all times.

The second alternative guideline is a specific cash value test patterned after a traditional whole life policy. That is, death proceeds paid from a flexible premium life insurance contract will be excluded from the beneficiary's gross income if, by the terms of the contract, the cash value may not exceed at any time the net single premium payable at such time for the death benefit under the contract (without regard to any qualified additional benefit). If the contract does not meet the requirements of either alternative, it will be treated as providing a combination of term life insurance and an annuity or deposit fund (depending on the terms of the policy).

Annuities

The taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn. Amounts paid as an annuity are fragmented under an exclusion ratio with a portion included in income and taxed at ordinary income rates. The remainder is treated as a return of capital and not included in income. Policy dividends paid after annuity payments begin are not subject to the exclusion ratio, but are taxable in full to the policyholder as ordinary income. Prior to TEFRA, amounts paid out under a contract before the annuity payments began, such as payments upon partial surrender of a contract or policyholder dividends, were first treated as a return of the policyholder's capital and were taxable (as ordinary income) only after all of the policyholder's investment in the contract had been recovered.

Two changes with respect to annuities were made by TEFRA. First, under TEFRA, partial surrenders or cash withdrawals prior to the annuity starting date are income to the extent that the cash value of the contract exceeds the investment in the contract. To the extent that such cash value does not exceed the investment in the contract, such withdrawals are a return of capital to the policyholder and reduce the taxpayer's investment in the contract. Policyholder dividends paid prior to the annuity starting date are cash withdrawals subject to the new rules and included in income to the extent that the cash value of the contract exceeds the investment in the contract. Such policyholder dividends are not included in the taxpayer's income to the extent they are retained by the insurer as premiums or other consideration paid for the contract.

The second change made by TEFRA is that a penalty is imposed on certain distributions from an annuity contract. The penalty is equal to 5 percent of the amount includible in income, to the extent the amount is allocable to an investment made within 10 years of the receipt of such amount. For this purpose, amounts are allocable first to the earliest investments in the contract, and then to subsequent investments. Also, because policyholder dividends received before the annuity starting date are cash withdrawals and includible in income to the extent there is income in the annuity contract available for distribution, such amounts are also subject to the 5-percent penalty to the extent the income in the contract is allocable to an investment within the last 10 years. If the policyholder dividend is retained by the company and reinvested in the contract, it is not includible in income and is not subject to the 5-percent penalty.

3. Issues

a. Should taxpayers be allowed to use tax-free investment earnings to purchase life insurance protection?

The present law provisions for deferral of tax on income from life insurance products, in effect, allow taxpayers to purchase life insurance protection with tax-free investment earnings credited to a policy by the company. This can act as an incentive for taxpayers to save by the purchase of insurance products as well as to provide adequate economic protection against an untimely death. However, if one accepts the general principle that investment income should not be taxed if used to purchase insurance protection, then arguably taxpayers should not be taxed on interest on a savings account to the extent it is used to purchase term life insurance protection. Also, if individuals who purchase whole life policies can acquire additional insurance with investment income that has not been subject to tax, then it might be argued that individuals acquiring term insurance should be allowed to deduct a portion of their expense.

b. Should the use of life insurance contracts as investment vehicles be limited?

Although arguably a social purpose of encouraging insurance protection is served when investment earnings on premium dollars are used to purchase additional insurance, in some cases insurance products are marketed as investment vehicles with emphasis on the product's buildup of cash value and the ease with which loans can be made on the policy. Since such products assume the nature of investment rather than insurance, some limitation on the tax benefits afforded these products may be justified.

c. What kinds of limitations would be effective?

One limitation that would likely restrain the growth of investment-oriented insurance products would be to limit the definition of "life insurance" contracts (which enjoy tax advantages) to contracts that provide a minimum amount of true insurance protection. This was the approach taken in TEFRA. It is also the approach taken by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee in the bill ordered reported on September 27, 1983 (hereinafter referred to as the House Subcommittee bill). Under the House Subcommittee bill, the temporary guidelines of present law would be extended to all life insurance products, strengthened, and made permanent.

Both TEFRA and the House Subcommittee bill provide alternative tests that a contract must meet in order to be treated as life insurance. One alternative focuses on two characteristics of insurance protection. First, the approach assumes that the investment portion of the insurance at any time should not greatly exceed the investment portion value of a traditional whole life insurance policy thus preventing an early cash buildup in the policy. This is generally accomplished by limiting the aggregate amount of premiums paid at any time for the policy to the aggregate amount of premiums paid at such time in a traditional policy. The major issue, then, is what type of "traditional" insurance policy should be the standard for the test. For example, if the standard is an ordinary life insurance policy payable over 10 years, then a single premium policy would never meet the test, and if it could not meet the alternative test as well, such a policy could not be marketed as life insurance.

In addition to limiting the amount of the premium that can be paid early in the term of the contract, this alternative requires that a certain percentage of the contract represent pure insurance protection. TEFRA and the House Subcommittee bill require that the face amount of the contract (the amount payable upon death) be a specified percentage of the contract's cash value. In TEFRA, the face amount generally had to be 140 percent of the contract's cash value. The issue to be decided is whether that percentage should be increased (to require more insurance protection compared to the cash value of the policy at different points during the term of the contract).

TEFRA and the House Subcommittee bill provide that if both these tests cannot be met, an alternative test is available. This test is designed to allow use of a whole life policy, where high premiums paid early in the contract's term generate investment income that will pay for the more expensive life insurance coverage in later years. This test thus prohibits the cash value of the contract at any time from exceeding what would be the premiums required for pure death benefit protection. Again, the important decision is the selection of the method of determining the premiums that will be the basis of comparison.

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (the difference between the face amount and the cash surrender value) would be treated as term life insurance exempt from income tax under section 101, and the cash surrender value would be treated as a deposit fund, and income earned on the fund would be taxable currently.

d. Should funds invested in annuity contracts be subject to the rules and restrictions on early withdrawal placed on individual retirement accounts?

TEFRA adopted rules imposing penalties on certain distributions from annuity contracts prior to the annuity starting date which discourage early withdrawals or distributions from such contracts. The amount of the penalty imposed under these rules is half of the amount imposed on early distributions from individual retirement accounts, presumably because annuity contracts are funded with after-tax dollars. Further, the penalty is only applied to distributions of income that have not been taxed.

Also, a rationale for allowing a tax-free inside buildup in annuity contracts is that this recognizes the importance of encouraging individual taxpayers to provide retirement funds for themselves in addition to any amounts they may be provided in a qualified pension plan. If this is the rationale, however, then it can be argued that rules and restrictions relating to distributions from individual annuity contracts should be conformed to those applicable to individual retirement accounts.

e. With respect to annuity contracts, what purpose is served by imposing a penalty tax only for distributions of income allocable to investments in the contract made within 10 years of the date of distribution?

Penalties are imposed on certain distributions from an annuity contract within a 10-year period. This 10-year period is arbitrary, and it may be appropriate to amend this provision and substitute a different period. Alternatively, the period during which the distribution is subject to penalty could be related to the age of the insured and the average period of mortality. That is, if the social purpose of the tax preference for deferred annuities is to encourage saving for retirement, the penalty for distributions should apply until a person approaches retirement age and should be used to provide retirement income rather than to build a larger estate for the benefit of heirs.

Generally, under the House Subcommittee bill, the penalty on premature distributions of income would continue at the present-law level of 5 percent, and would not apply to income distributions (1) on or after the policyholder reaches age 59-1/2, (2) upon the death of the policyholder, (3) upon the policyholder becoming disabled, (4) if the distribution is one of a series of substantially equal periodic payments for life or for at least 5 years, or (5) from a qualified pension plan.

An additional issue is whether the 5-percent penalty for early distributions is a sufficient incentive to retain the amounts deposited with the insurance company until the annuity period is scheduled to begin.

f. Should the tax treatment of policyholder dividends paid on annuity contracts depend on whether or not they are reinvested in the contract?

Some observers have contended that, with respect to policyholder dividends paid prior to the annuity starting date, the distinctions between taxable and nontaxable policyholder dividends are arbitrary, and that policyholder dividends should be treated in the same manner whether they are paid out to the prospective annuitant or retained by the company. These observers contend that the present rules create an improper bias in favor of leaving policyholder dividends with the company. It is argued that this is especially inappropriate if the dividends reflect redundant premiums. Further, it is argued that if the dividends reflect excess earnings, such dividends should be taxable.

C. Other Issues Relating to the Taxation of Policyholders

1. Background

There are a number of additional ways in which Congress has provided life insurance companies and their products with tax-favored treatment. For example, there are provisions that allow employers to provide tax-free group-term life insurance protection for employees and others that provide specific rules for loans on life insurance contracts. To a large extent, these provisions reflect the recognition of the social value of insurance.

