BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Billions Of Dollars Are Involved In Taxation Of The Life Insurance Industry -- Some Corrections In The Law Are Needed

The income of U.S. life insurance companies is taxed under a special subchapter of the Internal Revenue Code that was enacted in 1959 and tailored to the life insurance industry as it then existed. In the last 20 years many changes occurred in the industry, not only in its structure but also in the products it offers. The economic environment in which life companies operate has also changed. These changes in the industry and economy have rendered certain provisions of the Act inappropriate and in need of revision.

In this report GAO examines the life insurance industry and considers how it has changed since 1959. The complex rules by which company income is taxed are explained in detail. Several problems in the law are carefully presented. Income tax data from a sample of company tax returns are analyzed, and the effects on tax burdens of some alternatives to the current rules are discussed. The report concludes with three specific recommendations for changes in the law and identifies six additional issues for study by the Congress.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To The President of the Senate and the
Speaker of the House of Representatives

This report examines the provisions of the Internal Revenue Code under which life insurance companies are taxed. We made this review to determine whether the provisions, which were enacted in 1959 and have not been reviewed since, were in need of revision in the light of changed conditions in the economy and the life insurance industry.

We are sending copies of this report to the Director, Office of Management and Budget, the Secretary of the Treasury, and the Commissioner of Internal Revenue.

Milton J. Socolar
Acting Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

BILLIONS OF DOLLARS ARE INVOLVED IN TAXATION OF THE LIFE INSURANCE INDUSTRY--SOME CORRECTIONS IN THE LAW ARE NEEDED

D I G E S T

The Life Insurance Company Income Tax Act of 1959 under which life insurance companies are taxed needs updating to reflect substantial changes in the industry and economy. This law was enacted in 1959, retroactive to 1958, and culminated 50 years of trial and error with alternative methods of taxation. The 1959 Act contained a number of controversial provisions, and many features of the law were written to tax the industry as it was structured in 1959 (see chapter 3):

--The industry was dominated by mutual companies (cooperative ventures) that represented only about 11 percent of the total number of companies in business but held 75 percent of industry assets and sold 63 percent of U.S. life insurance.

--Whole life insurance (a life insurance policy for the whole of life payable at death), generating large reserves and investment income, was the predominant product sold.

--The rate of inflation in the U.S. was low (0.8 percent annually compared to recent rates of 10 percent and more), and earnings rates on investments were much lower than current rates.

The Congress considered the structure of the industry in 1959 and provided special features in the Act that recognized (see chapter 3):

--the competitive balance between mutual and stock companies (mutual companies, unlike stock companies, do not have stockholders);

--the importance of fostering the survival of small life insurance companies that were by far the largest in number of companies doing business; and

--the long-term nature of the life insurance business (life insurance contracts span many years).

Tear Sheet

In the past 20 years the life insurance industry has changed considerably. These changes include (see chapter 2):

--the balance in the industry has shifted, and mutual companies no longer dominate, though they are still a major factor in the industry;

--the lines of business life companies write have shifted from whole life to term and group insurance (term life coverage is for a specified number of years and expires without cash value if the insured survives, and group insurance provides coverage to many insureds under a single policy);

--there has been a dramatic increase in the pension line of business as well as tax-deferred annuities (annuities on which income tax is postponed until a payment is made), and growth in these lines of business has yet to peak; and

--policy loan provisions have induced unanticipated demands on life company assets in recent years.

OBJECTIVES, SCOPE, AND METHODOLOGY

Because of the changes specified above, which may have rendered certain provisions of the Act inappropriate and in need of revision, GAO conducted this examination of the 1959 Act. This report provides the Congress with recommendations for changing the 1959 Act.

GAO's examination of the 1959 Act began with a study of the industry's structure in 1959 and how it had changed in 20 years (chapter 2). The nature of income of a life insurance company was examined (chapter 3). GAO studied certain specific provisions of the law (chapter 4). The subjects of reinsurance (an agreement between two or more insurance companies by which the risk of loss is shared) and the cooperative nature of mutual companies were also analyzed (chapter 5).

GAO obtained tax data on 42 of the largest life insurance companies for the 5-year period 1974-78 that provided a foundation for our analyses of the taxation of life insurance companies (chapter 6). In 1978 these 42 companies held approximately 72 percent of the industry's as-

sets and wrote about 62 percent of life insurance in force. GAO also analyzed tax data on 1,254 life companies with assets of less than $25 million (appendix IV).

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

GAO concludes that, primarily due to changes in the industry structure, its product offerings, and the effects of inflation, there are three sections in the Act that the Congress should consider changing. These sections deal with:

--the method by which the reserve deduction, that portion of current income necessary to meet future obligations, is calculated;

--the definition of taxable income; and

--the method for approximating those reserves that are computed on a preliminary term basis. (Under a preliminary term basis, a company adds less to its reserves during the early years of a policy and then makes up for the deficiency in later years. The company may elect to compute these reserves either exactly or approximately.)

Six additional issues merit the Congress' consideration. Because of time constraints and limited availability of data, GAO is unable to make specific recommendations for changes in these areas; however, because of the extensive litigation arising from some of these issues, GAO is certain that the Congress will wish to study them further in the future. The three specific changes will be presented first, followed by a brief description of the six additional problem areas.

RESERVE DEDUCTION

The method by which a life insurance company calculates its reserve deduction is crucial in determining its tax liability. This results because the higher the reserve deduction the lower the tax liability. From extensive analyses of the subject, GAO found (chapters 4 and 6):

--that due to spiraling inflation, changes in product mix, and increasing earnings rates, the current method of calculating the reserve

deduction is no longer appropriate. If the gap between the current earnings rate and the assumed rate (used in computing reserves) continues to widen, the reserve deduction will first become larger and then smaller because of the 10 to 1 approximation. (The 10 to 1 approximation adjusts reserves downward 10 percent for every 1 percent by which the interest rate earned exceeds the rate used in computing reserves.) Many large companies are approaching the maximum reserve interest deduction available under current law. Therefore, GAO concludes:

--that the portion of the Code specifying the calculation of the reserve deduction should be revised to reflect the changes in the industry over the past 20 years and the changed economic environment in which the industry operates.

Further, GAO recommends:

--that the amount of the deduction should be evaluated in light of the following considerations:

    --the assumed rate used by the companies in computing reserves;

    --the inflationary environment in which the industry has operated in recent years; and

    --the practice approved by the Congress in 1959 of allowing life insurance companies to deduct amounts in excess of the required interest implied in the assumed rates.

Three basic alternatives to the 10 to 1 rule are discussed in this report. The alternatives are:

--substituting the required interest based on assumed rates for the 10 to 1 approximation;

--replacing the 10 to 1 approximation with a geometric approximation, which provides a larger reserve deduction in the current economic environment; and

--substituting a 4.5 percent maximum for the average earnings rate with either the 10 to 1 approximation or the geometric approximation.

GAO recommends that the Congress consider selecting one of the above alternatives to replace the 10 to 1 approximation.

TAXABLE INCOME

The importance of the method used by life insurance companies in determining their taxable income is paramount. In this area, GAO found (chapters 4 and 6 and appendix III):

--that the provisions of the Act which control the determination of life insurance company taxable income are no longer appropriate. The deferral of one-half of the underwriting gains (income that a company generates from insurance operations as distinct from investment income) accruing to all companies can no longer be justified, and should be revised to reflect current realities. The stated purpose of the tax deferral was to provide a cushion, particularly to small and new companies, to meet the contingencies of catastrophic losses. However, the industry's operations over the last 20 years have proven quite predictable. Stock companies are the primary beneficiaries of this provision. Among the stock companies, many larger companies already have accumulated considerable amounts of policyholders' surplus.

Therefore, GAO concludes:

--that there should be no automatic deferral of one-half the excess of gain from operations over taxable investment income for life insurance companies; however,

GAO recommends:

--that elimination of this tax deferral should be gradual and indexed to the age of the individual companies. This deferral would be 50 percent for new companies for 15 years and then phased out for them as well as for the companies already in existence for 15 years or more by decrements of 10 percent per year over a period of the next 5 years.

RESERVE REVALUATION

The method by which life insurance companies revalue reserves is important because it can significantly reduce their tax liability. This results because in revaluing the reserves

there is a direct effect on the size of the reserve deduction. In examining this area, GAO found (chapters 4 and 6):

--that the current law provides two methods of revaluing reserves (1) exact revaluation, and (2) approximate revaluation. The latter allows for permanent policies of insurance an increase of $21 per thousand dollars of the amount at risk. Such an allowance is excessive and not appropriate as it results in unwarranted reserve deductions.

GAO concludes:

--that the above allowance of $21 is greater than what is actuarially needed (chapter 7). A lower allowance is more appropriate today because of changes in product offerings and reserve methods prevalent in the industry.

Therefore, on the basis of actuarial analyses, (appendix III), GAO recommends:

--that only $15 per thousand dollars of the amount at risk be allowed in revaluing reserves for permanent insurance plans.

There are six additional provisions of the Act that GAO feels merit further consideration by the Congress. GAO's suggestions for the six provisions concern:

--the appropriateness of the tax treatment of investment type contracts designed to take advantage of the current high interest rates and favorable tax treatment afforded tax-deferred annuities;

--a definition of a life insurance company tightened to prohibit a company doing mostly nonlife insurance business from qualifying as a life insurance company for tax purposes;

--a clear definition of life insurance reserves;

--a modification of the portion of the Code dealing with the deduction for investment expenses to specify which expenses are deductible;

--a clearer definition of assets; and

--an examination of the use of modified coinsurance, a form of reinsurance, to avoid taxes.

AGENCY AND INDUSTRY COMMENTS

GAO received comments on a draft of this report from the Department of the Treasury, the Internal Revenue Service, and several life insurance industry trade associations. These comments were organized in the following manner: An overview covering broad issues was followed by a more in-depth discussion. Following these comments were page-by-page suggested changes. All but the page-by-page comments are reprinted in appendix VIII. The comments dealt with a wide range of topics and changes have been made to the report in response to some of these comments.

The comments from the Department of the Treasury and IRS suggest that GAO is sponsoring overall tax relief for the industry and question whether such relief is necessary. GAO disagrees with this assertion and points out that two of the alternatives concerning the reserve deduction as well as two specific recommendations of the report would result in increased taxation. Treasury and IRS also comment on certain issues that GAO did not address in the report. Finally, Treasury questioned GAO's acceptance of the framework of the 1959 Act as a basis for its analysis.

The industry representatives disagreed with the report's recommendations and objected to GAO's conclusion that the performance of the life insurance industry has proven to be predictable. GAO's conclusion was based upon industry-wide data spanning some 50 years. These representatives also questioned the appropriateness of GAO's sample and argued that GAO's data base did not reflect the industry's overall composition. GAO disagrees with this assertion and points out that, though small in number, the sample companies would certainly reflect the revenue effects of any proposed changes in the law. (See appendix VIII.)

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ABBREVIATIONS

A and H	Accident and health insurance
ACLI	American Council of Life Insurance
ALC	American Life Convention
CRVM	Commissioners Reserve Valuation Method
CSO	Commissioners Standard Ordinary Mortality Table of 1941
DOC	Department of Commerce
GAAP	Generally Accepted Accounting Principles
H. Rpt.	House Report
IRS	Internal Revenue Service
LICITA	Life Insurance Company Income Tax Act of 1959
NAIC	National Association of Insurance Commissioners
NALC	National Association of Life Companies
S. Rpt.	Senate Report
TSA	Transactions of the Society of Actuaries

GLOSSARY

Adjusted reserves rate The lesser of current or average earnings rates (for the current and preceding four years).

Admitted assets Assets of an insurer permitted by a State to be taken into account in determining its financial condition.

