C. Taxation of Life Insurance Companies and Annuities

Present Law

Introduction

Generally, a life insurance company receives income from two primary sources: the premiums it receives from policyholders, and investment earnings on the portion of premiums set aside to pay future claims. Although life insurance companies pay income tax at the regular corporate rates, the tax rates are applied to a tax base determined in a special manner.

Taxable income

The regular corporate income tax rates are imposed on "life insurance company taxable income," which is defined as the sum of:

(1) the lesser of (a) taxable investment income or (b) gain from operations;

(2) 50 percent of the amount by which the gain from operations exceeds taxable investment income; and

(3) amounts subtracted from the policyholders' surplus account for the taxable year.

To describe generally a company's applicable tax base, a company is commonly referred to as a "phase I" company if the tax base is taxable investment income; a "phase II negative" company if the tax base is gain from operations which is less than taxable investment income; and a "phase II positive" company if the tax base is the sum of taxable investment income and 50 percent of the excess gain from operations.

The 50-percent portion of gain from operations in excess of taxable investment income that is not taxed currently under (2) above must be added to the policyholders' surplus account and is taxed when distributed from that account.

Taxable investment income

In determining taxable investment income, there first is excluded the portion of the "investment yield" treated as the policyholders' share, i.e., the portion necessary to fund future claims. The "investment yield" means gross investment income (interest, dividends, rents, royalties, short-term capital gains, and trade or business income) reduced by certain deductions (investment expenses, real estate expenses, depreciation, depletion, and trade or business expenses).

The excludable portion treated as the policyholders' share of investment yield is determined by allocating the portion of each item of investment yield which reflects the percentage obtained by dividing the "policy and other contract liability requirements" by the investment yield. For this purpose, the liabilities reflect the follow-

ing: (1) the adjusted life insurance reserves (described below) multiplied by the adjusted reserves rate (the lesser of an average rate for a 5-year period or the current earnings rate); (2) the mean of the pension plan reserves at the beginning and end of the taxable year multiplied by the current earnings rate; plus (3) interest paid.

The taxable investment income for a life insurance company is the sum of the remaining portion of the investment yield (i.e., the company's share) and the net capital gain (long-term capital gain in excess of net short-term capital loss) reduced by the company's share of tax-exempt interest income, dividends received deductions, and a small business deduction (10 percent of investment yield up to a maximum deduction of $25,000).

Gain from operations

In determining gain from operations, there first is excluded the share of investment yield set aside for policyholders.

For this purpose, a formula different from that used for purposes of determining the company's taxable investment income is used. The share of investment yield that is excludable from gain from operations is determined by allocating the portion of each item of investment yield which reflects the percentage obtained by dividing the "required interest" by the investment yield.

The required interest is determined by multiplying the required or assumed rates of interest used by the company in calculating reserves for State insurance law purposes by the mean of the applicable reserve at the beginning and end of the taxable year. Generally, there are six categories of items taken into account as reserves related to insurance and annuity contracts.

A company's gain from operations is the sum of its share of investment yield, the amount of a net capital gain, and underwriting income (premiums, decreases in certain reserves, and all other items of gross income), reduced by specified deductions allowed.

Modified coinsurance

A life insurance company sometimes will insure itself against some policyholder risks it has undertaken. This type of insurance between insurance companies is referred to as "reinsurance". Modified coinsurance is a type of reinsurance agreement under which the company transferring some of its risks (the "ceding" company) retains ownership of the assets connected with the risks reinsured and also retains the reserve liabilities connected with the risks reinsured. The company which has agreed to assume the risks under the agreement (the "reinsurer") receives both premium income and investment income attributable to the policies reinsured from the ceding company. Thereafter, periodic settlements are made between the companies for premiums collected, benefits paid, etc.

Code section 820 contains a rule which allows the ceding company and the reinsurer to report a modified coinsurance transaction for tax purposes as if the assets relating to the risks reinsured were transferred to the reinsurer, as if the premium income for the reinsured policies and the investment income on the assets were received directly by the reinsurer, and also as if the reserves to re-

flect liability for future claims were maintained by the reinsurer. No transfer of assets or reserve liability actually occurs.