2. Present Law

a. Group-term life insurance

Under present law, an employee must include in gross income the cost of group-term life insurance on his life provided under a policy carried directly or indirectly by his employer (or employers) only to the extent such cost exceeds the cost of $50,000 of such insurance plus the amount (if any) paid by the employee toward the purchase of such insurance. Under a provision adopted in TEFRA, the exclusion from income of the cost of the first $50,000 of group-term life insurance is not available to key employees if the coverage is provided under a plan that is discriminatory. For these purposes, the cost of the group-term life insurance is determined on the basis of a uniform cost table prescribed by regulations.

In contrast, employees who have terminated their employment, either because of retirement or upon becoming disabled, do not have to include the cost of group-term life insurance protection in gross income.

b. Policyholder loans

Generally, life insurance companies allow policyholders to borrow from the company using the cash value of an insurance policy as security. Under present law, a policyholder is allowed to deduct interest payments on such loans only in certain limited circumstances. No deduction is allowed for interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract. Likewise, no deduction is allowed for interest paid or accrued with respect to indebtedness on multiple premium life insurance, endowment or annuity contracts if the borrowing is pursuant to a plan which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract. [4] However, exceptions are provided to the rule disallowing interest paid or accrued pursuant to a plan of systematic borrowing. That is, the interest is deductible if (1) no part of four of the first seven annual premiums is paid by means of indebtedness, (2) the total of the amounts paid or accrued during the taxable year and for which no deduction would be available does not exceed $100, (3) the indebtedness was incurred because of an unforeseen substantial loss of income or increase in financial obligations, or (4) the indebtedness was incurred in connection with the taxpayer's trade or business.

c. Determination of a policyholder's investment in a contract

Under present law, income is recognized by policyholders on the withdrawal of cash from, or surrender of, a life insurance policy. The amount that is recognized is the excess of the cash surrender value over the policyholders' investment in the contract (i.e., aggregate premiums paid less any amounts previously treated as a return of capital or "returned premiums").

3. Issues

a. Should the $50,000 cap on exclusion from income of group-term life insurance and the nondiscrimination rules be extended to retired employees?

Present law allows retired employees to exclude the cost of all group-term life insurance from income. As a result, the provision of large amounts of such insurance has become a major element of deferred compensation plans for highly compensated key employees. Under present law, an employer can prefund the cost of retired employees' group-term coverage on a tax-deductible basis. However, no amounts are required to be included in income by the employee either when the cost of the insurance is prefunded or when the employee retires and the coverage begins. Some observers contend that the application of the rules that provide for a deduction at the corporate level, on one hand, and the exclusion of income by the insured, on the other hand, should be limited. One way to accomplish this would be to extend the cap on the income exclusion and the nondiscrimination rules to retired employees. Others might argue, however, that this would, in effect, punish retired employees for the current misdeeds of their prior employers. The House Subcommittee bill extends the $50,000 cap on exclusion of the cost of group-term life insurance to retired employees (but not to employees who terminated employment due to disability) and also extends the nondiscrimination rules to retired employees.

[4] Code sec. 264, which denies these interest deductions, also denies any deduction for premiums paid on any policy covering the life of any officer, employee, or financially interested person, when the taxpayer is a beneficiary.

b. Should the limitation on the amount of group-term life insurance that can be provided to an employee tax-free be raised?

As discussed above, under present law an employee need only include in gross income the cost of employer-provided group-term life insurance that exceeds the cost of $50,000 of such insurance, as prescribed by a uniform cost table. The rates stated in the cost table are so structured that, in effect, they allow the employer to purchase more than $50,000 worth of insurance for an employee without including the cost in income. When changes in the taxation of insurance products were being considered in TEFRA, the question of raising the $50,000 limit arose, and it was decided to require the Treasury to amend further its uniform cost table to allow, in effect, increased insurance protection to be purchased by amending the estimated cost of $50,000 worth of insurance. Treasury has issued proposed regulations responding to that requirement.

c. Should a limitation on the borrowing on life insurance contracts be imposed?

The safe-harbor provisions contained in section 264(c) were designed to permit the deduction for interest on certain nontax-motivated loans.[5] Recently, however, life insurance companies have marketed their plans not only by pointing out the benefits of tax-deferral, but also by emphasizing the present tax benefits under maximum borrowing provisions. Although these plans literally fall within the safe-harbor rules, an investor can obtain substantial tax sheltering of outside income through tax-deductible policy loan interest payments that are funded primarily through tax-free investment earnings on a policy. Some insurance products are now marketed almost solely on the basis of this tax arbitrage opportunity. In light of such marketing activities, the need for any safe-harbor rules arguably should be reexamined.

In addition, if one reasons that deferral of tax on earnings within a life insurance contract should be allowed so that policyholder can save for the future or premature death, then it would be inconsistent to let a policyholder borrow against the cash value of a contract at all. Such borrowing not only allows current use of the money tax-free, but results in an interest deduction for interest paid. In light of certain tax policy decisions already adopted in the areas of retirement plans and annuities (which treat loans as cash distributions of income, to the extent there is income in the contract), it might be suggested that similar treatment be considered for life insurance policies.

d. If additional limits are imposed on borrowing on life insurance contracts, what method of limitation would be appropriate?

One solution would be to place a dollar ceiling on the amount of outstanding life insurance loans on which no limits on borrowing are imposed; this would be similar to the treatment of loans from qualified retirement plans. Alternatively, the law could limit the deductibility of interest liabilities on the loans in excess of a dollar amount. This is generally the approach taken by the House Sub-

[5] H.R. Rep. No. 88-749, 88th Cong., 1st Sess. (1963).

committee bill. An alternative to these provisions would be to put a ceiling on loans based on a ratio of loans to cash value. Whichever alternative may be chosen, the essential issue is the amount of the ceiling to be imposed.

e. If a limitation is imposed on borrowing on life insurance, what transitional rules would be appropriate?

It might be argued that a limitation based on loans issued with respect to current policyholders would, in effect, decrease the value of the insurance product sold to the individual because the individual depended upon the availability of the loans under current law when he purchased the policy. Thus, it may be more appropriate to impose the limitation on loans issued under policies issued after the effective date of any new legislation. On the other hand, if such products were marketed with emphasis on the tax-motivated advantage of borrowing from an insurance policy, purchasers of such products should have been aware that a change in tax policy might change the attractiveness of their investment.

f. Should the definition of a policyholder's investment in the contract be changed?

Upon withdrawal or surrender of a life insurance policy, income is recognized to the policyholder only to the extent that the cash surrender value exceeds the premiums paid by the policyholder. Some have argued that for purposes of calculating the income to be recognized to the policyholder in such circumstances, the cash value should be increased to include the cost of the life insurance coverage that the policyholder had received prior to surrender. Others reject this approach, arguing that the value of any asset (such as a house) is never increased to reflect prior use afforded the owner.

III. TAXATION OF LIFE INSURANCE COMPANIES

A. Overview

The history of life insurance taxation illustrates Congress' attempts to define the economic income of a life insurance company. The earliest life insurance company tax legislation taxed life insurance companies only on the portion of their net investment income that was treated as unnecessary to meet obligations to policyholders (i.e., free investment income)." The measure of the company's obligations to policyholders varied from a fixed percentage yield on reserves (i.e., amounts representing the company's liability to its policyholders) to more complex formulas. Life insurance companies were not taxed on their underwriting income (i.e., income attributable to favorable mortality and expense experience) on the theory that, given the long-term character of life insurance products, it would not be possible to measure underwriting income accurately on an annual basis. However, in response to a concern that prior law had failed to tax income from profitable underwriting activities of certain stock life insurance companies, Congress enacted the Life Insurance Company Tax Act of 1959, which subjects both investment income and underwriting income to taxation.

Accepting the policy decision to tax all the income of life insurance companies, one is faced with the unique problem of an extraordinarily competitive industry that is made up of both stock and mutual organizations. Stock life insurance companies, like other corporations, have customers (policyholders) and owners (stockholders). Unlike stock companies, mutual life insurance policyholders alone benefit from favorable investment and underwriting experience since there is no separate group of equity owners. The market share of the business is split more or less evenly.[1] Given this fact, an important question to be answered in connection with any reform of life insurance company taxation is, which organization should be used as the model for the company taxation—the stock company or the mutual company? Once a model is chosen, it must then be determined what adjustments are necessary to reflect the different operation of the two segments. This concern also raises the question of the allocation of the aggregate industry tax burden among the stock and mutual segments of the industry.

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[1] Each of the stock and mutual segments of the industry is responsible for a substantial share of the life insurance business. For example, mutual companies held slightly less than 60 percent of the assets held by the industry, approximately 50 percent of insurance in force, and received more than 40 percent of premiums in 1982. However, the stock companies outnumber the mutual companies by more than 9 to 1.