Amount at risk Face amount of a policy less accumulated reserves.

Annuity An annuity contract is a promise by an insurance company to pay the annuitant or a designated beneficiary a specified sum (frequently in installments) for the duration of a designated life or lives in return for a consideration which is often referred to as a premium.

Assessable policies Policies requiring the insured pay an additional amount to meet losses greater than those anticipated.

Assumed earnings rate The weighted average rate of earnings assumed in the calculation of reserves. This is not the rate assumed in calculating premiums.

Current earnings rate The amount determined by dividing annual investment yield by the mean of the assets at the beginning and end of the year.

Due and deferred premiums The balance, on December 31 of each year, of premium installments not yet due (deferred) plus premium installments due but uncollected (due).

Endowments Endowment life insurance, as distinguished from term life or whole-life insurance, pays the face amount of the policy at the time of the insured's death or after a stated number of years, usually 20 to 30 years, whichever occurs first.

Gain from operations All of a company's receipts (gross income) reduced by the policyholders' exclusion and certain other deductions.

Graded premium policies On these plans the initial premium is 40-50 percent of the ultimate premium. The ultimate premium is reached by uniform additions each year for 5, 9, or 10 years.

Graded reserves Reserves which are low initially and increase gradually until they equal net level reserves at 10-20 years.

Industrial insurance Insurance, currently marketed as home service life, wherein premiums are primarily intended to be paid on a weekly basis, although less frequent intervals of payment may be arranged, and the payments are collected

by an agent who calls at the home or place of work of the insured.

Inside buildup That portion of life insurance company earnings which have historically been untaxed, either to the company or the individual policyholder.

Life insurance policy A contract of insurance providing for payment of a specified amount on the insured's death either to his estate or to a designated beneficiary.

Life insurance, ordinary Whole-life insurance written under a contract providing for periodic payment of premiums as long as the insured lives. Life insurance (other than group) usually in amounts of $1,000 or more with premiums paid monthly or at longer intervals.

Life insurance, straight See Life insurance, ordinary.

Life insurance, term See Term life insurance.

Matching principle The accounting principle which dictates that expenses be matched with revenues for any given time period or accounting cycle.

Menge formula A means of adjusting the mean of life insurance reserves for the current year. The mean reserves are reduced by 10 percent for every 1 percent by which the adjusted reserve rate exceeds the weighted average rate of interest assumed in computing reserves. The life insurance reserves thus adjusted are multiplied by the adjusted reserve rate, and the product is added to the product of the mean pension plan reserves times the current earnings rate and to interest paid.

Modified coinsurance A form of indemnity reinsurance whereby the reinsured maintains the reserves on the policies reinsured and the assets held in relation thereto, and all or a portion of the investment income derived from those assets is paid to the reinsurer as part of the consideration for the reinsurance.

Mortality tables A statistical table showing the death rate at each age, usually expressed as so many per thousand.

Mutualization The conversion of a stock life insurance company into a mutual life insurance company.

Net level premium The cost of life insurance based upon pure mortality and interest from the inception of the contract until its maturity date.

Nonparticipating insurance Policies which guarantee the final cost in advance. They are called nonparticipating because they do not have dividends. Nonparticipating

Taxable investment income The interest earned, dividends earned, rents and royalties earned of a company less certain deductions (investment expenses, depreciation, real estate taxes and depletion) produces investment yield which is further reduced by the policyholders' share of this yield. Net long-term capital gains are added to investment yield which is then reduced by the company's share of tax-exempt interest and dividends received and the small business deduction. The remainder is taxable investment income.

Ten to one rule That portion of the Menge formula involving the 10 for 1 downward adjustment in reserves.

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CHAPTER 1

INTRODUCTION

Life insurance companies are taxed under provisions of the Internal Revenue Code enacted as the Life Insurance Company Income Tax Act of 1959 (LICITA). These provisions culminated 50 years of trial and error with alternative methods of taxation. The 1959 Act contains a number of controversial provisions, and, during the 20 years that have elapsed since its passage, the impact of these provisions on the industry has changed. Many features of the law were geared to the industry as it was structured in 1959, which may be described briefly as:

--mutual companies, which represented only 11 percent of the total number of life companies in business, dominated the industry;

--whole life insurance, generating large reserves and investment income, was the predominant life insurance product sold; and

--the rate of inflation was minimal (0.8 percent) compared to recent rates of 10 percent and more, and earnings rates on investments were much lower.

The Congress considered the industry's structure and provided special features in the 1959 Act that recognized:

--the competitive balance between mutual and stock companies,

--the importance of fostering the survival of small life companies that were by far the largest number of life companies doing business, and

--the long-term nature of the life insurance business.

In the past 20 years, the life insurance industry has changed considerably, reflecting the many economic pressures that U.S. businesses have had to face. The balance in the industry between stock and mutual companies has changed, and mutual companies no longer dominate the industry to the extent they did in 1959. This balance was a crucial factor in the House and Senate debates preceding passage of the Act. The lines of business that life insurance companies write has undergone a dramatic shift since 1959, away from whole life policies to term and group insurance. As a result of this shift away from whole life, insurance companies may become more dependent on underwriting income and less dependent on investment income which affects the way a life insurance company is taxed. There has been a dramatic increase in the pension line of business and its growth has yet to peak.

The effects of inflation on the industry are becoming more severe because of certain provisions of the Code applicable to the industry. The most dramatic effect of inflation on the operation of LICITA is embodied in the determination of the policyholder reserve interest deduction. As nominal earnings rates rise in conjunction with inflation, the life insurance reserve interest deduction at first becomes larger, then becomes smaller when earnings rates exceed a certain level. Many companies are approaching the maximum reserve interest deduction available under current law. A fall in the reserve interest deduction results in a rise in the firm's tax liability.

However, as with other financial intermediaries, the life insurance industry is somewhat shielded from the ravages of inflation. The bulk of life companies' liabilities arise from long-term contracts of fixed dollar amounts that are unaffected by inflation. On the other hand, to the extent life companies' assets are invested in long-term, fixed dollar issues, the value of these investments is eroded by inflation.

As for the policyholders, inflation has eroded the savings element of whole life policies. The low guaranteed rates on policy loans attached to these policies has induced unanticipated demands on life company assets. Inflation also renders term insurance more attractive because it offers higher coverages at a lower cost when compared to whole life policies.

The tax consequences of these changes are becoming greater with the passage of time, and the Congress has in the past expressed great concern over the vulnerability of various industries to such changed industry positions. Several provisions of the Act have given rise to much litigation, and the equity of some of these provisions remains in doubt even today.

CRITERIA FOR EVALUATION

The examination of any tax law must be considered in light of its equity and efficiency. An income tax is considered equitable if comparable firms with equal incomes are taxed equally. Efficiency concerns the allocation of resources. For a tax to be efficient, it must not adversely alter the pretax allocation of resources in the economy. The manner in which annual life insurance company income is measured may create some inequities arising from certain deductions and allowances. The type of corporate organization (stock or mutual) can also affect the equity of LICITA depending upon the role of the policyholder in the mutual.

In examining LICITA, special provisions that may distort the allocation of resources must be addressed. 1/ Principal among the tax-induced disortions is the effect LICITA has on company

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1/These issues are discussed at length in chapter 4.

investment policies. For example, the way earnings from tax-exempt securities are prorated between the policyholder and the company may have discouraged insurance companies from purchasing such securities. Furthermore, since capital gains are taxed favorably, companies are encouraged to purchase deep discount bonds. Also, large companies taxed primarily on investment income endeavor to arrange their business transactions to generate underwriting gains rather than investment income. Further, the income tax-exempt status of a portion of permanent policy proceeds favors life insurance over alternative forms of individual savings.

Our examination of LICITA begins with changes in the industry over the past 20 years. Most of these changes have direct tax consequences. The examination of changes in the industry is followed by an explanation of this very complex portion of the Code, including a brief history of Federal taxation of the industry and a discussion of the nature of life insurance company income. Following this is an examination of specific provisions of the Act and credit life reinsurance companies are then discussed. The report concludes with a discussion of various alternative changes to the Act that the Congress may find useful in any future discussion of the taxation of the life insurance industry.

OBJECTIVES, SCOPE, AND METHODOLOGY

This report provides the Congress with:

--an overview of the life insurance industry and changes in the industry since 1959,

--a detailed analysis of certain specific provisions of the Act in light of the changed industry conditions, and

--an examination of the revenue impact of certain proposed changes in various key provisions of the Act.

The framework of the 1959 Act has been accepted for the purposes of this study, though acceptance should.not be construed to mean endorsement. Among the topics that are not considered within these pages are:

--the propriety of allowing companies a current deduction for additions to policyholders' reserves rather than postponing the deduction until benefits are paid, as some commentators have suggested;

--the extent to which the omission from the individual income tax base of amounts credited by the company to policyholders' reserves (the "inside buildup") should affect the structure of company-level taxation;

--the possibility of attributing company earnings to policyholders and taxing them at the individual level as a substitute for company-level taxation;

--the question of whether special offsets should be allowed during an inflationary period against taxes imposed on returns to capital, whether the recipients are life insurance companies, other companies or entities, or individuals;

--the propriety of bending tax policy to respect the "competitive balance" (the term normally used) between stock companies and mutual companies within the life insurance industry; and

--the relevance today of certain social and economic objectives that were expressed in the 1959 Act.

Some points relating to these omitted topics are raised in the comments we received on a draft of this report from the Department of the Treasury, the Internal Revenue Service, and industry representatives.

The literature available on the life insurance industry was reviewed and recognized experts in the area of life insurance taxation were consulted. Discussions were also held with the staff of the Joint Committee on Taxation, and their guidance and interest were most helpful. The life industry trade association, the American Council of Life Insurance (ACLI), and the National Association of Life Companies (NALC) were also most helpful. A.M. Best & Company, the principal reporter of life insurance industry data, was a valuable source of information. Much data on taxation of the industry was provided by the Internal Revenue Service. We obtained tax data for 42 of the largest life insurance companies for the 5-year period 1974-78 which provided a foundation for our analyses. Sample size was limited by the number of companies whose returns were available for the entire period. In 1978, these 42 companies held approximately 73 percent of the industry's assets and wrote about 62 percent of life insurance in force. While small in number, this sample represents a large portion of the industry's assets, premiums received, new business written, and insurance in force; and the revenue effects of any changes in the law would certainly be reflected in the returns of these companies. We also analyzed tax data for a sample of small life companies.

Methodological approach

This review was conducted in two phases. First, a survey of the industry was made to determine what issues were paramount, what data were appropriate to analyze, and what information would be most useful to the Congress in its legislative process. In August 1979, GAO hosted a conference of industry representatives and recognized tax experts. Additional meetings were held with industry representatives, the ACLI, the NALC, leading academic experts on life insurance, and industry executives.

During the implementation phase of our work we performed extensive analyses of taxpayer returns for categories of life companies segregated by asset size and form of organization.

This was done to ensure that all life company categories were fairly represented. In addition to taxpayer returns, a variety of data from other sources was examined to ascertain that our taxpayer analyses were as accurate as possible. Our recommendations reflect the results of the analyses performed.