Section 820 was originally intended to avoid possible double taxation to both the ceding company and the reinsurer when a modified coinsurance agreement is used. However, some life insurance companies have used modified coinsurance to avoid or substantially reduce income tax paid by both the reinsurer and the ceding company. For example, since a life insurance company cannot deduct policyholder dividends in excess of underwriting income (plus $250,000), it would benefit by converting investment income into underwriting income which then may be offset by excess policyholder dividends which would not otherwise be deductible. Similarly, a company with gain from operations exceeding its investment income, but without sufficient dividends to offset all underwriting income, could benefit by converting investment income into underwriting income because the tax on half of the underwriting income is deferred.

Any increased income to the reinsurer because of the deemed transfer of investment income could be offset by an "experience refund" to the ceding company equal to the investment income minus a minor "service charge." Moreover, a reinsurer may receive an additional benefit of sheltering its other income if it has elected the approximate method for revaluing reserves computed on a preliminary term basis.

Thus, the effect of entering into a modified coinsurance agreement with a section 820 election has often been to convert taxable investment income into underwriting income on which a lesser or no tax is paid by the ceding company and to reduce gain from operations for the reinsurer.

Policyholder dividends

In addition to ordinary business deductions, special deductions are allowed in computing a life insurance company's gain from operations. The combined deductions for policyholder dividends, certain amounts attributable to nonparticipating contracts, and to accident and health and group life insurance contracts, are subject to a special limitation. Under the limitation, these deductions cannot exceed $250,000 plus the amount by which gain from operations (computed without regard to these deductions) exceeds taxable investment income.

Reserves

The concept of reserves is taken into account for several purposes under the life insurance company tax rules. The concept of life insurance reserves is relevant to the definition of a life insurance company which is subject to the special tax provisions; the concept of adjusted life insurance reserves is taken into account for purposes of determining the policyholders' share of investment yield which is excludable from taxable investment income; and increases and decreases in life insurance and other reserves are taken into account in determining gain or loss from operations.

"Menge" formula

A formula, commonly called the "Menge" formula, is used to compute the amount of adjusted life insurance reserves. Simply stated, the "Menge" formula is a mechanical arithmetic adjustment used to compute adjusted life insurance reserves. This computation is then used in determining the policyholders' share of investment yield and accordingly affects the computation of a life insurance company's taxable investment income.

The formula operates to reduce life insurance reserves (other than pension reserves) by 10 percent for each percentage point by which the adjusted reserves rate (the lower of the average earnings rate for a 5-year period or the current earnings rate) exceeds the interest rate assumed in calculating the reserves.

Revaluation of reserves

Present law permits taxpayers to revalue life insurance reserves computed on a preliminary term basis to a net level premium basis. This revaluation may be done under either an exact revaluation method or an approximate revaluation method. (Under the approximate revaluation method, reserves are generally increased by $21 per $1,000 insurance in force other than term insurance less 2.1 percent of reserves under such contracts. Reserves for term insurance are increased by $5 per $1,000 term insurance in force covering a period of more than 15 years, less 0.5 percent of reserves under such contracts.)

Certain reserves for guaranteed interest

Under present law, certain taxpayers have calculated reserves for certain deferred annuities and similar contracts (including certain tax-qualified pension contracts) in a manner that accelerates deductions for interest in excess of the assumed rate that is guaranteed for longer than one year. In general, the reserve is computed by taking the interest guaranteed for future periods into account at the guaranteed rate but is discounted to present value at the end of the company's taxable year at the low rate required to be assumed by State regulatory authorities (typically at a rate of approximately 4 percent). The effect of computing reserves in this manner is to accelerate deductions in computing gain from operations for interest payable in subsequent taxable years. This computation also increases the reserves for purposes of computing the portion of investment yield excludable from taxable investment income.