The use of reserve accounting

As discussed above, an individual who purchases life insurance often acquires both insurance protection and an investment. Thus, the question arises as to whether the entire premium dollar should be treated as gross income to the insurance company. If the portion of the premium not required for current insurance protection is viewed as similar to a deposit in a bank, it may not be appropriate to include it in income of the insurance company. However, if that portion is viewed as a current overcharge to offset increased costs in later years, the company's liability for those future benefits giving rise to these costs should be recognized currently in order to properly match income and expense. This type of income analysis gives rise to a reserve method of accounting. Under any framework for taxing life insurance companies that recognizes reserve accounting to measure and currently accrue future liabilities, the question of how those reserves are computed is very important.

Reserves can be seen as a current expression of a company's liability to pay amounts in future years. Life insurance reserves are less than the full face amount of death benefits of all of a company's policies, because the company can expect to earn additional funds before the death of all of its customers, both through future premiums and through earnings generated by investment of income already earned. Exactly how much smaller the current reserve liability is, in relation to the death benefits ultimately payable, depends on the time remaining before the benefit is paid and the investment return that the company can earn in the meantime. A mortality factor (the expression of the likely timing of policyholder deaths) is used to determine how long the company can expect to receive premiums and investment earnings from its policyholders, and an interest factor is used to determine what the company can safely be expected to earn on the investment of premiums and the reinvestment of investment income. By performing an actuarial computation that takes into account the mortality factor for the type of policies involved (for example, nonsmoking males born in 1952), the interest factor, the future premiums expected, and the death benefits that will be owed, companies can compute the reserves allocable to its outstanding policies at the end of each year. As time passes, the time remaining before payout shrinks, so the size of the reserve must grow.

Additions to reserves, which arise from the growth of existing reserves and from the issuance of new policies, are deductible from income under the reserve accounting method. Accordingly, the selection of interest and mortality factors has a significant impact on the determination of net income. If a company uses conservative assumptions for interest and mortality, the initial reserve must be higher (i.e., more "premium contributions" must be set aside initially) to grow at a conservative interest rate to the maturity value of the contract. Such conservative assumptions may not be economically realistic, and may not be used by the company for purposes of pricing its product. For tax purposes, then, the use of conservative assumptions in computing reserves may have the practical effect of accelerating deductions for the company, causing a mismatching of income and expense.

An ownership differential between stock and mutual companies

The 1959 Act taxed both stock and mutual companies on their free investment income unless such income was offset by underwriting losses. With respect to underwriting income, the 1959 Act adopted the mutual company as its model, allowing a tax-free distribution of underwriting profits to policyholders through a deduction for policyholder dividends. Because it was anticipated that, unlike mutual companies, the stock companies would not be able to distribute all of their underwriting profits to policyholders, the 1959 Act allowed additional special deductions that principally benefited stock companies (e.g., the deductions for nonparticipating contracts, and for accident and health insurance and group life insurance contracts). In addition, the 1959 Act provided for the deferral of the tax on one-half of underwriting income.

An alternative to the approach adopted under the 1959 Act would be to use the stock company as the model for company taxation and achieve any desired competitive balance by requiring mutual companies to recognize a portion of their underwriting profits. Adoption of this approach might be based on the view that the business of insurance is so essentially a commercial activity that any organization that engages in such activity should recognize some minimum tax liability. This tax policy view might be compared with the theory of the unrelated business taxable income provisions for tax-exempt organizations, and contrasted with the treatment accorded mutual savings banks and nonlife mutual insurance companies.

If a stock company model were to be adopted, one would have to consider whether some portion of the investment income accruing to policyholders of a mutual company should be treated as income accruing to them as equity owners of the company. If so, application of the corporate rate of tax to such portion might be appropriate. The remaining portion of the income that is distributed to policyholders might be viewed as a deductible return of premium overcharges to customers.

Aggregate industry tax burden

Traditionally, life insurance companies have enjoyed a favorable status for Federal income tax purposes as a portion of revenue has always been excluded from the current tax base of life insurance companies. Prior to 1959, all underwriting income was excluded. This exclusion was justified on the grounds that the long-term nature of life insurance risks makes it extremely difficult to measure a company's current liabilities and income. In 1959, intending to broaden the life insurance company tax base, but concerned about the impact of a dramatic increase in the industry's tax burden, Congress decided to expand the current tax base of life insurance companies to include 50 percent of underwriting income.

Any attempt to reform the tax treatment of life insurance companies must involve consideration of the expansion of the current tax base. Further, if a decision is made to expand the tax base, it will be necessary to consider whether certain special rules should be adopted to reduce the tax burden that would otherwise result.

The use of consolidated returns

Under present law, an affiliated group of corporations may elect to join in the filing of a consolidated Federal income tax return. Among the many benefits that may result from the filing of a consolidated return is the opportunity to use losses of a loss corporation to offset current income of profitable affiliates.

For taxable years beginning prior to January 1, 1981, life insurance companies were prohibited from filing consolidated returns with nonlife companies. Congress imposed this prohibition in light of the benefits already available to life insurance companies under the special tax accounting rules specifically applicable to such companies.

During the early 1970s, many casualty companies experienced losses, which were used by noninsurance affiliates to offset current income. In 1976, Congress decided that the prohibition resulted in a hardship for casualty companies that were affiliated with life insurance companies and permitted life-nonlife consolidations for taxable years beginning after December 31, 1980. To insure that a minimum life insurance company tax base was preserved, however, Congress enacted a provision limiting the extent to which nonlife losses could be used to offset life insurance income.

Because life insurance companies are taxed under favorable tax accounting rules not generally applicable to other corporations, some may still question the propriety of life-nonlife consolidations. If a decision is made to permit such consolidations, special rules under which losses offset income before application of any of the special deductions would be appropriate to consider. For example, rules limiting the benefits generally available to corporations that file consolidated returns may be necessary. Alternatively, rules could be added limiting certain deductions that would otherwise be available to life insurance companies.

B. Tax Treatment of Reserves

1. Background

The State law treatment of reserves for insurance regulatory purposes is significant because it provides the basis for the tax treatment of reserves. The concept behind statutory reserves is to guarantee that a company can meet all future claims. State laws regulate the amount of reserves maintained by the company, and stipulate methods of valuation, the selection of mortality tables, the amount of the reserves maintained by the company and the maximum interest rates assumed. Because the State is interested in minimizing the risk of an insurer's insolvency, the methods, mortality tables, and rates assumed are conservative in nature and provide for reserves that are generally larger than would be true for reserves computed under more realistic assumptions, such as the assumptions used for pricing policies.

In the case of a life insurance company, the word "reserve" does not have the same meaning as is usually applied in the case of ordinary commercial undertakings in which the term reserve may refer to the enterprise surplus. The reserve of a life insurance company is not its surplus; rather it is a measure of the company's obligations to the policyholders. At any point in time, the company's liability to policyholders is the difference between its policy obligations at that time (which is the present value of future benefits) and the amount that the company can expect to receive on the policies in the future (which is the present value of future premiums). In computing the present value of future benefits or premiums, the company must make assumptions concerning the interest to be earned in the future and the mortality rate that might be experienced with respect to existing contracts.

In the simplest mathematical sense, a reserve is established for each individual policy. It is assumed that a premium will be paid on a periodic (usually annual) basis which, along with an assumed growth (earnings) rate, will equal the face amount of the policy at some specified time in the future (maturity of the policy). In reality, companies aggregate policies into blocks of insurance based upon the assumptions made for State reserve purposes when issuing the policy.

a. Interest and mortality assumptions

The growth rate of a reserve is heavily dependent upon two factors. The first factor is the assumed interest rate which fixes the discount rate. The second factor is the assumed mortality factor which determines the time the liability will be paid. A company may use whatever assumptions it deems necessary in pricing a policy, considering economic conditions. The assumptions used in valuing the minimum reserves required for the annual statement are mandated in the State regulations. Thus, a company may use one set of assumptions in pricing a policy while it uses a completely different set of assumptions in valuing the reserves for State purposes.

The State's primary concern is that a company remain solvent, that is, it have enough assets to meet all its obligations to policyholders. To accomplish this goal, States generally have required that life insurance companies use conservative assumptions in estimating the reserve liabilities and that companies hold assets at least equal to its liabilities.[2] Thus, States prescribe the use of certain recognized mortality tables and maximum interest rates. In the past, maximum interest rates have been fixed by State statutes, but more recently the States have adopted dynamic interest rate laws. Under these laws, a formula determines the maximum interest rates rather than specifying the rates themselves. The dynamic formula rate is intended to provide a closer approximation to long-term market interest rates and to allow for a flexibility when interest rates change with market conditions. It should be noted that lower assumed interest rates produce reserves that are larger in size, both initially and throughout the life of the policy.