CHAPTER 2

THE LIFE INSURANCE INDUSTRY IN THE AMERICAN ECONOMY: TWO DECADES AFTER THE 1959 ACT

INTRODUCTION

By any measure, the life insurance industry is a major component of the domestic economy. In 1978, 86 percent of American families owned life insurance at an average level of coverage per insured family of $40,800. 1/ U.S. life insurance companies received life insurance premiums, annuity considerations, and health insurance premiums that year in the amount of $78.8 billion 2/, which represented 5.4 percent of disposable personal income in 1978. 3/ Their net investment earnings in the same year totaled $25.2 billion. 4/

An important measure of industry size is the amount of life insurance in force, i.e., the face value of all outstanding policies. This amount represents the total of all potential policyholder claims against an insurer--the amount a company would have to pay in benefits should all of its policies suddenly mature. Total life insurance in force was nearly $2.9 trillion at the end of 1978, $288 billion more than a year earlier. 5/

During 1977 the entire insurance industry employed 1.5 million persons. By comparison, motor vehicle and related equipment production accounted for 891,000 workers and the Federal Government employed 2.7 million. Total nonagricultural employment in the U.S. in 1977 numbered 82.1 million; accordingly, insurance employment composed approximately 2 percent of the total. 6/

1/American Council of Life Insurance, Life Insurance Fact Book 1979 (hereinafter Fact Book 1979) (ACLI, 1979), p. 9.

2/Ibid., p. 7.

3/U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business vol. 60, April 1980, p. 16.

4/Fact Book 1979, p. 56.

5/Ibid., p. 7. Note: These numbers may not precisely match data collected by other sources, e.g., there are relatively minor differences in data collected by Flow of Funds, Best's Reports, and the ACLI.

6/U.S. Bureau of the Census, Statistical Abstract of the United States 1978 (DOC, 1978), pp. 415-16.

A prerequisite to examining the LICITA is understanding the life insurance industry's role and structure in the American economy. This is especially important since the life insurance industry today has changed substantially since 1959.

In the following pages, these topics will be closely examined:

--the benefits of life insurance to the individual policyholder that include the security, saving, credit, and estate creation functions of life insurance;

--the nature of the life insurance business;

--the changing nature of consumer demand for life insurance company product offerings over time;

--the role of the life insurance industry in capital formation; and

--the structure of the industry.

LIFE INSURANCE AND THE INDIVIDUAL POLICYHOLDER

Life insurance provides a number of important advantages for policyholders and their families. Principal among these are the role of life insurance as an estate creator, as a provider of security, as a saving medium, and as a credit mechanism.

Estate creation role

Perhaps the most important aspect of the role of life insurance is its estate creation function. Immediate estate creation is a feature inherent in every life insurance policy. The full value of the estate is created immediately following receipt of the initial premium payment (i.e., when the policy first goes into effect). Policyholders thereby guarantee some financial security for their surviving beneficiaries (death proceeds are tax free to the beneficiaries).

The security function

Individuals are exposed to many serious uncertain events, including premature death and disability. A primary function of insurance is to compensate individuals by having the losses of the few paid for by the contributions of the many who are exposed to similar risks.

From the individual's perspective, life insurance can be defined as a contract under which, for a stipulated premium, the insurer agrees to pay the insured or a beneficiary a defined amount in the event of death, disability, or some other stipulated contingency.

In addition to the principle of risk pooling, a firm's ability to issue life insurance is dependent on its ability to predict, with reasonable accuracy, the number and amount of claims that can be expected over a given interval of time. Fortunately for the insurer, the "law of large numbers" is applicable to underwriting operations. 1/ If a company insures an extremely large number of lives, practically all uncertainty regarding the amount of policyholder claims over a given period is removed. Life companies are therefore able to enter into long-term contracts due to the highly predictable nature of mortality experience. 2/

A vehicle for saving

In paying their annual premiums, life policyholders obtain financial protection against unforeseen events, but at the same time under "permanent" types of life insurance and annuities they obtain an element of savings that is somewhat analogous to a deposit in a thrift institution. 3/ During inflationary periods, this savings element of permanent insurance becomes less attractive, and permanent policy purchases decline as other savings media offer higher interest rates.

During the initial years of an individual permanent-type policy, premiums will be in excess of the current cost of insurance protection. The insurance company retains this differential as reserves and reinvests it to make up for the deficiency in later years when the annual individual premium is insufficient to cover the actual costs of protection. These excess charges during an individual policy's early years comprise a savings element that is accumulated and held by the company for the policyholder.

Hence, the ordinary life policy, as is true in other forms of permanent insurance, provides protection and savings. By entering into a contract with a savings feature, individuals volunteer to pay the insurer periodically an amount sufficient so that, after some agreed upon period, these funds will be

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1/The "law of large numbers" is a part of the theory of probability that is the basis of insurance. The larger the number of risks or exposure, the more closely will the actual results obtained approach the probable results expected from an infinite number of exposures. See Lewis E. Davids, Dictionary of Insurance (hereinafter Dictionary), 5th ed. (Totowa, N.J.: Littlefield, Adams & Co., 1977), p. 147.

2/Mortality experience is predicted using mortality tables which show the death rate at each age, usually expressed as so many deaths per thousand individuals. See Dictionary, p. 170.

3/Permanent insurance refers to a policy that accrues cash values It includes whole life, ordinary life, and endowment policies.

returned to the insureds or their beneficiaries with interest. In this way, life insurance acts as a form of programmed savings.

A credit mechanism

An additional feature of the life contract is its performance as a credit source. Like other financial assets, life insurance can be considered property. The life contract provides its holder with collateral for loans, and financial institutions are assured that a potential borrower has financial stability. By doing this, life insurance increases the amount of potential individual credit available in the economy.

Cash values accumulated on permanent life policies constitute savings that are easily quantifiable and readily available. These funds make possible the policy loan privilege: The insurance company advances, on the security of a policy, an amount with an interest charge that does not exceed the accumulated cash value. Interest rates specified on such loans are usually quite low, in the neighborhood of 5 to 6 percent (increased to 8 percent for newly-issued policies). 1/ An important advantage of the policy loan is that the policy's savings element can be used on a borrowed basis while the absolute size of the savings element continues to increase. The policy loan privilege provides a highly flexible source of individual liquidity that continues to grow as long as the insurance contract remains in effect. For the policyholder, it is the combination of tax deductible interest, offset by the benefit of partially tax-exempt income, that makes policy loans so attractive.

FINANCIAL INTERMEDIATION

Through their insurance policies, millions of individuals have accumulated savings while providing security for their family's financial position. These premium dollars are pooled by insurers who cycle these funds back into capital markets in the form of investments. This process is conventionally labeled "financial intermediation." Financial intermediaries act as middlemen between suppliers of capital--savers, depositors, investors, shareholders, policyholders, or beneficiaries--and investors in real assets. In addition to life insurers, the principal financial intermediaries are: commercial banks, savings and loan associations, mutual savings banks, fire and casualty insurance firms, mutual funds, public and private pension plans, and real estate investment trusts.

1/The National Association of Insurance Commissions is sponsoring a model bill pending in a number of State legislatures that provides that interest rates for policy loans be indexed and vary with the market.

Among financial intermediaries, life companies rank third by asset size. As of March 1979 commercial banks were by far the largest intermediary with $1,332.5 billion in assets, followed by savings and loan associations with $539 billion. The life insurance industry was third with $399 billion, followed by private pension funds, mutual savings banks, State and local government employee retirement funds, other insurance companies, and credit unions, whose assets were substantially less. 1/ Life companies as a group have demonstrated a relatively stable pattern of growth in comparison to most intermediaries. Noninsured or trusteed pension funds, those pension plans not administered by life companies, have exhibited the most rapid growth and now rank as the fourth largest intermediary. 2/

Investments of life insurers

Having obtained the savings of individual policyholders, life companies allocate these funds among alternative investment outlets. Life insurers make investment decisions based on some of the following considerations:

--safety considerations require that substantial reserves be maintained to meet obligations to policyholders;

--investments are predominantly long-term, reflecting the long-term obligations implicit in most life contracts and pension accounts;

--companies seek to maximize after-tax investment income subject to limitations on the extent of risk acceptable on the principal;

--insurers seek to diversify their assets among many investments to achieve portfolio effect and thereby reduce risk; 3/

--investments must provide sufficient liquidity to meet cash needs resulting from variations in policy loan demand, claims experience, and investment yields; and

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1/Flow of Funds data, available from Flow of Funds Section, Board of Governors of the Federal Reserve System (hereinafter Flow of Funds).

2/If a pension plan is insured, the funding agency is an insurance company to which the employer pays funds set aside for future pension benefits. In a trusteed plan, the agency receiving employer payments is a bank and/or trust company.

3/Through diversification, the combined risk of the portfolio is smaller than of the individual items in the portfolio.

--State laws set restrictions on the proportion of assets that may be invested in real estate, common stock, and other assets.

Various States have also set limitations on the proportion of assets invested in the equity or obligations of a particular issuer and on the percentage of a particular company's stock that a life insurer may own. States have also delineated the quality of bonds that may be purchased and the type of collateral that can be held against mortgages.

Constrained by these factors, investable funds have been allocated predominantly to corporate paper, mortgages, and policy loans. Although companies exercise considerable freedom in their investment decisions, it should be emphasized that company discretion operates within statutory limits.

Changes in life company assets since 1952

The magnitude and structure of life company investment portfolios have changed substantially since 1952. Although life insurance has experienced a decline relative to other savings media, life companies continue to exercise a major influence on capital markets. In 1978, life insurers accounted for 54.8 percent of all new funds raised in the corporate bond market and 6.2 percent of total new mortgages. Over the 27-year period, 1952-1978, the total financial assets of life companies experienced a more than five-fold increase, from $71.5 billion at the end of 1952, to $378.3 billion as of December 31, 1978. 1/ During the same time, bank assets increased 6 times, pension plan assets 20 times, and savings and loan assets 20 times. 2/

Table 1 shows the changes in the industry's investment portfolio over the 1952-78 period. Throughout this time, corporate bonds and mortgage financing constituted well over two-thirds of total financial assets. Corporate bonds did, however, undergo a slight percentage decline until 1971, falling from 42.8 percent of total assets in 1952 to 36.9 percent in 1970. A recovery occurred in following years reaching a level of 41.9 percent at the end of 1978. Openmarket paper, consisting of commercial paper, certificates of deposit, and other short-term financial instruments, are recent additions to investment portfolios. 3/ Prior to 1970, life companies' holdings of openmarket paper were negligible, but by the end of 1978 they composed nearly 2 percent or $6.4 billion in assets. These instruments are relatively liquid and bear high short-term interest rates. Coupled with increasing policy loan demand, their attractiveness to the insurance industry is obvious.

1/Flow of Funds.

2/Ibid.

3/Ibid.

Table 1

Major Asset Holdings: U.S. Life Insurance Companies 1952-78, (percentages of total financial assets)

Year	Corporate Bonds	Mortgages	Corporate Equities	Policy Loans	Miscellaneous Assets
1952	42.8%	29.7%	3.4%	3.8%	2.7%
1953	43.5	30.5	3.4	3.8	2.7
1954	43.0	31.6	4.0	3.8	2.8
1955	42.3	33.5	4.1	3.7	2.8
1956	42.1	35.4	3.8	3.8	3.0
1957	42.7	35.9	3.5	3.9	3.1
1958	42.5	35.5	3.9	4.0	3.1
1959	42.2	35.6	4.1	4.2	3.3
1960	41.6	36.1	4.3	4.5	3.4
1961	41.2	36.0	5.1	4.7	3.5
1962	41.1	36.3	4.9	4.8	3.5
1963	40.9	36.9	5.2	4.9	3.6
1964	40.2	38.1	5.5	4.9	3.6
1965	39.6	38.9	5.9	5.0	3.7
1966	39.1	39.8	5.4	5.6	3.7
1967	38.9	39.1	6.3	5.8	4.0
1968	38.7	38.2	7.2	6.2	4.1
1969	38.0	37.7	7.2	7.2	4.4
1970	36.9	37.0	7.7	8.0	4.6
1971	37.0	35.1	9.6	7.9	4.7
1972	37.3	33.1	11.6	7.7	4.8
1973	37.8	33.2	11.6	7.7	4.8
1974	37.8	33.8	8.6	9.0	5.2
1975	37.7	31.9	10.0	8.7	5.4
1976	39.4	29.4	11.0	8.3	5.3
1977	41.5	28.5	9.7	8.1	5.6
1978	41.9	28.0	9.4	8.0	5.7

Source: Flow of Funds data, provided November 1979, Federal Reserve Board.