Consolidated returns

Two or more affiliated domestic life insurance companies may elect to file a consolidated return. Also, beginning in 1981, life insurance companies may be included in consolidated returns with non-life affiliated companies. For reporting purposes, some taxpayers have taken the position that taxable income first is determined for each component member of the affiliated group (e.g., taxable investment income for some companies and gain from operations for others) and then consolidated by adding those separate company

taxable income bases. This approach is sometimes referred to as the "bottom line" method of consolidation.

The ruling position of the Internal Revenue Service, as taken in letter rulings, has been that the taxable investment income bases and the gain from operations bases first must be aggregated to arrive at consolidated group amounts and then these aggregate tax bases (taxable investment income and gain from operations) apply for the consolidated group. This approach is sometimes referred to as a "phase-by-phase" method of consolidation.

Under regulations proposed on June 3, 1982, with respect to consolidation of non-life and life companies, a modified phase-by-phase method of consolidation would apply to a life insurance subgroup of companies. Consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup, and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount (including the 50-percent deferral for gain from operations in excess of taxable investment income and the limitation on policyholder dividends and special deductions). The proposed regulations would apply to the first taxable year for which the due date (without extensions) for filing a return is after the date final regulations are adopted. The proposed regulations would apply only in the limited context of consolidation of life insurance companies and non-life affiliates, but indicate a preference of the Internal Revenue Service for "phase-by-phase" consolidation over "bottom line" consolidation of life insurance companies.

Taxation of policyholders

Gross income includes any gain received as an annuity under an annuity, endowment, or life insurance contract. Amounts received before the annuity starting date are first considered to be nontaxable returns of premiums and other consideration paid. Except for certain annuities under qualified pension plans, no special rules are provided with respect to the tax treatment of loans against an annuity contract or for withdrawals before either a specified time or attainment of a specified age.

Indeterminate premiums and excess interest

In recent years, many stock companies have begun to offer "indeterminate premium" policies under which the company charges a premium lower than the maximum premium fixed in the policy and "excess interest" policies under which the company credits interest at a rate in excess of the low, permanently guaranteed rate in the contract. Such lower premiums and higher interest rates are guaranteed to the policyholder on a temporary basis because the rate of interest companies can permanently guarantee in setting policy benefits is limited as a practical matter by State law (to as low as 4 to 5 percent in the case of life insurance reserves).

In computing their taxable income, these companies have included only the payments that they actually received under their indeterminate premium policies and have fully deducted, as additions to reserves to provide for guaranteed benefits, the amounts that they credited as excess interest. Recently, however, the Internal Revenue Service has suggested that the excess of the maximum

premium chargeable over the premium actually collected may be income to these companies with the difference being deductible only as policyholder dividends. Also, the Internal Revenue Service has suggested that the excess interest may not be fully deductible by these stock companies by treating it as a policyholder dividend subject to the limitations previously described.

In a widely publicized private letter ruling, issued in June 1982, the Internal Revenue Service held that the excess of the maximum premium chargeable over the premium actually collected should be treated as a distribution of policyholder dividends which is paid back as a premium to the company and that excess interest credited to policies was deductible only as a policyholder dividend. Also, the Internal Revenue Service took the position (Rev. Rul. 82-133) that the excess interest credited with respect to certain deferred annuity contracts is a policyholder dividend subject to the statutory deduction limitation.

Administration Proposal

The provision of the Code that treats modified coinsurance arrangements as conventional coinsurance arrangements would be repealed. In addition, the proposal would clarify the treatment of experience refunds by providing for an allocation between investment and underwriting income. Also, the tax treatment of coinsurance arrangements would be revised to prevent disproportionate allocation of investment and underwriting income between the reinsured and the reinsurer.

These provisions generally would apply to all reinsurance arrangements entered into after 1981. The provisions relating to experience refunds and disproportionate allocations would apply after 1981 to all reinsurance arrangements.