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[2] Use of conservative assumptions provides an interesting result in States that limit the size of the surplus a company may retain by reference to a percentage of the company's reserves. In these States, companies that compute reserves on the basis of more conservative assumptions will have larger reserves and thus be allowed to retain a larger surplus. Companies using less conservative assumptions will have smaller reserves and thus a smaller allowed surplus. The result is incongruous, as the more conservative company is less likely to need the surplus for unforeseen contingencies and the less conservative company is more likely to need the surplus.

Thus, what is a conservative reserve estimate for solvency purposes may be considered an aggressive position for tax purposes.

b. Reserve methods

In addition to the mortality and interest assumptions, the States also prescribe certain methods of valuation for reserves to ensure that certain minimum reserves are recognized. As a policyholder ages, the mortality costs increase, and if premiums were based strictly on mortality costs, premiums would have to increase correspondingly. Thus, to charge a level premium over the life of the policy, insurers charge premiums that are higher than necessary for the early years, using the excess to build up a savings element. As the savings element (which is also used to fund the death benefit) increases, the necessary insurance element becomes smaller. Based on the assumed rate of interest and mortality factor, this level premium will accumulate with interest and result in a fund that is sufficient to pay the death benefit when due (not taking into account any charges to cover other expenses). A level premium that will fund a policy in this manner is known as the valuation net premium.

There are two reserve valuation methods generally permitted by the States, the net level and the preliminary term methods. Under the *net level method*, the valuation net premium treated as available for the reserve remains constant over the period the premiums are to be paid. As a practical matter, however, the gross level premium may not be sufficient to cover the loading of first-year expenses (e.g., commissions) as well as the required addition to the reserve. Because the net level method assumes that the net premium is available every year for the reserve, use of this reserve method can result in a reduction in surplus and impair companies with a limited surplus account.

Generally, under a *preliminary term method*, first-year expenses are funded from the net premium for the first year and not from surplus. This assumes that the entire gross premium, less first-year insurance costs, is available to pay expenses and not needed for the reserve. The reserves are gradually graded up over the premium paying period (or a shorter period) to equal reserves calculated under a net level method. Generally, for an assumed interest and mortality rate, reserves computed using a net level premium method are higher than reserves computed using a preliminary term method. However, the annual additions in later years to such reserves are generally lower than are the additions to preliminary term reserves.

2. Present Law

In computing their taxable income under present law, life insurance companies are permitted a deduction (or exclusion from income) for increases in reserves. The reserve increases taken into account under present law are those with respect to State-required reserves which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest and set aside to mature or liquidate future claims.

Reliance on State law reserves to determine deductions or exclusions from income could create the potential for companies with greater available assets to establish larger reserves and thus obtain a tax advantage vis-a-vis companies with smaller amounts of surplus assets. For example, a small company with limited surplus must, practically speaking, use a preliminary term method of calculating its reserves because it will not have sufficient resources to both pay commissions and establish net level premium reserves. A more established company could establish net level premium reserves which would produce a greater initial reserve deduction.

The 1959 Act addressed this potential tax disparity by allowing companies to use the net level method for tax purposes, even if they used the preliminary term method for State law purposes. A company using the preliminary term method thus restates or "revalues" its reserves for tax purposes. Reserves computed for State purposes under a preliminary term method can be revalued for Federal income tax purposes under an exact revaluation method or under an approximate revaluation formula. Under the exact revaluation method, the reserves are recomputed to be exactly what they would have been had the company used the net level method initially. Under the approximate formula, preliminary term reserves could be revalued by increasing such reserves by (1) $21 per $1,000 of insurance in force for other than term insurance, less 2.1 percent of the reserves under such contracts, and by (2) $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula was presumably adopted to aid small companies for whom exact revaluation would be costly and complex, but use of the approximate revaluation formula is not limited to companies of a certain size.

The approximate revaluation formula may have been accurate when it was adopted, but with changes in mortality and interest rates and methods of computing preliminary term reserves, application of the approximate revaluation formula often results in an amount of reserves greater than possible using an exact revaluation method. In addition, since virtually all companies now use a preliminary term method, revaluation is no longer needed to equalize the reserve deductions of various companies. Also, when reserves are valued for a graded premium product using a preliminary term method, approximate revaluation may result in a larger deduction than would occur with a net level premium reserve. TEFRA permanently reduced the amount of increase to be allowed for insurance other than term insurance from $21 to $19 for contracts issued after March 31, 1982. This change reduced, but did not eliminate, the tax saving that can be enjoyed by life insurance companies using the approximate revaluation formula.

State law reserves are also significant in determining whether an insurance company will be taxed as a life insurance company. In particular, an insurance company is treated as a life insurance company if the company's life insurance reserves, plus unearned premiums and unearned losses (whether or not ascertained) on group life and noncancellable health, or accident policies not included in life reserves comprise more than 50 percent of the company's total reserves.

3. Issues

a. Should a Federal tax structure allow a deduction based on State requirements or based on a Federal standard?

State insurance regulatory authorities are primarily concerned that mortality and interest rate assumptions made for reserves assure that insurance companies will be solvent and able to meet the insurance contract obligations. However, reserves computed under State guidelines are not necessarily limited to the minimum amounts required to fund future liabilities to policyholders. As a matter of tax policy, the deduction of additional amounts may not be justified. In addition, if all State insurance authorities do not adopt common requirements, interstate insurance companies would have to meet multiple regulatory requirements.

Federal standards for the computation of tax reserves could limit reserves to the minimum required to fund future liabilities to policyholders, and provide a degree of uniformity. This is the general approach of the House Subcommittee bill. Under the bill, reserves would be calculated on a contract-by-contract basis, and a life insurance company would be able to deduct as an addition to its life insurance reserves an amount equal to the excess of the higher of the actual surrender value of the contract, or the reserve calculated under a specified method, over the prior year's reserve for such contract. For this purpose, the actual surrender value would be computed by reference to the provisions in the contract, if any, guaranteeing cash values, reduced by any penalties or charges which would be imposed upon surrender. Generally, the specified tax reserve would be computed by application of the appropriate Commissioners' reserve valuation method in combination with the prevailing State assumed interest rate and standard mortality and/or morbidity tables appropriate to the risks insured under the contract. For purposes of computing tax reserves, no revaluation of reserves from preliminary term to net level premium reserves would be permitted.[3]

Thus, under these rules, if a company elects to maintain for State purposes a reserve that is higher than both the current liability of the company to the policyholder as reflected in cash values and the minimum reserve which the State would find to be adequate, that excess would be treated as a voluntary reserve rather than a proper measure of liabilities.

It can be argued, however, that, depending on the nature of their business, some insurance companies should use conservative assumptions when calculating reserve liabilities. Requiring use of the "prevailing" State interest and mortality/morbidity tables might discourage life insurance companies from including necessary reserves in their calculation of reserves.

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[3] Under the House Subcommittee bill, special rules are provided for noncancellable accident and health insurance contracts and annuity contracts. In the case of noncancellable accident and health insurance contracts, a 2-year full preliminary term reserve method would be required. With respect to annuity contracts, the tax reserve would be computed using the Commissioners' annuities reserve valuation method.

b. If Federal tax standards are applied, what should those standards be?

Mortality tables.—Recent mortality tables reflect increased longevity. However, not all State regulatory authorities have prescribed such tables for life insurance companies doing business within their State. Older mortality tables do not reflect most recent improvements in longevity and result in larger annual additions to reserves during the early years of a policy.

Interest rates.—Interest credited to reserves affects the rate at which the reserves grow to meet the company's obligations under the insurance contract. Thus, if higher assumed interest rates are used, a smaller percentage of premiums would be required to be added to reserves and excluded from gross income.

Reserve methods.—As discussed above, the net level premium method and the preliminary term method differ because of the treatment of commissions and administrative charges during the first year of the contract. The difference affects the level of deductions in the first year and the rate of reserve buildup in subsequent years until the preliminary term method coincides with the net level premium method.

Small companies have argued that they must use a preliminary term method for valuing reserves for State purposes, and that it is unfair to let larger companies with greater statutory surplus take advantage of the larger deduction offered by the net level premium method. In response to this concern, section 818(c) allows all companies to revalue their reserves using the net level method in determining federal tax liability.

In addition, section 818(c)(2) allows companies to use a revaluation method that approximates the change from the preliminary term method to the net level premium method. The reason for this formula was to allow an administratively simple method for determining reserves for small companies that did not have access to computer facilities. However, the ability to use the formula was not limited to small companies. Moreover, this approximate revaluation formula has resulted in reserves that were greater than actuarially needed. The practical effect of this change has been to accelerate reserve deductions faster than when the formula was developed in 1959.