U.S. Treasury and Agency Issues	State and Local Obligations	Open Market Paper	Demand Deposits and Currency	Total financial assets (billions)
14.3%	1.6%	0.0%	1.6%	$ 71.472
12.8	1.7	0.0	1.6	76.513
11.0	2.2	0.0	1.5	82.188
9.8	2.3	0.0	1.4	87.851
8.1	2.4	0.0	1.4	93.194
7.2	2.4	0.0	1.3	98.190
6.9	2.6	0.0	1.3	104.266
6.3	2.9	0.1	1.2	109.999
5.6	3.1	0.3	1.1	115.811
5.1	3.2	0.2	1.1	122.809
4.9	3.1	0.3	1.1	129.184
4.4	2.8	0.3	1.1	136.802
3.9	2.6	0.2	1.0	144.942
3.4	2.3	0.2	1.0	154.203
3.2	2.0	0.2	1.0	162.287
2.8	1.8	0.3	0.9	172.645
2.6	1.7	0.3	0.9	183.067
2.4	1.7	0.7	0.9	191.296
2.3	1.6	1.1	0.9	200.934
2.1	1.6	1.3	0.8	215.198
2.0	1.4	1.3	0.9	232.365
2.0	1.4	1.3	0.9	244.750
1.7	1.4	1.6	0.8	255.018
2.2	1.6	1.7	0.7	279.674
2.5	1.8	1.7	0.6	311.079
2.7	1.8	1.4	0.6	339.788
3.0	1.7	1.7	0.6	378.284

U.S. Government bonds, both Treasury and agency issues, have declined sharply in both relative and absolute terms. Their share has fallen from the 1952 level of 14.3 percent to 3.0 percent in 1978. State and local government obligations, meanwhile, have remained relatively constant. Initially, they experienced a significant increase from 1.6 percent in 1952 to approximately 3.2 percent in 1961. Thereafter, a relative percentage decline is evident. This reduction is related, at least in part, to the treatment accorded tax-exempt securities under the Life Insurance Company Income Tax Act of 1959.

Because of the way taxable income is computed, life insurance companies effectively pay tax on a portion of the earnings on tax-exempt bonds. As a result, an insurer receiving an additional dollar of tax-exempt interest income will actually incur an increased tax liability. 1/ However, the tax liability incurred on an additional dollar of tax-exempt interest income is less than that incurred on an additional dollar of taxable interest income. Consequently, life insurance companies felt that these bonds were less attractive than they were prior to 1959 when tax-exempt interest was wholly excludable from taxable investment income.

Equity investment

In 1952, corporate equities accounted for only 3.4 percent of total financial assets. They remained a relatively minor investment item through the mid-1960s. Over the past 27 years, however, changes in legal limitations on equity holdings and investment approaches of life companies have transformed this situation so that for the last 5 years 10 percent of total financial assets were channeled into stock market investments. 2/

Although corporate equities once composed a majority of life company assets, State regulations arising in the aftermath of the 1905 Armstrong investigation sharply restricted such purchases. 3/

1/This occurs because only the company's portion of tax-exempt interest is deductible from investment yield that has already excluded the policyholders' share of investment yield. If a dollar of tax-exempt investment income is substituted for a dollar of taxable investment income, total taxable income is reduced. This presumes that marginal changes have no effect on earnings rates and reserves. For a more detailed discussion, see John C. Fraser, "Mathematical Analysis of Phase I and Phase II of The Life Insurance Company Income Tax Act of 1959," TSA, vol. 14, pt. 1, 1962, p. 67.

2/Flow of Funds.

3/The Armstrong investigation revealed a number of inequitable practices widespread in the insurance industry. Some insurance companies were engaged in banking through ownership of bank

New York, among other States, mandated that insurance companies operating within their borders were prohibited from equity investment. In 1928 New York amended its law to permit purchases of preferred and guaranteed stock. 1/ Portfolio acquisitions of common stock were not allowed until 1951. Initially, equity investments were set not to exceed the lesser of 3 percent of company assets or one-third of total reserves. This initial ceiling has been raised to 10 percent of assets or 100 percent of surplus, whichever is less. Separate accounts (assets that are accounted for separately) that do not support guaranteed benefits have been exempted from such limitations. These accounts enable life companies to compete in the market for equity-funded retirement plans.

Life companies have traditionally been rather conservative toward taking on the additional risk associated with equity investment. This conservatism can be attributed to fixed-dollar liabilities, and it follows that investments which offer the potential for sizable capital losses should be avoided. Life companies are also concerned with the practice of valuing equity investments at current market prices in annual statements.

Under guidelines set by the National Association of Insurance Commissioners (NAIC), common stocks are valued at the official market price delineated by the NAIC (the last selling price on December 31 of the year reported). If stock market prices decline sharply and a sizable percentage of assets are invested in common stock, an insurer's surplus could be largely depleted. As a result, companies may elect not to purchase equities up to the permitted ceiling. Increased equity investments may also partially stem from LICITA's treatment of dividends received. Prior to 1959, life companies were not allowed the 85 percent deduction on dividends received permitted other firms. Dividends were treated as part of regular taxable income.

Compared to the 1955-57 tax years, the 1959 Act raised the effective life company tax rate and made dividends paid on corporate equities eligible for the 85 percent deduction. As a result, corporate stock became more attractive to portfolio managers since the dividends received were taxed only partially. This incentive may have influenced preferred stock purchases. Preferred equity held by U.S. life insurance companies stood at $7 billion at the end of 1974, or 2.6 percent of total assets.

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stock, and other companies were selling securities and acting as investment bankers. To eliminate these activities, the Armstrong Committee recommended that, among other things, life insurance companies be prohibited from investment in equities. See Robert I. Mehr, Life Insurance: Theory and Practice (Dallas, Tex.: Business Publications, 1977), pp. 709-34.

1/A guaranteed stock is an equity that entitles the holder to receive dividends at a fixed annual rate, the payment of which is guaranteed by some outside person or corporation.

This compares to 1960 figures of $1.8 billion, or 1.5 percent of assets. 1/ This increase in equity holdings provides another example of LICITA's direct impact on corporate investment strategies and managerial behavior.

Mortgages

Except for corporate bonds, mortgage loans have been the most popular life insurer asset during the past several decades. Table 2 indicates that relative mortgage holdings have been quite variable. Mortgages comprised 29.7 percent of assets in 1952, increased to 39.8 percent in 1966, and then experienced a steady decline in most recent years, reaching 28 percent of assets at the end of 1978. This reduction in mortgage activity has been attributed to increases in policy loan demand that necessitated a rearrangement of portfolio allocations. 2/ It may also stem from the increasing attractiveness of corporate equity.

Savings through life insurance has declined relative to other outlets for consumer savings. Table 3 shows this decline. Life insurance savings are defined to include both changes in reserves on life policies and life company administered pension reserves. Based on this measurement, savings flows through life companies have ranged as a percentage of total financial asset acquisitions from a high of 18.8 percent in 1954 to a low of 8.6 percent attained in 1972.

Declines in mortgage market participation have not occurred uniformly among all types of mortgages. Life companies, through their mortgage lending, provide funds to individuals for the purchases of homes, to businesses for the construction of a new plant, to investors for building and expanding residential structures, and to others for such institutional development as hospitals and medical centers. It appears that most of the decline in mortgage financing can be attributed to a withdrawal from the home mortgage field, which may be due in part to State usury ceilings on personal loans. Mortgages financing 1 to 4 family residential dwellings peaked as a proportion of total mortgages financed by insurers in 1956, reaching 60.9 percent. Afterwards their relative contribution declined and by the end of 1978 only 15.2 percent of mortgage funds were channeled in this direction. 3/

1/George A. Bishop, Capital Formation Through Life Insurance (Homewood, Ill.: Richard D. Irwin, 1976), pp. 159-61.

2/J. David Cummins, An Econometric Model of the Life Insurance Sector of the U.S. Economy (Lexington, Mass.: Lexington Books, 1975), p. 57.

3/Flow of Funds.

Table 2

Changes in Mortgages Held by
U.S. Life Insurance Companies 1952-78
(dollar amounts in billions)

Year	Total Mortgages	Home Mortgages	Commercial Mortgages	Multi-Family Mortgages
1952	$ 1.937	$ 1.147	$ 0.355	$ 0.257
1953	2.071	1.438	0.377	0.075
1954	2.654	1.958	0.493	0.041
1955	3.469	2.508	0.588	0.148
1956	3.544	2.469	0.804	0.063
1957	2.247	1.311	0.897	-0.064
1958	1.826	0.933	0.814	-0.004
1959	2.135	1.209	0.647	0.119
1960	2.574	1.296	0.924	0.199
1961	2.432	0.897	0.962	0.385
1962	2.699	0.598	1.373	0.498
1963	3.642	0.957	1.698	0.595
1964	4.608	1.194	1.009	1.893
1965	4.861	1.064	1.703	1.575
1966	4.596	0.644	2.057	1.478
1967	2.907	-0.470	1.620	1.428
1968	2.459	-0.733	1.921	1.037
1969	2.052	-1.381	1.982	1.481
1970	2.348	-0.887	1.595	1.764
1971	1.121	-2.117	2.538	0.748
1972	1.452	-2.330	3.105	0.600
1973	4.421	-1.889	4.888	1.104
1974	4.865	-1.400	4.760	1.174
1975	2.934	-1.436	3.940	0.004
1976	2.387	-1.502	3.668	-0.451
1977	5.210	-1.361	5.524	-0.371
1978	9.167	-0.278	7.698	0.219

Source: Flow of Funds, 1946-55 (December, 1976) pp. 57-59, and Flow of Funds, 1949-78 (December, 1979) p. 146, Federal Reserve Board.

Table 3

Savings Through Life Insurance Companies as a Proportion of Total Net Asset Acquisition of Financial Assets by Individuals - Annual Flows 1952-78

Year	Net Savings with Life Companies (billions)						Net Acquisition of Financial Assets (Billions)
	Life Reserves Amount	Life Reserves %distribution	Pension Reserves	Pension Reserves %distribution	Total Life Insurance Savings a/	Total Life Savings %distribution	100%
1952	$ 2.845	12.3%	$ 1.225	4.8%	$ 3.970	17.5%	$ 23.207
1953	2.908	12.8	1.125	4.9	4.033	17.7	22.784
1954	3.001	13.5	1.175	5.3	4.176	18.8	22.176
1955	3.070	11.0	1.325	4.7	4.395	15.7	28.001
1956	3.167	10.5	1.175	3.9	4.342	14.4	30.203
1957	2.651	9.3	1.600	5.6	4.251	14.8	28.635
1958	3.017	9.5	1.500	4.7	4.517	14.3	31.628
1959	3.312	8.9	1.975	5.3	5.287	14.1	37.401
1960	3.152	9.7	1.275	3.9	4.427	13.6	32.465
1961	3.354	9.3	1.400	3.9	4.754	13.2	35.927
1962	3.642	9.0	1.375	3.4	5.017	12.3	40.624
1963	4.106	8.7	1.675	3.5	5.781	12.2	47.253
1964	4.312	7.7	1.950	3.5	6.262	11.2	56.064
1965	4.691	7.9	2.075	3.5	6.766	11.4	59.045
1966	4.587	7.9	2.100	3.6	6.687	11.5	58.374
1967	4.983	7.1	1.607	2.3	6.590	9.4	70.420
1968	4.635	6.1	2.469	3.2	7.104	9.3	76.186
1969	4.912	7.6	3.180	4.9	8.092	12.5	64.522
1970	5.359	6.8	2.759	3.5	8.118	10.3	78.759
1971	6.277	6.1	4.624	4.5	10.901	10.6	102.996
1972	6.705	5.2	4.408	3.4	11.113	8.6	128.774
1973	7.414	5.0	5.504	3.7	12.918	8.7	148.475
1974	6.564	4.6	6.425	4.5	12.989	9.1	142.395
1975	8.523	5.1	8.086	4.8	16.609	9.9	167.240
1976	8.210	3.9	15.340	7.4	23.550	11.3	208.078
1977	11.396	4.7	13.876	5.7	25.272	10.4	241.733
1978	11.694	4.2	19.454	7.1	31.148	11.3	275.331

a/ Individual's savings represents a combined statement for households, farm business, and non-farm noncorporate business.

b/ Savings with life insurance is the net increase in life insurance reserves plus the net increase in insured pension reserve. Policy loans have not been deducted.