Senate Finance Committee Bill

The bill would repeal the modified coinsurance ("Modco") rules in section 820; treat existing Modco agreements as terminated on January 1, 1982, but allow a three-year installment payment of the tax increase from termination treatment of existing agreements for certain reinsurers; provide related party allocation authority for Treasury for future conventional coinsurance agreements; prevent tax avoidance by disallowing an interest deduction with respect to conventional coinsurance funded by a debt obligation; and grandfather prior Modco transactions except in the event of fraud.

The bill would raise the present $250,000 special deductions limit to $1 million, would impose an affiliated group limit, and target the provision to smaller companies. The bill also would allow a 100 percent deduction for policyholder dividends and interest for qualified pension business.

Under the bill, mutual life insurance companies would be allowed to deduct a minimum of 77½ percent of policyholder dividends on nonqualified business. Stock life insurance companies would be allowed a minimum policyholder dividend and interest deduction of 85 percent of amounts paid or credited on nonqualified business.

A geometric "Menge" formula would be provided to compute adjusted life insurance reserves for purposes of allocating investment yield to policyholders.

A "bottom-line" method of consolidation would be allowed for determining consolidated life insurance company taxable income.

The bill would revise the approximate revaluation formula for preliminary term reserves by reducing the revaluation from $21 to $19 per $1,000 of other than term insurance in force, for business written after March 31, 1982.

No reserve deductions would be allowed for interest guaranteed beyond the annual valuation date.

Tax treatment for modified coinsurance transactions with a section 820 election for periods prior to January 1, 1982 would be grandfathered except in cases of fraud. Excess interest credited to policyholders for years prior to 1982 would be fully deductible. Similarly, treatment claimed with respect to consolidation of two or more life insurance companies would be grandfathered for years prior to 1982.

The tax treatment of recipients of annuities would be modified. Withdrawals would be deemed to be taxable to the extent income from investment had been earned. A rule for treating loans as distributions and a 10-percent penalty for withdrawals prior to age 59½ or within 10 years of contribution, whichever period is shorter, would also be added. A 100-percent excess interest deduction would be allowed to insurance companies for amounts credited to deferred annuity business.

The bill would prescribe guidelines for eligibility of the proceeds from "universal life" products for the income tax death benefit exclusion and, except for grandfather protection for prior periods, would not prescribe tax treatment of excess interest (leaving the issue open for litigation during the effective period as to characterization as fully deductible interest paid, alternatively, or as a policyholder dividend deductible to the extent allowed under the percentage limitation safety net).

All of the above provisions would terminate after 1984 (a three-year stopgap period) except for (1) the treatment of modified coinsurance and related transactions, (2) the tax treatment of amounts received under an annuity contract and the deductibility of excess interest credited on deferred annuities, and (3) the "grandfather" rules.

Alternative Stopgap Proposal

Modified coinsurance

The alternative proposal would suspend for two years (a "stopgap" period) the modified coinsurance rules for purposes of determining taxable investment income (generally affecting the ceding or reinsured company); continue modified coinsurance treatment for purposes of determining gain and loss from operations (generally benefiting the reinsurer); and provide grandfathering protection for prior periods for certain modified coinsurance contracts (for taxable years beginning before 1982).

Policyholder dividend limitations

For a two-year stopgap period, companies would be given two alternative means of calculating the limitation for the policyholder dividend deduction and other special deductions.

The first alternative would incorporate the present limitation with only one change—the statutory dollar limit would be increased from $250,000 to $1 million.

The second alternative would provide a limitation determined as follows:

(a) 100 percent of the dividends attributable to insured qualified pension plans;

(b) a statutory amount of $1 million (same as in the first alternative); and

(c) in the case of a mutual company, 80 percent of any remaining dividends or, in the case of a stock company, 87½ percent of any remaining dividends and the special deduction for nonparticipating contracts.

The 7½ percent differential is intended to reflect that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (deriving from their ownership interest in the company), and, accordingly, should not be deductible.

(In addition to the higher percentage limitations proposed, this proposal differs from the Senate Finance Committee bill by not containing affiliated group and small company targeting limitations.)