It is not clear that small companies need this approximate revaluation formula for administrative purposes, and it is likely that the large companies do not. Many small companies have argued that they nonetheless need the tax advantage offered by the approximate revaluation formula.

There are a number of alternative methods to respond to the problem of small companies. First, section 818(c) could be allowed to remain intact. The problem with this solution is that it provides the vehicle for a subsidy for all taxpayers, regardless of need. Second, the law could allow use of the revaluation from preliminary term method to the net level premium method, but require an exact revaluation. Small companies might argue, as they have in the past, that it is too difficult to perform such an exact revaluation. In response to that argument, a third solution would be to extend the approach of TEFRA and further restrict the advantages of the approximate revaluation method. Finally, one could do away with section 818(c) entirely and provide assistance to small companies through an expanded small company deduction, as the House Subcommittee bill does.

c. *If the method for computing tax reserves is changed, how should any difference between old and new tax reserves be taken into account?*

In present law, reductions in reserves are included in income, while increases in reserves may be deducted from income. Under the provision for revaluing reserves (whether by the exact or approximate method), certain amounts were treated as added to reserves and deducted from income. To the extent such amounts are still held as reserves, they have never been included in income.

If a new reserve standard were adopted, it might be necessary to revalue existing reserves under the new method. With respect to the difference between existing and recomputed reserves, a fresh start approach could be adopted and a company's current tax liability could be computed as if the new system had always applied. Alternatively, the amount of the change could be included in income either as the existing contracts for which reserves are held lapse or mature, or it could be taken into account ratably over an extended period of years.

C. Policyholder Dividends

1. Background

The life insurance industry is composed of stock and mutual companies. Stock companies are operated to provide a return for their owners, or stockholders. These companies sell policies to their customers and, if profitable, pay dividends to their stockholders. In contrast, the mutual segment is made up of entities organized to provide insurance protection to policyholders who are entitled to share in any "surplus" or profits. Mutual companies sell policies to their policyholders and pay policyholder dividends to their policyholders. Mutual company policyholder dividends include a return to policyholder of "redundant premiums" [4] and a distribution of corporate profits. It may be argued that any system for taxing life insurance companies must take this essential difference between stock and mutual companies into account and not impose a disproportionate tax burden on one segment to the disadvantage of the other.

2. Present Law

Under the 1959 Act, the differences between mutual companies and stock companies are taken into account, and the relative tax burdens of the mutual and stock segments of the industry effectively are established by means of three special deductions and a provi-

[4] Participating insurance written by mutual companies is often written on a higher initial premium basis than is nonparticipating insurance. Policyholder dividends consist, in part, of a return of premium charges that are in excess of amounts needed to fund future liabilities to policyholders. The term "redundant premiums" refers to these amounts which are collected by mutual life insurance companies to provide a cushion against certain contingencies.

sion permitting a life insurance company to defer the tax on one-half of its underwriting gain. First, in the case of participating policies, a deduction is allowed for dividend payments or rate credits to policyholders. Presumably, the payment of policyholder dividends[5] reflects the fact that mutual insurance may be written on a higher initial premium basis than nonparticipating insurance. The amounts returned as policyholder dividends may in part, be redundant premiums which provide a cushion for mutual insurance companies for meeting various contingencies. They may also, in part, be investment earnings on the redundant premiums.

In order to have funds equivalent to a mutual company's redundant premiums, a stock company must maintain relatively larger surplus and capital accounts, and generally the surplus must be funded out of the income of the company. To compensate for this, a second special deduction is allowed for nonparticipating insurance.[6]

Finally, a third special deduction is allowed for accident and health insurance and group life insurance contracts.[7] This special deduction may be viewed as equivalent to a contingency reserve for these contracts. Arguably, this special deduction compensates for the lack of diversification of risk and higher probability of financial loss that is associated with group insurance. These contingency reserves may or may not be required by State law.

Under the 1959 Act, the special deductions and the deduction for policyholder dividends are limited to the excess of gain from operations, if any, over taxable investment income, plus $250,000. The combined limitation applied first to the amount of the deduction for policyholder dividends, then to the amount for accident and health and group life insurance contracts, and finally to the amount for nonparticipating contracts.

This limitation was revised under TEFRA and, for taxable years 1982 and 1983, alternative means of calculating the limitation were provided. The first option employs the prior formulation with the statutory dollar amount increased from $250,000 to $1 million. The second alternative is a limitation equal to the sum of (1) 100 percent of policyholder dividends allocable to insured qualified pension plans, (2) a statutory amount of $1 million, and (3) in the case of a mutual company, 77-1/2 percent of the amount of policyholder dividends other than dividends paid on qualified pension business or, in the case of a stock company, 85 percent of the sum of such policyholder dividends and the special deduction for nonparticipating contracts.

Under TEFRA, the $1 million minimum statutory dollar amount is increased to reflect the effects of inflation. However, the statutory dollar amount is temporarily targeted toward smaller companies; the amount is phased down when the sum of the policyholder

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[5] Under present law, policyholder dividends are defined as dividends and similar distributions to policyholders in their capacity as such; the term does not include interest paid. Further, the Treasury regulations provide that the term includes amounts returned to policyholders that are not fixed in the contract, but depend on the experience of the company or the discretion of the management.

[6] This special deduction is 10 percent of the annual increase in reserves for nonparticipating contracts or 3 percent of the premiums for the taxable year for nonparticipating contracts (other than group contracts) that are issued or renewed for 5 years or more.

[7] The deduction for accident and health and group life insurance contracts is 2 percent of the premium income from such insurance for the taxable year, the aggregate for all taxable years not to exceed 50 percent of the premium income for the current taxable year.

dividends and other tentative special deductions exceeds $4 million and totally eliminated when that sum equals or exceeds $8 million. In general, the alternative percentage limitation currently has the practical effect of allowing a larger percentage of such amounts to be deducted than would otherwise be deductible under the limitation adopted under the 1959 Act, which was designed to prevent the distribution of free investment income without tax at the company level.

With respect to the alternative percentage limitation, the 7-1/2-percent differential between mutual companies and stock companies was intended to reflect the fact that a portion of the dividend distribution to mutual company policyholders constitutes a return of company earnings to them as owners of the company and, accordingly, should not be deductible.[8]

Finally, as another temporary provision, the statutory dollar amount of the limitation, as applied to an affiliated group of corporations, is divided equally among the companies which are members of the group on December 31 of each taxable year, unless Treasury regulations are prescribed to permit an unequal allocation. This provision, together with the provision to target the statutory dollar amount for small companies, raises the unresolved question of whether the phasing-down procedure should be applied to the affiliated group as a whole or to the individual companies' allocable share of the statutory dollar amount.

Apparently, many mutual companies pay sufficient policyholder dividends to offset all of their gain from operations and the maximum amount of investment income. Thus, the special deductions for nonparticipating insurance and group insurance principally benefit the stock segment in dividing the tax burden of the industry.

As previously noted, if a life insurance company has gain from operations in excess of its taxable investment income, only one-half of such excess is taxed currently, while the other half is added to a deferred tax account called the policyholders' surplus account. This deferral was allowed because it was thought to be too difficult to establish with certainty the actual annual income of life insurance companies, given the long-term nature of life insurance contracts. Arguably, amounts that appeared to be income in the current year and proper additions to surplus would, as the result of subsequent events, be needed to fulfill obligations under life insurance contracts. Thus, present law does not attempt to tax on an annual basis all of a company's economic income. In addition, since the deferred income will be taxed if distributed to stockholders, companies have an incentive to maintain a conservative dividend policy, limiting stockholder dividends to currently taxed income.

Amounts added to the policyholders' surplus account are taxed at the company level when distributed as dividends to shareholders. (This tax is referred to as a Phase III tax.) [9] When a company

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[8] A similar percentage differential is contained in the deduction allowed for qualified interest credited by life insurance companies on annuity contracts (100 percent on nonparticipating contracts and 92-1/2 percent on participating contracts).

[9] Generally, any distribution to shareholders is treated as made first out of, and to the extent of, the shareholders' surplus account (i.e., the company's previously taxed investment and

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makes a distribution that is in excess of the previously taxed investment and underwriting income, the company itself has made a determination that additional amounts constitute income not required to be retained to fulfill the policy obligations. [10] Because, as a practical matter, mutual life insurance companies generally offset any potential underwriting gain with the payment of policyholder dividends, this deferral of taxes on half the underwriting gain of life insurance companies principally benefits stock companies and has contributed to the relative tax burden borne by segments of the industry.

3. Issues

a. Should a limitation be placed upon the deduction for policyholder dividends?