Source: Flow of Funds data, provided January 1980, Federal Reserve Board.

What has occurred is a redirection of mortgage funds from 1-4 family residences to multifamily residential and commercial construction. Table 2 documents this trend. Three factors appear to have some effect on this trend toward commercial property mortgages.

--Interest rates available on commercial mortgage contracts have increased relative to those available on residential mortgages.

--Higher administrative and handling costs of home mortgages have made them less attractive than larger commercial mortgages.

--Increasing competition among savings and loan associations, mutual savings banks, and other financial institutions for home mortgages has pushed life companies out of the residential market.

Pattern of savings with life insurance companies

Over the past three decades, two significant developments have affected the demand for life insurance as a savings medium:

--competition among financial intermediaries for consumer savings has sharply increased; and

--life companies have faced increasing demands for policy loans as yields have increased in alternative savings channels.

Much of the diminished role of life insurers in consumer financial asset accumulation stems from a pattern of reduced savings through life insurance reserves. Savings through life insurance fell by 66 percent as a proportion of total asset acquisitions between 1952 and 1978, the share of asset acquisitions accounted for by insured pension plans actually increased by 48 percent over this same period. Insurer gains in the pension area reflect a general movement of household savings into pension accounts during the post-World War II years. Total nongovernmental pension reserves, encompassing both insured and noninsured plans, accounted for 4.6 percent of total annual savings by individuals in 1946 and 14.2 percent in 1978. 1/

If policy loans are also considered, the decline in life insurance savings is even more striking. Policyholders may borrow against the cash value accumulated in their policies. By exercising their loan option, policyholders can shift their savings to outlets offering more attractive yields, while maintaining their insurance protection. Table 1 showed the pattern of policy loans as a percentage of total insurer assets between

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1/Flow of Funds.

1952 and the present. Until 1959, policy loans remained at a nearly constant 4 percent of industry assets. Beginning in 1966, policy loan demand rose dramatically, reaching 9.0 percent of total insurer assets in 1974. According to the most recent data available to us, policy loans comprise 8 percent of life company assets, making them the fourth largest asset classification after corporate bonds, mortgages, and corporate equity. 1/ The demand for these loans is subject to "runs," and the greatest demand will inevitably occur when the rates on these loans are low in comparison to other debt instruments. In times of inflation, life companies are forced to channel assets into policy loans earning low interest rates compared to other investments they could make earning much higher rates.

Two associated phenomena appear to largely account for the reduced role of insurance as an outlet for household savings. One is the recent trend toward greater specialization of financial intermediaries. Intermediaries are increasingly providing instruments designed specifically for the performance of certain functions. As pension accounts have experienced rapid growth, the demand for life insurance as a means of accumulating savings for retirement has declined. Where insurance had previously provided both protection and retirement income, these functions are increasingly performed by two distinct vehicles--a pension plan for savings and a term life insurance policy for protection.

Related to this trend is an additional element, the availability of increasingly higher yields in other investment options. Starting in the early 1960s, commercial banks and some thrift institutions introduced certificates of deposit that provide, in exchange for a reduction of liquidity, yields in excess of those available on conventional passbook accounts. These financial institutions, along with money market funds, provide competitive investment opportunities.

Shift to term insurance

Although life insurance (through the sale of permanent insurance) has declined as a savings medium, it continues to remain a prime method for protection against uncertainties. This pattern has been reflected in substantial shifts in consumer demand for insurance since the enactment of LICITA in 1959. Twenty years ago life insurance companies were predominantly sellers of permanent life insurance. It contains an important savings element since a portion of the premiums paid early in the duration of a policy is allocated to reserves.

In recent years, however, an increasing portion of policies issued are term life. A term policy, in contrast to permanent life, provides coverage for a limited period only and expires

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1/Flow of Funds.

without cash value in the event that the insured party survives the contracted coverage period. To maintain term policies, lower reserves are required than ordinary life policies with the same face values.

From examining the distribution of insurance in force by type of policy the shift to term insurance is evident. Table 4 provides a percentage breakdown between permanent and term forms of insurance. In 1957, only 45 percent of all policies in force were term. This proportion had increased to 65 percent by 1977. The relative decline in permanent insurance is significant since it indicates the reduced role of life insurance in household savings over this time. This shift away from permanent insurance could have been even more pronounced had it not been for industry sales practices that tend to encourage saving through purchases of permanent insurance.

Table 4

Face Value of Life Insurance in Force in United States, Selected Years, 1957-77
(dollar amounts in billions)

	Term Insurance		Permanent Insurance	
Year	Amount	As Percent of Total	Amount	As Percent of Total
1957	$ 208	45%	$256	55%
1962	341	51	334	49
1966	549	56	436	44
1974	1,246	63	740	37
1977	1,680	65	903	35

Source: American Council of Life Insurance, Life Insurance Fact Book 1979 (ACLI, 1979), p. 22; Life Insurance Fact Book 1968 (ACLI, 1968), p. 25.

Introducing variable life insurance represents the industry's effort to improve the attractiveness of the life product and to compete more effectively with other investment forms providing higher returns. Unlike traditional fixed-benefit insurance that guarantees a specific death benefit or annuity, variable insurance offers variable benefits and values dependent on the insurers' return from their investment portfolios. Normally a minimum death benefit is guaranteed. The concept of variable insurance is to provide policyholders a yield that is approximately indexed to changes in market rates of return.

Summary of financial intermediation role

Over the past three decades, life insurance has declined significantly as a medium for household savings. Savings reductions have contributed to an overall decline in the industry's

absolute position in the capital markets. The industry remains, however, vitally important in the corporate bond and commercial mortgage markets.

Insurer investments are distributed among Government securities, corporate bonds, stocks, mortgages, real estate, policy loans, and miscellaneous investments. Although State laws restrict companies to investments of certain types and various maximums, they have exercised considerable discretion in their choice of financial assets.

CHANGING NATURE OF PRODUCT OFFERINGS

Twenty years ago, life insurance companies primarily sold permanent ordinary life insurance (see table 4). With the increasing diversity of company offerings, the distinctions between the life insurance sector and other financial institutions have become blurred. Life insurance premiums have declined in their percentage contribution to the industry's premium receipts while health, annuity, and pension plan premiums have expanded. Accompanying product line diversification has been a movement toward "one stop selling", facilitated by the collaboration of life and health insurance companies with property, casualty, and other sister or subsidiary insurance companies. Companies have become increasingly able to meet most of their customers' insurance needs.

Although there has been substantial change, ordinary life insurance remains the principal form of life insurance coverage for most individuals. Of the total life insurance in force of $2,870 billion at year-end 1978, approximately $1,425 billion was in ordinary life insurance, representing approximately 50 percent of the total. The remainder consisted of group insurance of $1,243 billion (43.3 percent), $163 billion of credit life insurance (5.7 percent), and $38 billion of industrial life insurance (1.3 percent). In recent years, group insurance has undergone rapid growth and will, if current trends continue, surpass ordinary life. 1/

From a level of 22.7 percent of total life insurance in force in 1952, group life has grown to its current level of 43.3 percent. Such growth has had important implications for the channeling of consumer savings since the majority of group insurance purchased is one-year renewable term with no savings element. To the degree that group life insurance reduces the demand for savings-type insurance, savings flows through life insurance will be less then they would have been otherwise.

Most of the larger life insurance companies market group life insurance, a near-universal employee benefit in the United States. A survey of group life in force at the end of 1978 indicates group

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1/Fact Book 1979, p. 7.

protection most often covers employer-employee groups; in 1978, 91.7 percent of the master policies and 87.8 percent of the amount of group in force were of this variety. 1/

Within the ordinary insurance category itself there has also been a shift to policies with lower reserves. This may have resulted from larger social forces; however, to some extent the shift to lower reserve policies may be a result of LICITA (discussed further in chapter 4). This is evident in terms of face value as purchases of term insurance have grown as a percentage of ordinary life sales from 43 percent in 1968 to 52 percent in 1978. 2/ By contrast only 33 percent of ordinary life purchases in 1955 were term. 3/ Therefore, it is clear that a substantial shift toward term insurance has occurred during the past 25 years.

Credit life insurance

During the past two decades sales of credit life insurance (principally group term coverage) have grown rapidly. Traditionally, specialty companies wrote this type of insurance and generally issued it through banks, finance companies, credit unions, and retailers. Recently, larger and older insurance companies have entered the credit market. It is designed to pay the balance of a loan should the borrower die prior to repaying the amount owed. Accordingly, credit life will, in general, decrease as the amount of the loan is repaid. It is commonly incorporated into consumer credit contracts. Estimates of the penetration rate--the percentage of borrowers who buy the coverage--vary from 62 percent to 90 percent. Table 5 documents the impressive sales gains achieved subsequent to 1950.

Industrial life insurance

The final category of life insurance is industrial life insurance. This is a form of permanent insurance that is issued in small amounts, usually not over $1,000, with premiums payable on a weekly or monthly basis. Generally, a company agent collects policy premiums at the insured's home.

The total face value of outstanding industrial life insurance remained virtually unchanged for many years, but in recent years a slight decline has occurred. In 1978, it amounted to about $38 billion, somewhat less than the 1973 peak of $40.6 billion. 4/ Today, industrial represents only 1.3 percent of all legal reserve insurance in force, compared with 8 percent two

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1/Fact Book 1979, p. 30.

2/Fact Book 1979, p. 15.

3/Cummins, Econometric Model, p. 44.

4/Fact Book 1979, p. 32.

decades earlier. 1/ This decline has been attributed to two sources. First, as workers' incomes have grown they can afford more coverage than industrial policies typically provide. Second, group protection has negated much of the need to purchase protection on an individual basis. Third, large life companies no longer sell industrial life for a variety of reasons including high administrative costs.

Table 5

Credit Life Insurance in Force in the United States, Selected Years, 1950-78
(dollar amounts in billions)

Year	Amount	Percent of Life Insurance in Force
1950	$ 4	1.6%
1955	14	3.9
1960	29	5.0
1965	53	5.9
1970	77	5.5
1973	101	5.7
1976	124	5.3
1978	163	5.7

Source: American Council of Life Insurance, Life Insurance Fact Book 1979 (ACLI, 1979), p. 18.

Pensions

The administration of pension plans has become an important part of the life insurance business. Private pension plans have become a very important channel for private savings. Between 1952 and 1978 pensions, including both plans administered by life insurance companies and noninsured plans, have accounted for an average of 13.1 percent of individuals' annual savings, attaining a peak of 16.1 percent in 1960. 2/

Within the private pension market, life insurers steadily lost ground to trusteed plans in the competition for savings. As shown in table 6, the markets held by life companies declined steadily until the early 1970s, reaching a low of 25.1 percent in 1972. This downward trend was followed by a partial recovery in the industry's share, which stood at 37.5 percent at the close of 1978. During the past decade industry administered plans grew more swiftly than did noninsured plans. Between 1970 and 1978 the annual rate of growth in pension account reserves were 23.7 percent and 10 percent for insured and noninsured plans.