"Menge" formula

For a 2-year stopgap period, the 10-for-1 "Menge" formula would be revised to allow the policyholders' share of investment yield to be computed by using a geometric 10-for-1 formula to adjust statutory life reserves, and a 9.5 percent cap would be provided on the adjusted reserves rate that will be used.

(The Senate Finance Committee bill does not contain an adjusted reserves rate cap.)

Consolidated returns

For the 2-year stopgap period, the proposal would provide that consolidated life insurance company taxable income is determined by first computing the separate life insurance company taxable income for each affiliated company and then combining those amounts. Also, grandfathering protection would be provided for companies that have taken this reporting position for taxable years beginning before 1982.

(These proposals are consistent with provisions included in the Senate Finance Committee bill.)

Excess interest deductions

For taxable years beginning before 1982, the alternative stopgap proposal would provide that amounts treated as interest deductions by a taxpayer on insurance or annuity contracts will be protected from reclassification as policyholder dividends on audit by the Internal Revenue Service.

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(The Senate Finance Committee bill contains similar grandfather rules.)

Indeterminate premium policies

For taxable years beginning before 1982, the alternative stopgap proposal would provide that amounts that could have been charged as a premium or mortality charge, but were not, would not be included in income.

(The Senate Finance Committee bill contains similar grandfather rules.)

Proposal for Revaluing Certain Reserves

As recommended by a GAO report, the approximate revaluation method for revaluing life insurance reserves computed on a preliminary term basis could be revised for insurance (other than term insurance) so that reserves are increased by $15 per $1,000 insurance in force rather than by $21 per $1,000, and reduced by 1.5 percent of reserves rather than 2.1 percent. Alternatively, the approximate revaluation method could be repealed, so that the revaluation of reserves computed on a preliminary term basis would have to be computed under the exact revaluation method.

Pros and Cons

Argument for the Administration proposal

Repeal of the modified coinsurance provisions (with other conforming changes) would eliminate permanently the unintended tax benefits derived from the provisions, e.g., the conversion of taxable investment income into underwriting gains on which little, if any, taxes are paid.

Arguments against the Administration proposal

1. The modified coinsurance provision should be considered as part of a package with some other needed changes in the insurance tax laws.
2. Until there is a comprehensive review of the life insurance company tax laws, there should only be a suspension of the modified coinsurance provisions, together with temporary changes of certain other provisions of the 1959 Act which are outdated, for an interim period during which the Congress could conduct the comprehensive review.
3. A simple repeal of the modified coinsurance provisions would increase the tax burden of certain members of the life insurance industry too much. In addition, it would result in decreasing funds accumulated from the sale of life insurance policies that could be used as long-term capital.

Arguments for the alternative stopgap proposal

1. The stopgap proposal would raise a more appropriate amount of revenues from the life insurance industry, i.e., increasing revenues over present law with the present treatment of modified coinsurance, but providing some degree of tax relief from changed ef-

fects of certain provisions of the 1959 Act due to changed interest rates and different insurance products.

2. The alternative proposal would provide interim corrections during the two-year stopgap period (1982 and 1983) to permit a thorough Congressional review of the 1959 Act.

3. At a time of inflation and higher interest rates, the alternative proposals relating to limitations on the policyholder dividend and other special deductions would carry out Congressional intent that investment income attributable to insured pension plans would be tax-free and permit the insurance industry to compete effectively for qualified pension plan business. Also, by allowing a minimum deduction of 80 percent for mutual companies and 87½ percent for stock companies, the proposal would (1) temporarily correct the problem arising when increases in taxable investment income attributable to high interest rates decrease the limitation on deductible policyholder dividends (the portion of the limitation based on operating gains in excess of taxable investment income); (2) generally restore the level at which policyholder dividends were deductible in 1959 (approximately 90 percent of policyholder dividends were deductible in 1959, but the portion has been approximately 60 percent recently); and (3) permit life insurance and annuity policies to remain competitively attractive by allowing companies to reflect better investment performance by higher dividends, lower premiums, or increased benefits. Finally, the proposal would take into account the effects of inflation since 1959 by increasing the minimum dollar limitation from $250,000 to $1 million and thereby restore the assistance to small companies intended in 1959.