A limitation on the deductibility of policyholder dividends can serve one or both of two purposes. Limiting the deductible amount of distributions to policyholders in essence taxes a portion of the distribution at the company level. This could be viewed as a proxy tax on the policyholder's earnings from invested premiums in excess of the premiums necessary to provide insurance protection. Moreover, since mutual companies distribute returns to their owners through policyholder dividends, a limitation can also serve the purpose of recognizing the difference in the form of ownership between mutual and stock companies, and thereby maintain a competitive equilibrium between the two segments of the industry.

As discussed above, payment of policyholder dividends is an essential aspect of the operation of mutual life insurance companies. To the extent that policyholder dividends are, in effect, price rebates, such amounts should not be taxed at the company level. However, policyholders' dividends also include company profits comparable to the nondeductible amounts that are distributed as dividends by stock life insurance companies to stockholders. A 100 percent deduction for policyholder dividends could provide mutual life insurance companies with increased access to the capital market and a competitive advantage over stock life insurance companies. If the sole purpose of a limitation on deductibility is to neutralize this advantage, then the limitation on the deduction for policyholder dividends should be applicable only to mutual companies.

However, another argument for limiting the deduction for policyholder dividends could be that such a limitation is needed to impose a company level tax that would apply in lieu of a tax that, in theory, should apply at the policyholder level (i.e., a tax on the income accruing in the insurance contract). This tax also would prevent companies from reducing their taxable income by distribut-

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underwriting income), then out of the policyholders' surplus account, and finally out of other accounts. Each stock life insurance company must establish and maintain a policyholders' surplus account (the amount of such account was zero as of January 1, 1959). Because, as stated above, mutual life insurance companies offset any potential underwriting gain with the payment of policyholder dividends, only stock life insurance companies are required to maintain the policyholders' surplus account.

[10] The half of the underwriting income that is not taxed currently is taxed prior to distribution if the cumulative balance of the policyholder surplus account exceeds the greatest of 15 percent of life insurance reserves the end of the taxable year, 25 percent of the amount by which the life insurance reserves exceed those held at the end of 1958, or 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under the gain (or loss) from operations computation.

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ing investment earnings in excess of the amounts required to fund future policyholder liabilities and prescribe, in effect, a minimum tax on investment income. Under this rationale, there would be no reason to restrict the limitation on the deduction for policyholder dividends to mutual companies, but rather, the limitation could be imposed on both the mutual companies and (at least in part) on the stock companies.

If a limitation on the deduction of policyholder dividends is adopted, an additional issue is presented—should policyholder dividends be defined to include excess interest, premium adjustments, and experience-rated refunds?

In recent years, new product developments have raised the question of the scope of the definition of policyholder dividends and the application of the limitation. Specifically, the Internal Revenue Service has concluded in private ruling letters that interest credited in excess of the rate guaranteed for the life of the contract, and indeterminate premium adjustments, are policyholder dividends and not additional benefits under the policy or valid price adjustments.

Arguably, the guaranteed character of excess interest and the contractual adjustment for a reduction of future premiums cause such items literally and technically to fall outside the statutory definition of policyholder dividends. One can argue, however, that excess interest and indeterminate premium adjustments are policyholder dividends because they are not fixed (i.e., the guarantee changes from time to time) and the amount guaranteed depends on management's judgment on a company's anticipated experience.

Under a theory in which policyholder dividends reflect only the ownership differential between stock and mutual companies, such returns to policyholders should not be taxed at the company level, as long as they represent only rebates to customers and not a return on the owner's capital. Under a theory in which amounts earned from invested premiums are taxed, such excess interest and indeterminate premium adjustments should be taxed.

b. How should the limitation on policyholder dividends be measured?

(1) Present law

The current three-phase system for taxation of life insurance attempts to reflect the ownership differential through the limitation on the deduction for policyholder dividends, through the special deductions for nonparticipating and accident and health contracts, and through the deferral of one-half of the company's underwriting income. The limitation on deductible policyholder dividends, which is a statutory amount, could be interpreted as also reflecting a proxy tax theory in which some portion of a policyholder's investment income earned on premiums is indirectly taxed by a tax on the company.

(2) Limitation based on return on equity

One method of reflecting the equity ownership feature in dividends to policyholders would be to limit the deduction by reference to an imputed return on the "equity" of mutual companies. The imputed rate of return would be approximated by comparing returns generated by similar stock companies. Such an approach would provide for a full deduction of policyholder dividends (including excess interest, premium adjustments, and certain experience-rate refunds) paid by stock companies to policyholders in their capacity as customers or in their capacity as creditors. In the case of a mutual company, however, the deduction for policyholder dividends would be limited to the amount by which its financial gain from operations, before dividend distributions, exceeds this imputed return on equity.

An equity return based limitation would result in a company-level tax on that portion of the company's income which represents the earnings generated by the policyholders' investment in the company. Thus, this treatment of policyholder dividends attempts to tax only the ownership differential and does not impose a proxy tax on any investment returns from a policyholder's excess premiums.

In particular, the equity of a mutual life insurance company that is held for its policyholders in their capacity as owners could be the excess of the company's assets over its liabilities as shown on the annual statement required under State law, except that (1) assets would be increased by the amount of any nonadmitted financial (investment) assets and, (2) liabilities would be adjusted (a) to reflect the Federal tax computation of reserves described above, (b) to eliminate any deficiency reserve, voluntary reserve or reserve for securities valuation, and (c) to eliminate 50 percent of any provision for policyholder dividends payable in the following taxable year.

The company could be treated as earning, as a pre-tax return to their policyholders in their capacity as owners, a return on this equity equal to an amount determined under rules established in the tax law. The specific rate of return could be set and adjusted to reflect the rate of return enjoyed by comparable stock life insurance companies. If the taxable income of the company before policyholder dividends is less than the equity return, then that lesser amount would be subject to income tax. If, however, the taxable income before policyholder dividends exceeds the return on equity, the company would be taxed on its taxable income reduced by the deductible portion of policyholder dividends.

This approach would not require special deductions for nonparticipating contracts or for accident and health insurance and group life insurance contracts. Also, it would not defer the tax on any portion of a company's underwriting gain.

(3) Company level tax on distributed profits

Another approach suggests that while returns on equity may fluctuate from year to year, distributions of profits relative to capital and surplus are less volatile. One method of implementing such an approach, adopted by the House Subcommittee bill, would be to allow a mutual company as well as a stock company a full deduction for policyholder dividends but to include an additional amount in a mutual company's tax base. This "add-on" element of the mutual's tax base would be calculated by multiplying the equity of a mutual company, as computed in the tax law, by a rate equal to the difference between the rate of return on the equity for stock companies and for mutual companies (after deductions for policyholder dividends). The assumption underlying this theory is that the difference between the rates of return on equity for a stock and mutual company measures the returns paid to mutual policyholders in their capacity as owners of the company.

(4) Company level tax on excess dividends

An alternative to a tax on distributed equity would be an attempt to measure the investment return on excess premiums that an insurance company earns and passes through to its customers. This method assumes that a policyholder's premium is divided between the portion paid for pure insurance protection and an excess portion. The return on the excess portion can be seen to represent both the return on investment earned by the premiums and, in the case of a mutual company, dividends paid to policyholders in their role as owners of the company.

One way to determine the amount of an excess dividend payable to the policyholder would be to determine the rate of return needed to value reserves in order to price insurance policies. Arguably, this rate of return would be the rate of return assumed by the insurance companies to be needed for pure insurance protection. Such rates could be determined for both stock and mutual companies. Deductions for policyholder dividends could be denied for dividends representing an excess over this rate of return.

Presumably, the amount of the excess dividend would be greater for a policyholder of a mutual company than of a stock company, since theoretically a mutual company's dividend would include an ownership return that a stock company would pay to its stockholders rather than to its policyholders. Thus, a tax on this dividend would effect both an "ownership differential" and impose a proxy tax on the inside buildup of the policyholder's cash value.

(5) Excise tax on policyholder dividends

A final alternative would be to attempt to separate completely the taxation of the corporation as a business enterprise from the taxation of the policyholder. This method would allow complete deductions for all income credited to policyholders. However, an excise tax could be imposed at the company level on interest credited to policyholder dividends and the excess of death benefits over cash value as an express proxy tax for income received by the policyholder. Presumably, this tax would be larger for the mutual company, reflecting the greater amount of dividends paid to its policyholders.