1/Ibid.

2/Flow of Funds.

Table 6

Percent Breakdown of Private Pension Plan Assets, 1952-78
(dollar amounts in billions)

Year	Total Pension Assets	Assets Held by Trusteed Plans		Assets Held by Life Insurers	
	Amount	Amount	Percent of Total	Amount	Percent of Total
1952	$ 17.542	$ 9.842	56.1%	$ 7.700	43.9%
1953	20.572	11.747	57.1	8.825	42.9
1954	23.841	13.841	58.1	10.000	41.9
1955	29.667	18.342	61.8	11.325	38.2
1956	33.608	21.108	62.8	12.500	37.2
1957	37.537	23.437	62.4	14.100	37.6
1958	44.829	29.229	65.2	15.600	34.8
1959	51.688	34.113	66.0	17.575	34.0
1960	56.998	38.148	66.9	18.850	33.1
1961	66.390	46.140	69.5	20.250	30.5
1962	68.777	47.152	68.6	21.625	31.4
1963	78.320	55.020	70.3	23.300	29.7
1964	89.561	64.311	71.8	25.250	28.2
1965	100.972	73.647	72.9	27.325	27.1
1966	105.206	75.781	72.0	29.425	28.0
1967	121.467	89.417	73.6	32.050	26.4
1968	136.431	101.456	74.4	34.975	25.6
1969	140.285	102.385	73.0	37.900	27.0
1970	151.569	110.394	72.8	41.175	27.2
1971	176.471	130.121	73.7	46.350	26.3
1972	208.389	156.089	74.9	52.300	25.1
1973	190.434	134.349	70.5	56.085	29.4
1974	176.318	115.508	65.5	60.810	34.5
1975	219.034	146.824	67.0	72.210	33.0
1976	260.887	171.897	65.9	88.990	34.1
1977	280.061	178.541	63.8	101.520	36.2
1978	317.738	198.628	62.5	119.110	37.5

Source: Flow of Funds, available from Flow of Funds Section, Board of Governors of the Federal Reserve System.

Pension plan reserves represent a sizable fraction of total insurance company reserves. In 1978 they totaled $119 billion, more than six times their size in 1959. They amounted to about 62 percent of savings by individuals through life insurance.

Their growth is partially attributable to the tax exemption granted by LICITA to investment earnings credited to qualified pension plan reserves. The treatment of investment earnings was intended to parallel the tax advantages that had been accorded self-insured trusteed plans, whose earnings were tax free when earned. The 1959 Act as amended in 1962 specifically exempts income earned on pension reserves from taxable investment income when separate accounts have been elected. Under Section 805(a)(2), a life insurance company is permitted a deduction based on its current earnings rate rather than its adjusted reserves rate with respect to pension business. The ERISA may have contributed to the growth of pension plans. 1/

Prior to 1959, life insurance companies were at a serious competitive disadvantage in obtaining pension accounts. Qualified pension or profit-sharing trusts administered the bulk of these accounts, which were exempt from taxes on investment earnings. The Congress specifically included the pension provision to increase competition between life and nonlife pension plans. The Congress also anticipated that favored treatment would make insured plans more attractive to small businesses, many of which could not afford to establish more costly trusteed plans.

The advent of "separate accounts" also encouraged insurer growth in the pension area. Separate accounts are segregated from general insurance accounts. Prior to the early 1960s, life insurers were limited to the percentage of pension funds that could be invested in common stock. Trusteed plans were never subject to this restriction. These investments provided plans with a higher return on invested funds and thereby a lower cost for their plans. In most States, separate accounts have been exempted from stringent State restrictions applicable to general insurance accounts. During the early 1960s the Securities and Exchange Commission broadened the variety of separate account contracts they would permit and ruled that group annuities funded through separate accounts are not subject to the Federal Securities Acts, provided that certain conditions were met. 2/

1/The Employee Retirement Income Security Act of 1974 affects virtually every private pension plan in the U.S. It attempts to safeguard employee's pension rights by mandating many pension plan requirements, including minimum funding, participation, and vesting, which can influence employer's costs significantly.

2/See Bishop, Capital Formation, pp. 162-63, and Myer Melnikoff, "Separate Accounts," in Investment Activities of Life Insurance.

While the assets of private pension funds demonstrated rapid growth since the early 1950s, the proportion of total pension activity accounted for by life insurance companies declined significantly until 1972, after which there was a substantial percentage gain. The tax treatment of insured pension funds and the institution of separate accounts may have contributed to this recovery.

Other activities

Life underwriters have expanded their traditional insurance base into a wide variety of related financial servcies. For example, Prudential Insurance Company of America, the leading mutual and largest insurer, has established subsidiary companies for operations in casualty, real estate, and stock brokerage activities. Life insurance companies have increasingly become holding companies of other insurance and noninsurance businesses. 1/

Summary of life company product changes

In this section fundamental changes in life insurance company product offerings were discussed. The specific examples cited include:

--growth in the proportion of sales accounted for by group life insurance;

--dramatic growth of term insurance relative to permanent-type policies, which results in lower reserves;

--impressive gains achieved in credit insurance sales;

--slight decline in the aggregate amount of industrial life insurance in force;

--major expansion of insurer activity in the pension area; and

--expansion of insurer operations into nonlife businesses.

Companies, ed. J. David Cummins (Homewood, Ill.: Richard D. Irwin for the S.S. Huebner Foundation for Insurance Education 1977), p. 190.

1/For example, in the case of Transamerica Corporation, their life insurance subsidiary, Occidental, accounted for only 32 percent of total corporate earnings in 1978. The bulk of the parent corporation's income is derived from property insurance, consumer and commercial financing, transportation, computer leasing, automobile rentals, and movie production. See Transamerica's Annual Report 1978.

INDUSTRY COMPOSITION

Although the largest life companies continue to be organized as mutuals, stock life companies as a group have grown faster than mutuals. Mutual companies differ from stock companies because they have no stockholders; instead, policyholders are technically the owners of these enterprises. In terms of admitted assets in 1979, 15 of the 20 largest life companies were organized as mutuals. If insurance in force is the measure of company size, mutuals provided $1,568 billion or 51 percent of the total life insurance in force in 1978. 1/ Mutuals are only 8 percent of the total number of life companies, but they provide more than half of all life insurance in force.

At the time of LICITA's passage, mutual companies accounted for 63 percent of life insurance in force and 75 percent of the industry's assets. In relative terms, stock companies have experienced a major gain in both insurance in force and admitted assets. The mutual companies' 63 percent share of insurance in force in 1959 fell to 51 percent by 1978, with a corresponding increase in the share of stock companies from 37 to 49 percent. A similar gain in admitted assets was experienced by stock companies, increasing from 25 percent in 1959 to 37 percent in 1978. Table 7 presents a breakdown for number of companies, assets held, and insurance in force for mutual and stock life companies for selected years, 1959-78.

It is evident that in recent years stock companies have grown more rapidly than mutual companies. The number of life companies increased more than 33 percent from 1959-78, and the bulk of these companies were stocks. During this period the number of mutual companies remained nearly constant.

SUMMARY

Since 1959 the life insurance industry has changed significantly. Many of these changes result from larger social forces and cannot be attributed directly to LICITA. The security, estate creation, and credit functions of the industry appear primarily intact; while the savings function has apparently declined. The nature of the industry is relatively unchanged, although the shift in demand from whole life to term reduces the long-term nature of the business. This change in consumer demand, together with the substantial increase in pension business, will continue to affect the industry as a whole and its role in capital formation. The economic performance of the industry will hopefully reflect an ability to adapt to changing circumstances, and, after a period of transition, will continue to demonstrate stable growth patterns. Having profiled the industry in the U.S. economy the next chapter will explain the 1959 Act and outline the history of prior taxation of the industry.

1/Fact Book 1979, p. 21.

Table 7

Number, Assets, and Insurance in Force of Mutual and Stock Life Insurance Companies, Selected Years, 1959-78

Year	Mutual Companies			Stock Companies			Total Number of Companies
	Insurance in Force a/	Assets a/	Number of Companies	Insurance in Force a/	Assets a/	Number of Companies	
1959	63%	75%	153	37%	25%	1,212	1,365
1961	60	73	155	40	27	1,286	1,441
1963	58	72	157	42	28	1,312	1,469
1965	56	70	154	44	30	1,393	1,547
1967	54	69	154	46	31	1,550	1,704
1969	51	NA	154	49	NA	1,619	1,773
1971	51	67	153	49	35	1,619	1,765
1973	51	65	147	49	35	1,619	1,766
1975	51	64	143	49	36	1,603	1,746
1977	51	62	142	49	38	1,647	1,789
1978	51	63	142	49	37	1,682	1,824

a/These numbers are a percentage of the industry total.

Source: Fact Book, various years.

CHAPTER 3

FEDERAL INCOME TAXATION OF LIFE INSURANCE COMPANIES

Life insurance companies have been subject to a Federal tax on income since the Civil War years, with some gaps for companies issuing participating policies. Even during the earliest period of the Federal income tax there were conceptual difficulties in how to tax a life insurance company, particularly companies issuing participating contracts (the 1894 Tax Act specifically exempted any life company, mutual or stock, doing business on a participating basis). 1/ These early years of Federal taxation of income were fraught with difficulties and constitutional issues not finally resolved until 1913 when the 16th Amendment was ratified. However, the life insurance industry presented especially difficult problems in imposing any Federal tax on their income, problems that still persist. The various States, perhaps recognizing the seemingly insurmountable complexities of taxing life insurance company income, early on opted for an excise tax on premium income.

In this chapter the life insurance industry's characteristics will be outlined and the history of taxation of the industry at the Federal level will be developed. The various methods used in the past to tax the industry will be discussed. Finally, the remainder of this chapter will explain the law and its principal complexities.

CHARACTERISTICS OF THE LIFE INSURANCE INDUSTRY

The Life Insurance Company Income Tax Act of 1959 was designed to tax the industry in a way that recognized its basic characteristics. Experience with several taxing formulas during the 50 years prior to the Act made it evident that a permanent taxing formula must recognize three basic and distinct features of the industry.

First, the income of life insurance companies is difficult to measure on an annual basis. The companies write long-term policies that create commitments lasting into the future, and they contend that what appears to be income in one year may, in fact, be required to meet future needs. The life insurance industry maintains that this concept of reserves for future contingency payments is necessary.

Second, the industry contains two kinds of life insurance companies. Currently, mutual companies number only 8 percent of all companies in the industry but account for 51 percent of the

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1/ Roy E. Moor, "Federal Income Taxation of Life Insurance Companies" (Ph.D. diss., Harvard University, 1958), p. 113.

life insurance written and 60 percent of industry assets. 1/ The owners of mutual life insurance companies are also the policyholders, and, therefore, the companies are cooperative-type ventures. The owners of stock companies are the stockholders, and these companies are therefore analogous to other noninsurance corporate entities. In recognizing these two distinct types of companies, special provisions were included in the Act to avoid disrupting the competitive balance between them.