4. The proposal would correct inaccuracies attributable to substantial increases in interest rates in recent years with respect to the 10-for-1 "Menge" formula used to revalue statutory reserves.

5. The proposal relating to consolidated returns would permit life insurance companies to file consolidated returns on a basis comparable to other taxpayers.

6. The grandfathering provisions for previous modified coinsurance arrangements, consolidated returns, excess interest, and indeterminate premium products would remove doubt about the tax treatment for such items for prior taxable years.

Arguments against the alternative stopgap proposal

1. Because of the general acknowledgment that modifed coinsurance has been abused, the modified coinsurance provisions should be repealed, rather than merely suspended for a two-year period (including repealing present treatment for reinsurers as well as for reinsured companies). If the present treatment of modified coinsurance were merely suspended, some unintended benefits could continue.

2. The proposal relating to provisions other than modified coinsurance should be considered within the context of a thorough review of the 1959 Act to develop permanent, rather than temporary, solutions.

3. Grandfathering protection for past modified coinsurance transactions sets an inappropriate precedent as a matter of tax policy and would unduly restrict the authority of the Internal Revenue Service to examine the substance of past transactions. If the trans-

actions do not meet long-standing general requirements for favorable tax treatment, they should be challenged by the Internal Revenue Service. Other grandfathering provisions would also set inappropriate precedents.

4. The proposal does not deal with all provisions that are not operating correctly because of changed circumstances since 1959, e.g., the approximate method for revaluing life insurance reserves computed on a preliminary term basis.

5. The minimum policyholder dividend deduction levels under the proposal would not sufficiently reflect the status of a policyholder of a mutual company as an owner-investor, i.e., amounts equivalent to nondeductible regular corporate dividends should not be deductible as policyholder dividends. Further, the proposal does not sufficiently reflect the tax deferral and exemption treatment available to policyholders on dividends credited to their policies.

6. The proposal relating to consolidated returns fails to reflect the general rule applicable to other taxpayers that dollar or percentage limitations should be determined on a consolidated basis.

7. Technical modifications to the alternative stopgap proposal are necessary.

Arguments for proposal as to revaluing certain reserves

1. As indicated by a GAO report, the approximate method for revaluing reserves for life insurance other than term insurance that are computed on a preliminary term basis ($21 per $1,000 insurance in force) should be revised because it produces reserves greater than what is actuarially needed. This is due to changed circumstances since 1959 (mortality, product, and reserve method changes). Likewise, many large established companies have obtained excessive allowances by electing the method which was originally intended to aid new and small companies.

2. The proposal to revise the approximate method for revaluing life insurance reserves on a preliminary term basis would remove an unintended benefit which now results in a substantial revenue loss.

3. The proposal is consistent with a package of changes to deal with circumstances which have changed since the 1959 Act was enacted.

Arguments against proposal as to revaluing certain reserves

1. The proposed revision of the approximate method of revaluing life insurance reserves computed on a preliminary term basis would increase the tax burden of the life insurance industry by too much.

2. Revision of the approximate method of revaluing life insurance reserves would impact heavily upon smaller stock companies.

3. These proposals should be considered only in the context of a thorough review of the tax rules relating to life insurance taxation.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1982	1983	1984	1985	1986	1987
Administration proposal	0.9	2.6	2.5	2.7	2.9	3.2
Senate Finance bill [1]	.5	1.5	1.5	2.2	2.9	3.2
Alternative stopgap proposal [2]	.4	1.2	.6			

[1] The provisions would be effective for a 3-year stopgap period except for repeal of the modified coinsurance provisions, certain deferred annuity provisions, and grandfathering provisions.
[2] The proposal is only for a 2-year stopgap period.