D. Special Provisions Relating to the Tax Burden on Life Insurance Companies

1. Background

Traditionally, life insurance companies have enjoyed a favorable status for Federal income tax purposes. Prior to 1959, life insurance companies were taxed only on their net investment income in excess of amounts needed to fund obligations to policyholders. Underwriting income was not subject to tax. The decline in interest rates during the period following World War II, however, caused the erosion of the investment income tax base to the point that the life insurance industry paid virtually no tax in 1947 and 1948. The Congress responded by enacting a series of three different temporary life insurance tax acts. In 1954, Congress began to design permanent legislation which was eventually enacted as the Life Insurance Company Tax Act of 1959. As discussed below, although the tax base for life insurance companies was expanded by the 1959 Act, life insurance companies still enjoyed the benefit of a number of special provisions not generally applicable to other corporations. In addition, life insurance companies traditionally have benefited, at least indirectly, from tax advantages enjoyed by their customers. As discussed above, many life insurance products are, in part, tax-favored investment vehicles.

2. Present Law

The tax liability of mutual life insurance companies is greatly affected by the deduction for policyholder dividends. By making distributions to policyholders, a mutual company can reduce its excess gain from operations and substantially reduce its Federal income tax liability. The benefits enjoyed by stock companies are principally derived from (1) the deferral of 50 percent of gain from operations in excess of taxable investment income, and (2) the special deductions for nonparticipating policies and group life, accident and health insurance. Present law also provides a special deduction for small life insurance companies and a special formula under section 818(c)(2) which accelerates the deduction for increases in reserves and is used by both mutual and stock companies.

Individuals who invest in life insurance products also enjoy substantial tax benefits. Death benefits are not subject to income tax and, under certain circumstances, may even be excluded from the insured's estate for Federal estate tax purposes. Further, as discussed above, many forms of life insurance products include an investment component as well as an insurance component. As a general rule, policyholders are not taxed on a current basis on investment earnings generated by their investment in an insurance contract. Although such deferral is not limited to investments in life insurance, deferral is not available to bank depositors whose investments may in other ways be similar to the investment component of a life insurance contract.

3. Issues

a. Should special provisions be imposed to reduce the aggregate tax burden of the life insurance industry if special deductions and accounting rules formerly available to the industry are eliminated?

Any effort to reform the taxation of the life insurance industry must include consideration of the expansion of the tax base of life insurance companies. Specifically, it is necessary to consider whether to limit the deduction for additions to reserves, or to eliminate the special deductions and deferral of 50 percent of under-

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writing income. If this were to occur, the industry's tax burden could be increased significantly compared to present law. However, if this were to occur, other financial intermediaries might gain a competitive advantage over life insurance companies, or the economic viability of outstanding policies priced under existing law might be threatened. Thus, special rules that would offset, and mitigate the effect of, the increased burden on a permanent or temporary basis could be appropriate.

Under the House Subcommittee bill, for example, the various rules of present law that have reduced the tax burden of the life insurance industry would, for the most part, be eliminated. However, the bill includes two special deductions that would provide life insurance companies with substantial benefits for Federal income tax purposes—a special life insurance company deduction and a small company deduction.

Under the House Subcommittee bill, all life insurance companies would be allowed a deduction for any taxable year of a specified percentage of taxable income. This deduction would only apply with respect to income resulting from a company's insurance business. This provision will prevent life insurance companies from entering a noninsurance business and using the deduction to gain an unfair advantage over noninsurance competitors.

b. Should special advantages be granted small life insurance companies?

Small companies have argued that they need special tax benefits to compensate for the economies of scale and the substantial assets held by large companies. Present law recognizes this argument by allowing a special small company deduction in computing gain or loss from operations. If it is decided that small insurance companies should receive tax benefits in addition to those available to small companies generally, then the structure and magnitude of such benefits must be determined.

Under the House Subcommittee bill, an additional special deduction would be allowed for small life insurance companies. The amount of the deduction is 60 percent of so much of tentative life insurance company taxable income for such taxable year as does not exceed $3 million, reduced by 15 percent of the excess of tentative life insurance company taxable income over $3 million. "For example, if a small life insurance company has tentative life insurance company taxable income of, say, $2.9 million, its small life insurance company deduction would be 60 percent of $2.9 million or $1.74 million. If the company's tentative life insurance company taxable income is, say, $5 million, its small life insurance company deduction would be $1.44 million, i.e., $1.74 million reduced by $300,000. This deduction would be allowable to companies with assets of less than $500 million."

c. Should special provisions imposed to reduce the aggregate tax burden be permanent or temporary?

To the extent the special provisions are seen as a measure to allow insurance companies to adjust their products and practices to an increased tax burden, the special provisions could be phased out after the adjustment period.

To the extent special provisions are included in the scheme of taxation because an attempt to measure the economic income generates a tax burden that is greater than the burden previously imposed on the industry, the special provisions could be permanent unless Congress sees fit to increase this tax burden. If Congress determines that the tax burden of the life insurance industry should be compared to other financial service industries such as banks and property/casualty insurers, it might also be argued that the special deductions should stay in place unless the aggregate tax burdens of those industries change.

Moreover, if the small company deduction has an intra-industry effect of limiting the competitive advantages of large life insurance companies, the deduction could be retained unless and until it is determined that small companies do not need this incentive to remain in business.

E. Consolidation of Life Insurance Companies

1. Background

Under present law, an affiliated group of corporations generally may elect to join in the filing of a consolidated Federal income tax return. For these purposes, an affiliated group means one or more chains of "includible corporations" connected by stock ownership with a common parent corporation, provided certain percentage of ownership tests are met. The basic principle of the consolidated return is that the group is taxed upon its consolidated taxable income, representing principally the results of its dealings with the outside world after the elimination of intercompany profit and loss. Among the principal advantages of filing a consolidated return is the opportunity to use losses of a loss member of a group to offset current income of profitable affiliates. [11]

For taxable years beginning prior to January 1, 1981, life insurance companies were generally prohibited from filing consolidated returns with nonlife companies. This prohibition resulted from the concern that if life insurance companies, which benefit from favored tax treatment under special tax accounting rules, were to consolidate with other corporations using generally applicable tax accounting rules, the consolidated companies might receive even more favorable tax treatment than the treatment to which they were entitled under then applicable tax accounting rules. Two or more domestic life insurance companies meeting the definition of an affiliated group, however, were permitted to file a consolidated return, even if the life insurance companies were affiliated with nonlife companies.

During the early 1970s, many casualty insurance companies incurred losses. Under then existing law, if a stock casualty company and a noninsurance company were affiliated, they were permitted to file a consolidated return on which the losses of the casualty company would be used to offset the other company's profits. However, if the other company was a life insurance company, the casu-

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[11] The use of a loss member's losses to offset income generated by profitable affiliates is not unlimited. See, for example, the rules relating to built-in deductions.

alty company's losses could not be applied against the life insurance company's income.

2. Present Law

The Tax Reform Act of 1976 included a provision, effective for taxable years beginning on or after January 1, 1981, permitting an affiliated group that includes one or more stock life insurance companies, a mutual life insurance company, or a mutual property and casualty company and nonlife companies to elect to join in the filing of a consolidated return. If no election were made, prior law would be applicable. In addition, the Code provision that requires that life insurance companies use a calendar year for tax purposes was amended to permit life insurance companies joining with nonlife companies in the filing of a consolidated return to adopt the taxable year of the common parent corporation. At that time, it was recognized, presumably, that consolidated returns are filed by corporations in virtually all other industries and that the ban on life-nonlife consolidations resulted in a hardship for casualty companies affiliated with life companies.

Limitations were imposed on the amount of a consolidated net operating loss which could be applied to offset income generated by a life insurance company in order to insure that a minimum tax base for life insurance companies was preserved. Under this provision, the amount of the net loss generated by the nonlife companies that could be taken into account to offset income generated by a life insurance company in any one year is limited to the lesser of (1) 35 percent of the life insurance company taxable income of the life insurance companies included in the group, or (2) 35 percent of the sum of the loss of the nonlife affiliates.[12]

A number of other rules were provided in the 1976 legislation. For example, a life insurance company is not permitted to join in the filing of a consolidated return with a nonlife company unless the companies have been affiliated for the preceding 5 years. In addition, if a nonlife company were to join in a consolidated return with an affiliated group that includes a life insurance company, the losses of the nonlife company cannot be used to offset the income of the life insurance company until the nonlife company has been a member of the affiliated group for at least 5 years.

Before enactment of TEFRA, the manner in which the consolidated income of 2 or more domestic life insurance companies is to be computed was in dispute. Some taxpayers were using a "bottom line" method of consolidation under which consolidated income is computed by aggregating the separate life insurance company taxable income of each life insurance company member. The Internal Revenue Service, however, had taken the position in letter rulings that a "phase-by-phase" method should be used under which the taxable investment income and gain from operations bases of all of the life insurance company members are aggregated to arrive at consolidated amounts which apply for the affiliated group filing a consolidated return. Under this method, a company's underwriting losses cannot be used to offset an affiliate's investment income.

[12] For 1981 and 1982, the percentages were 25 percent and 30 percent, respectively.