Third, a fundamental tax policy problem exists in trying to decide what share of investment income should be set aside to meet policyholders' future claims and what should be considered the "company's share." The Congress developed the concept that the life company and its policyholders were partners sharing investment income and expenses. Just as the members of a partnership share in the profits and losses of the venture, so the Congress believed the company and policyholders should share proportionately each investment income and expense item. 2/

METHODS OF TAXING LIFE INSURANCE COMPANY INCOME

An insurance company typically has two primary sources of income, underwriting income and investment income. Underwriting income consists of mortality gains (fewer people died than the mortality table used predicted 3/) and loading gains (the annual cost of operations was over-estimated). Investment income includes interest earned, dividends received, rents, royalties, and other items of income (e.g., net short-term capital gains, commitment fees and bonuses, etc.).

Because of these two types of income, the Congress has in the past wrestled with various conceptual approaches to adopt in taxing the life insurance industry. These approaches were the total income approach, the free investment income approach, and

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1/Fact Book 1979, p. 89.

2/Life Insurance Company Income Tax Act of 1959, Report of the Senate Committee on Finance to accompany H.R. 4245, Senate Report 291, 86th Cong., 1st sess. (1959) (hereinafter S. Rpt. 291), p. 2.

3/Mortality tables are actuarial tables based upon statistical records of mortality over a number of years, e.g., a decade, giving the rate of death per 1,000 individuals in each age group. The Federal tax code specifies only that life insurance reserves be "... computed or estimated on the basis of recognized mortality...tables..." (Internal Revenue Code, Sec. 801(b)(1)(A)). For tax purposes the choice of which mortality table to use is not usually a major concern, and most life insurance companies use whatever table is prescribed by their State of domicile as the minimum standard, though more conservative tables could be employed.

the net investment income approach. The total income basis treated all forms of income and all lines of insurance uniformly. Life insurance companies were taxed as any ordinary corporation under the general provisions of the tax code. Under the free investment income approach life companies were taxed only on the excess of net investment income above amounts required to be set aside to meet obligations to policyholders. The net investment income basis taxed the industry on net investment income without a deduction for reserve additions. However, the tax rate was set at a level designed to produce tax revenues as though the tax were levied on free investment income. The present tax law represents a combination of these approaches. Table 8 compares the three conceptual approaches as they were used in the past to tax the life insurance industry.

Taxation prior to 1958

The Congress made various attempts to tax the life insurance industry during the half century prior to LICITA. The laws and formulas that it enacted proved unacceptable for various reasons. Initially, from 1909 to 1920, the life insurance industry computed taxable income in the same manner as other corporations, except they were allowed two special deductions: (1) net additions to reserves and (2) sums, other than dividends, paid on insurance and annuity contracts. These special deductions caused much litigation because of the amounts the companies deducted for additions to reserves and because reserve requirements varied from State to State. Due to continual litigation and the complexities of administering the law, a different tax formula was devised in 1921.

The 1921 free investment income formula was a major tax policy change because the tax base was redefined to include only net investment income. In arriving at taxable income companies were permitted reserve deductions based on a uniform interest rate set by the Congress at 4 percent for the industry. This industry average taxing formula, with a downward revision of the uniform rate to 3.75 percent in 1932, was used until 1941. Companies' average earnings rates on investments declined in the late 1930s leaving little investment income to be taxed after additions to reserves were subtracted, and it was evident that a different formula was needed.

The Revenue Act of 1942 retained the investment income approach to determine taxable income but changed the method of computing deductions for reserves. This method was based on the "Secretary's Ratio." Each company reported actual reserve requirements to the Secretary of the Treasury, and an annual ratio of policy requirements to total investment income earned was published. Under this method, companies computed their reserve deduction by multiplying investment income by the published ratio. The portion not allowable as a reserve deduction was taxable investment income. Once again tax revenue declined to a point

Table 8

A Comparison of Conceptual Approaches Used in Taxing the Life Insurance Industry

	[1909-1920]	[1921-1951] a/	[1951-1957] a/
	Total Income	Free Investment Income	Net Investment Income
Gross Income	Premiums Annuity considerations Gross investment earnings Capital gains	Net investment earnings b/	Net investment earnings b/
less	Gross income expenses (including investment expenses) Ordinary corporate deductions Benefits paid Net additions to reserves Cash policy dividends paid	Ordinary corporate deductions Net additions to reserves	Ordinary corporate deductions
equals	Taxable income	Taxable income	Taxable income
Tax Rate	Regular corporate rate	Regular corporate rate	Lower rate than other companies paid c/

a/Between 1921 and 1957 the only substantial taxation issue was what formula to use for computing the reserve deduction. These chronological groupings are arbitrary and were selected to simplify and illustrate the conceptual approaches used.

b/Net investment earnings consist of interest earned, dividends received, rents, royalties, and other income items less expenses allocable to investment activities.

c/When the net investment income method was used, the tax rate was set at a level designed to produce approximately the same tax revenue as a tax on free investment income would have produced.

where, in 1947 and 1948, companies paid no taxes on investment income. 1/

The Revenue Act of 1950 was enacted, retroactive to 1949, to raise more revenue. This formula, eliminating the industry average component, was the first in a series of stopgap measures used until a permanent method of taxation could be devised. For the period 1951-57 a portion of net investment income was allowed as a deduction. The amount of the deduction was calculated as a fixed percentage of net investment income. From 1951-54 the percentage of net investment income permitted as a deduction was 87.5 percent; and for 1955-57 the allowable deduction was 87.5 percent of the first $1 million of investment income and 85 percent of the balance.

Table 9 shows the percentage of life insurance company net investment income deductible for the period 1942-57.

LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959

In 1959, the Congress enacted a new formula for taxing the life insurance industry that was intended to be a permanent solution. This formula culminated 50 years of trial and error under preceding formulas. The Life Insurance Company Income Tax Act, as amended, represents a total income approach. It remedied the most significant defect of post-1921 methods, the omission of some elements of income from the tax base. Previous formulas taxed life companies on investment income only and did not recognize underwriting gains and losses or capital gains and losses. The Report of the Committee on Ways and Means noted:

> The. . .basic problem involved in taxation of insurance companies arises from the fact that any formula based only on investment income omits from the tax base significant elements of income and loss. 2/

1/During 1947 and 1948 no taxes were paid on life insurance operations; however, a small amount--$1-2 million each year--was paid on the excess of underwriting gains from health insurance operations over the negative investment income of the companies. See Dan McGill, Life Insurance (Homewood, Ill.: Richard D. Irwin, 1967), p. 906.

2/Life Insurance Company Income Tax Act of 1959, Report of the House Committee on Ways and Means to accompany H.R. 4245, House Report 34, 86th Cong., 1st sess. (1959) (hereinafter H. Rpt. 34), p. 3.

Table 9

Percentage of Net Investment Income Deductible in Computing Taxable Income, 1942-57

Calendar Year	Formula Applicable	Percentage of Net Investment Income Deductible
1942	1942	93.00%
1943	1942	91.98
1944	1942	92.61
1945	1942	95.39
1946	1942	95.95
1947	1942	100.61 a/
1948	1942	102.43 a/
1949	1950 stopgap b/	93.55
1950	1950 stopgap	90.63
1951	1951 stopgap	87.50
1952	1951 stopgap	87.50
1953	1951 stopgap	87.50
1954	1951 stopgap	87.50
1955	1955 stopgap	87.50-85.00 c/
1956	1955 stopgap	87.50-85.00 c/
1957	1955 stopgap	87.50-85.00 c/

a/No tax on life insurance operations was paid in these years.

b/Temporary legislation enacted on a yearly basis to provide taxes until a permanent tax formula was enacted.

c/87.5 percent was deductible on the first $1 million of net investment income and 85 percent on the balance.

Source: Department of the Treasury, Internal Revenue Service, Secretary's Ratio, various years. Also cited by Gerald I. Lenrow, Ralph Milo, and Anthony P. Rua, Federal Income Taxation of Insurance Companies, 3rd ed. (New York: John Wiley, 1979), p. 5.

For a company to qualify as a life insurance company for Federal tax purposes it must meet three conditions: (1) it must be an insurance company; (2) it must issue certain types of policies, e.g., life, annuity, noncancellable accident and health, etc.; and (3) more than 50 percent of its total reserves must be life insurance reserves and/or unearned premiums and unpaid losses on certain noncancellable policies. 1/ This legal requirement of 50 percent life reserves emphasizes the crucial importance of the reserve calculation. It helps determine not only the company's taxable income but also whether the company qualifies to compute its tax under LICITA.

Once a company has qualified as a life insurance company for tax purposes, the Act specifies how taxable income shall be computed. Although the Act itself makes no mention of phases, it is conventional today to distinguish three steps, or phases, when calculating taxable income. Phase I measures the net investment income. Phase II measures gain from operations (the sum of investment income and underwriting income). Phase III determines the taxability of half of the excess of gain from operations not taxed in Phase II. The Act also makes life insurance companies' income taxable at normal corporate rates.

Long-term nature of the policies

In developing the new formula, the difficulty of taxing the industry was recognized. The chairman of the House Committee on Ways and Means, Wilbur Mills, began his summary of prevailing attitudes by stating:

> There are three basic and fundamental reasons for the difficulty in taxing life insurance companies. The first reason is that the companies write contracts which commit them to make payments as far into the future as 100 years. 2/

In contrast to the revenues that other businesses receive, the premiums received by life companies are not necessarily taken into income in the same year because some or all of that revenue may be required to meet future claims. Accordingly, the life insurance industry contends that income is difficult to measure on an annual basis. The measurement of annual income using generally accepted accounting principles presents some difficulties for any business. These difficulties are largely overcome by applying the matching principle. Appropriate expenses are matched against revenues so that realized income may be properly

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1/Internal Revenue Code, Sec. 801(a).

2/105 Congressional Record 2566 (1959).

determined. 1/ For reporting purposes, this principle prescribes that annual revenues earned be matched with annual expenses incurred, with the remainder representing annual income (the Code requires life insurance companies to file on a calendar year basis).

Herein lies a key conceptual problem with taxing the life insurance industry. A tax base for life insurance companies has been created with little or no relation to an accounting definition of income. The result has been instances in which the industry has paid little or no income tax while showing accounting income. Because premiums must be invested to earn income over time so that there is a fund to pay future policy benefits, the life companies argue that these cash inflows are not entirely income when received. The Congress has accepted this argument as sound and through LICITA permits a deduction for reserve additions.

The Act, as amended, provides for a 3-year loss carryback and a 7-year loss carryforward. New companies may carry losses forward 10 years. 2/

The Phase II deferral of half of the excess of gain from operations over taxable investment income was designed to provide a "cushion" for stock life companies in the event of catastrophic losses. 3/ This surplus accumulation is subject to limitations under the Act. Additional deductions that reflect the long-term nature of the business were also provided for reinsurance payments and mutualizations.

Prorating income between policyholders and the company

Mr. Mills continued:

> A second [reason] . . . is that . . . [the savings] operation is so intertwined with the pure insurance operation that it is difficult to determine what

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1/American Institute of Certified Public Accounts, Accounting Procedures Committe, Accounting Research Bulletin No. 43.

2/Internal Revenue Code, Sec. 812(b)(1).

3/S. Rpt. 291. It is interesting to note that in the fire and casualty insurance industry, taxed under a different section of the Code, mutual companies are permitted to defer a portion of their underwriting income. This deferral was justified on the grounds that mutual companies do not have the "cushion of equity capital that stock companies have." (Hearings on President's 1961 Tax Recommendations Before House Committee on Ways and Means, 87th Cong., 1st Sess. (1961), pt. 3, pp. 1948-49.

investment income goes to policyholders and what part does go to the company . . . 1/

Trying to determine the company's share and the policyholders' share of investment income has always been difficult. Premiums for cash value insurance have a twofold purpose: to provide protection against individual uncertainty and to provide a form of savings to the insured. These two functions cannot easily be separated. To compound the difficulty, insurance premiums are based on an estimated rate of return at the time the contract is written; actual earnings are bound to be different.