Further, proposed regulations issued on June 3, 1982, would employ a "modified phase-by-phase" method to consolidations of a group of life insurance companies with nonlife affiliates.

Congress temporarily resolved this controversy by providing in TEFRA that, for a 2-year period, consolidated life insurance company taxable income would be determined by (1) computing the separate life insurance company taxable income for each affiliated life insurance company, and (2) combining those amounts. This provision applies to the consolidation of affiliated domestic life insurance companies and to the consolidation of a life insurance subgroup within an affiliated group. It is effective for taxable years beginning after December 31, 1981, and before January 1, 1984. In addition, Congress prohibited the Internal Revenue Service from recomputing on a phase-by-phase basis consolidated taxable income that was computed by a taxpayer on a bottom-line basis.

3. Issues

a. Should life insurance companies be allowed to file consolidated returns with nonlife companies?

The general rule permitting the filing of consolidated returns allows income-producing companies to consolidate with companies that have tax losses. This may be appropriate if the activities conducted in the separate companies could be conducted in a single entity with the same aggregate tax result. However, if certain classes of taxpayers are afforded unique tax treatment, consolidation may be considered objectionable if it, in effect, increases the favored tax treatment granted such taxpayers or allows other taxpayers (not within the specified class) to benefit from the special tax provisions.

The House Subcommittee bill would retain the general approach of the 1976 Act permitting life-nonlife affiliated groups to join in the filing of a consolidated return, with special provisions limiting the extent to which nonlife losses can be used to offset life insurance company taxable income.

b. If the three-phase system is eliminated, and a structure for taxing life insurance companies is adopted that taxes more closely their current economic income, should there be special loss limitation rules?

The special loss limitation rule added in the 1976 Act denies life insurance companies certain benefits of consolidation generally available to other corporations. This special rule was adopted, in part, to insure that a minimum tax base on life insurance company income be preserved. In addition, the law ensures that taxable income computed after applying the deferral of 50 percent of underwriting gains, special deductions for nonparticipating contracts, and accident and health and group life insurance contracts, and the approximate revaluation of reserves for tax purposes could not be completely offset by losses generated by nonlife affiliates. If the three-phase system is eliminated, along with many of these special tax rules, the justification for the present limitation on consolidated losses may no longer exist.

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On the other hand, if the current life insurance tax base were expanded, life insurance companies could be allowed certain special deductions designed to reduce their tax burden. In this case special rules for consolidation of life and nonlife companies may continue to be necessary.

In particular, allocation of affiliate losses to the deferred or exempt portion of a life company's income, as well as to the currently taxable portion, might be appropriate. For example, if the general rule is that life companies may exclude or deduct, say, 25 percent of their otherwise taxable income, a special consolidation rule could require that a dollar of affiliate loss offset 75 cents of taxable income and 25 cents of income exempted by the special 25 percent deduction. Under such an allocation rule, the net tax benefit of a dollar of affiliate loss would be a reduction of 75 cents in life insurance company taxable income.

Such an allocation rule would be particularly appropriate if special deductions are viewed as a device to reduce the rate of taxation of life insurance company income without actually revising the corporate tax rates prescribed in section 11. Under a system in which there are no such deductions, but life insurance company income is subject to tax at, say, 75 percent of the regular corporate rates, consolidation of $4 million of life insurance company income with $3 million of affiliate loss would leave $1 million of life insurance company income subject to tax at 75 percent of the regular corporate rate. Under a system with full tax rates and a, say, 25-percent deduction, application of a "bottomline" consolidation method to $4 million of life insurance company income and $3 million of affiliate loss would produce taxable income of zero: The life insurance company income would first be reduced from $4 million to $3 million, and then the $3 million affiliate loss would reduce taxable income to zero. If, however, the $3 million loss were allocated ratably between the $1 million of excluded income and the $3 million of taxable income, then $750,000 of income would remain subject to tax at the regular corporate rate. This is the same net result as full consolidation at 75 percent of the regular rate.

Such a provision could prevent life insurance companies from entering a noninsurance business and using consolidation to gain an unfair advantage over noninsurance competitors. Without such a provision, a life insurance company might be induced to transfer certain deductions and preference items generally allowable to all corporations to an affiliated company that does not qualify for the special deduction and, on a consolidated basis, derive a greater benefit from the generally allowable deductions and preference items than it would otherwise derive.

The House Subcommittee bill included two special deductions to reduce the effective rate of tax on life insurance company taxable income. One, the small life insurance company deduction, would only apply to companies with assets of $500 million or less. The other, the special life insurance company deduction, would apply to all companies taxed as life insurance companies under the bill. In addition, the House Subcommittee bill would add a special rule to apply in situations in which one or more life insurance companies join with nonlife companies in the filing of a consolidated return. Under this rule, consolidated income or loss of nonlife companies

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in a consolidated group would not be taken into account for purposes of computing the amount of the special deductions (which are based on a percentage of income). However, the House Subcommittee bill did not require allocation of nonlife insurance company affiliate losses to the portion of a life insurance company affiliate's income that is exempt from tax by virtue of the 25 percent special life insurance company deduction.

In addition, the House Subcommittee bill contains a number of special provisions that would limit the amount of certain deductions by treating related corporations as one corporation whether such corporations join in the filing of a consolidated return or file separate returns. For example, for purposes of computing the amount of the special deduction, all life insurance companies that are members of the same controlled group[13] would be treated as one company and any special life insurance company deduction determined with respect to such group would be allocated among the life insurance company members of such group in proportion to their separate tentative life insurance company taxable incomes.

c. What is the appropriate treatment of stock subsidiaries of mutual companies?

Another issue involves the treatment of affiliates when computing the limitation on the deduction for policyholder dividends of mutual companies. To prevent a mutual from using a stock subsidiary to avoid the limitation on deductions for policyholder dividends, stock companies that are at least 80 percent owned (by value of stock) by one or more mutual life insurance companies could be treated as mutuals. The rationale for this treatment would be the concern that such subsidiaries would, in fact, be operated in the same manner as the parent mutual company.

On the other hand, such an approach ignores the fact that such subsidiaries do indeed have stockholders who should expect a return on their invested capital. An alternative to recharacterizing the stock subsidiary as a mutual company could be to include the assets in the subsidiary when computing the mutual parent's equity. This latter approach is reflected in the House Subcommittee bill.

d. Should the effects of intercompany reinsurance agreements be allowed to be maximized by filing a consolidated return?

Reinsurance involves the process of providing insurance coverage to an insurer that has previously assumed a risk. Thus, to reduce exposure to loss for a particular risk, reinsurance can be used to pass all or a portion of the risk to another insurer. Case law and Internal Revenue Service rulings relating to reinsurance have established that, in order to be effective for Federal income tax purposes, reinsurance must, in fact, involve a shifting of risk and there must be an independent business reason for the reinsurance (but see *Consumer Life Insurance Company* v. *United States,* 430 U.S. 725 (1977)).

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[13] The term "controlled group" is defined in the House Subcommittee bill by reference to sec. 1563.

Despite the requirement that reinsurance involve risk-shifting and a valid business purpose, significant tax benefits can be derived by reinsuring, because the transaction may alter the timing of income and deductions. For example, if an insurance company has an unused loss carryover that would expire in a taxable year, it may reinsure a portion of its risks. This reinsurance serves to accelerate the company's income on the reinsured risks, thereby utilizing a tax benefit that would otherwise be lost.

If property and casualty insurance companies and life insurance companies are consolidated, these tax benefits may be even greater. For example, the rules relating to the consolidation of affiliated companies place two limitations on the amount of nonlife company losses that can be applied against the income of the life insurance company members of the group. However, both life insurance companies and property and casualty insurance companies issue group health and accident insurance. By reinsuring in a year in which the nonlife members will have losses in excess of the limitations, the nonlife members accelerate income to offset those losses. Therefore, a property and casualty insurer could use reinsurance of certain accident and health policies effectively to pass its losses to the life insurance company notwithstanding the limitation on losses for nonlife companies that may be taken into account to offset life insurance income. [14]

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[14] Similarly, a life insurance company member of an affiliated group may reinsure accident and health insurance business with a property and casualty company to shift a deduction for retrospective rate credits to the property and casualty company. Retrospective rate credits are basically refunds for premiums previously paid, determined under a formula that considers the policyholder's loss experience. The Internal Revenue Service has taken the position that these retrospective rate credits must be treated as dividends to policyholders if they depend on the experience of the company. However, the deduction for policyholder dividends (when combined with two special deductions) for life insurance companies is subject to a limitation. No similar limitation applied to property and casualty insurance companies. Thus, the use of reinsurance can provide an opportunity for life members of an affiliated group to avoid the general limitation that may be applicable to policyholder dividends.

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