Under LICITA, adjusted life insurance reserves are computed based on actual company rate of return experience. The computation reconciles reserves based on assumed rates to actual earnings rates. Insurance reserves are defined as "liabilities under contracts with policyholders which the insurance company must set aside for the fulfillment of benefits payable under those contracts." 2/ The various States have legislated only the basis on which minimum reserves are to be computed. The highest assumed earnings rate generally permitted by States for ordinary insurance reserves is 4.5 percent. Life insurance companies are allowed to use any other basis that will produce reserves equal to or larger than those produced by the statutory method. The more conservative the interest rate assumed, the higher the reserves.

LICITA also contains the following special provisions for computing or changing reserves:

--election for conversion to net level premium method for tax purposes of life insurance reserves computed on the preliminary term basis,

--reserves for guaranteed renewable contracts (largely accident and health contracts) treated for tax purposes the same as life insurance reserves, and

--spreading ratably over 10 years the effects of reserve strengthening or weakening.

1/105 Congressional Record 2566 (1959).

2/Revenue Ruling 63-241, 1963-2 C.B. 231. A typical State statute defines reserves as follows: [R]eserves for the life insurance and endowment benefit policies providing for a uniform amount of insurance and requiring the payment of uniform premiums shall be the excess, if any, of the present value, at the date of valuation, of such future guaranteed benefits provided by such policies, over the then present value of any future modified net premiums therefor (26 Oklahoma Statutes Annotated, Sec. 1510(E)(2)[1958]).

Tailoring the tax law to mutual and stock companies

Mr. Mills concluded:

> The third reason. . .[is that] the overwhelming bulk of the business is done by cooperative organizations. 1/

There is a conceptual problem in trying to determine the income of a cooperative organization. For a mutual company, the classes of customers, creditors, and owners are confused or merged. Policyholders are indeed the owners since a mutual company is a cooperative-type venture. Policyholders are also customers since they buy policies from the company. In addition, policyholders may be regarded as creditors since they provide most of the funds the company receives through the premiums paid. Are dividends that are paid to mutual company policyholders a distribution of income or a rebate of excessive charges? Under the current law they are treated as rebates to policyholders for tax purposes. In the case of stock companies, the owners are the stockholders (who may or may not be policyholders), and dividends are deemed to be a distribution of income. The problem, therefore, is to recognize the different organizational structures and devise a formula that taxes mutual and stock companies in a fair and equitable way.

Accompanying LICITA, a Senate report notes that a special problem was presented in trying to apportion tax burdens fairly between the mutual and stock companies. 2/ This special problem, the policyholders' dividend exclusion, was of considerable importance because the larger insurance companies were mutual companies, which generally write participating policies. The basic question to be answered was whether amounts distributed to policyholders as dividends should be considered part of a life company's tax base.

It was recognized that the treatment afforded policyholders' dividends would, to a large degree, affect the relative tax burdens on mutual and stock companies. If the tax were based on total income and a full deduction of policyholder dividends had been allowed, mutual companies would have carried 58 percent of the tax burden in 1958 and stock companies the other 42 percent. However, if the industry were taxed on investment income only and no deduction for policyholder dividends were permitted (as under the 1942 formula or the 1955 stopgap formula), mutual

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1/105 Congressional Record 2566 (1959).

2/S. Rpt. 291.

companies would have borne 75 percent of the tax burden and stock companies 25 percent. 1/

The compromise formula devised for taxing the industry provided that mutual companies would pay 69 percent of the tax burden for 1958. The formula did so by limiting a company's policyholder dividends deduction to the excess of gain from operations over taxable investment income plus $250,000. The Senate report does not state how the compromise ratio of 69 percent/31 percent was decided; however, it was believed that the ratio was determined by averaging the mutual companies' share of all life insurance in force (63 percent) with its share of industry assets (75 percent). 2/ If this same averaging were done today, mutual companies would pay only 56 percent (the average of 51 percent share of insurance in force and 60 percent share of assets held). 3/ Table 10 presents the changes in shares of taxes paid as well as changes in the shares of industry and life insurance in force for the periods 1965-68 and 1972-75.

Stock companies are allowed a special deduction for nonparticipating contracts. In a nonparticipating contract the premium is fixed and no rebate is given the policyholder should mortality and administrative expenses be less than assumed in setting the premium rate. This deduction reduces the currently taxed portion of the gain from operations and is added to the tax-deferred account. These deductions allow stock companies to compete better with mutual companies writing participating contracts. Typically mutual companies charge high premiums and rebate a portion should underwriting expenses and mortality experience be less than assumed in the premium rate determination. 4/

HOW TAXABLE INCOME IS ESTABLISHED

The formula for computing taxable income is divided into three phases; a detailed explanation of each phase and an illustrative case example is presented in appendix I. All life insurance companies are permitted three types of deductions in arriving at taxable income:

--those that are allowed any other corporate entity;

1/S. Rpt. 291, pp. 10-11.

2/Robert Charles Clark, "The Federal Taxation of Financial Intermediaries," Yale Law Journal, vol. 84 (July 1975), p. 1649.

3/Source of statistics for insurance in force and assets held, Fact Book 1979, p. 89.

4/This is not to imply that all dividends represent rebates. There is an implicit earning of interest element in these dividends.

--those that reflect the basic characteristics of the industry; e.g. policyholders' dividend deductions, nonparticipating policy deductions, etc.; and

--those intended to help new and small companies.

Table 10

Share of Federal Corporation Income Taxes on U.S. Life Insurance Companies that Was Paid by Mutual Companies and Average of Mutual Companies' Share of Industry Assets and Life Insurance in Force, 1965-68 and 1972-75

Year	Taxes Paid a/	Industry Assets and Life Insurance in Force b/	Difference
1965	68.0%	63.2%	4.8%
1966	67.1	62.4	4.7
1967	68.2	61.6	6.6
1968	69.4	61.0	8.4
1972	67.5	58.5	9.0
1973	66.9	58.0	8.9
1974	65.9	58.0	7.9
1975	66.3	57.5	8.8

a/Percent of industry total.

b/Average of percentages of industry totals.

Source: Assets and insurance in force from American Council of Life Insurance, Life Insurance Fact Book (ACLI, annual), various years; taxes paid from U.S. Internal Revenue Service, Source Book Statistics of Income--Corporation Income Tax Returns (IRS, annual), various years. Percentages computed by GAO.

Mutual companies (and large stock companies) generally pay taxes only under Phase I (taxable investment income less $250,000). This is attributable to Section 809(f) of the Act, which limits total Phase II deductions for policyholders' dividends and for group and nonparticipating contracts to $250,000 plus the amount by which gain from operations, computed without such deductions, exceeds taxable investment income. The level of policy dividends declared by most mutuals is such that only a new mutual company would have difficulty increasing dividends sufficiently to reduce taxable income to a level of $250,000 below taxable investment income (Phase I).

Stock companies are subject to tax under the three phases. Total company tax liability is the sum of the taxable income computed under each phase. These three phases are not mutually exclusive; any change that affects investment income also affects gain from operations as gain from operations is the sum of investment income and underwriting income.

Phase I: Taxable investment income

Taxable investment income is computed by prorating investment yield between the company and the policyholders (see appendix I). Only the company's share is taxable. Table 11 outlines how taxable investment income is computed.

Phase II: Gain from operations

Gain from operations is the sum of income from investments and underwriting gains less the special deductions. Simply stated, Phase II determines the taxable underwriting gain that is half of the excess of gain from operations over taxable investment income determined in Phase I.

The other half of the excess of gain from operations over investment income is tax deferred. This deferred amount is taxable when it is distributed to the shareholders or when it exceeds certain limits. Table 12 outlines the steps to be followed in computing gain from operations.

Phase III: Deferred income taxes

Insurance companies may defer a part of the tax on their underwriting income. The law provides that stock companies, unlike mutual companies, must establish two accounts: a shareholders' surplus account and a policyholders' surplus account. These two accounts are not balance sheet items; they are maintained for tax purposes only.

The shareholders' surplus account is a tax-paid account while the policyholders' surplus account consists of the deferred portion of gain from operations plus amounts deductible under the special provisions of the Act (e.g., nonparticipating contracts, group life insurance, etc.).

Table 11

Phase I Computation of Taxable Investment Income

Gross Investment Income	Interest Dividends Rents and royalties Prepaid charges, standby fees, etc. Short-term capital gains Income from any trade or business (other than insurance business)
less	
Investment Deductions	Investment expenses Real estate expenses Depreciation Depletion Trade or business expenses related to the income from such sources
equals	
Investment Yield	
less	
Exclusion--Policyowners	Exclusion for policyowners' share of investment yield
equals	
Company's Share of Investment Yield	The company's share is the balance after subtracting the policyowners' share
plus	
Net Long-term Capital Gains	All the long-term capital gains are attributable to the company
less	
Reduction items	Company's share of tax-exempt interest Company's share of intercorporate dividends received Small business deduction (limited to $25,000)
equals	
Taxable Investment Income	

Source: Adapted from William B. Harman, Jr., "Taxation of Companies," in eds. Davis W. Gregg and Vane B. Lucas, Life and Health Insurance Handbook (Homewood, Ill.: Dow Jones-Irwin, 1973), p. 1062.

Table 12

Phase II Computation of Gain from Operations

Gross Amounts	Premiums and annuity considerations Gross investment income (as computed in Phase I) All other items of gross income Long-term capital gains Decreases in reserves
less	
Policyowners' Exclusion a/	Exclusion of policyowners' share of investment income
less	
General Deductions	Ordinary corporate deductions Investment and similar expense deductions Deductions peculiar to insurance business Death benefits and claims Additions to reserves Reinsurance payments
equals	
Tentative Gain (Loss) from Operations	
less	
Special Deductions (Subject to Limitation)	Special deductions for: Policyowner dividends Nonparticipating policies Group life insurance and accident and health insurance
equals	
Gain (Loss) from Operations	Tax Base

a/This is not the same as the amount calculated in Phase I. In Phase II the policyowners' share of investment income is based on assumed rates.

Source: Adapted from William B. Harman, Jr., "Taxation of Companies," in eds. Davis W. Gregg and Vane B. Lucas, Life and Health Insurance Handbook (Homewood, Ill.: Dow Jones-Irwin, 1973), p. 1058.

For tax purposes any distribution made to shareholders is first considered to be from the previously-taxed funds of the shareholders' surplus account. Funds are not considered to be distributed from the policyholders' surplus account until the balance in the shareholders' account falls to zero or certain reserve limitations are reached.

These limitations are determined by applying four tests. One, if the company distributed dividends to shareholders in excess of its previously taxed income, a tax on the deferred income will be triggered to the extent of the excess. Two, there is a ceiling on the amount that can be accumulated in the deferred account. This ceiling is the highest of (1) 15 percent of life reserves at year end; (2) 25 percent of the difference between current year-end reserves and reserves at December 31, 1958; and (3) 50 percent of current premium income. Three, the tax on the deferred account becomes due if the company ceases to be a life insurance company. Four, the company may elect to transfer amounts from the tax-deferred account in a given year, especially if the company can reasonably predict that the Phase III tax will be triggered in a future period when its tax position will be less favorable than at present. In practice it seems unlikely that much tax has been paid under Phase III. 1/

If a withdrawal is made from the policyholders' surplus account it must be "grossed up," which means the company must withdraw sufficient amounts from the tax-deferred account to pay dividends to the shareholders and the Federal taxes applicable to the withdrawal. If the tax rate is 46 percent and the desired distribution is $54,000, this grossing up would result in a total withdrawal from the account of $100,000.

Special provisions of the 1959 law

The law contains many special provisions designed to assist life insurance companies in dealing with the industry contention of uncertainty. Provisions to benefit small and new companies and provisions to avoid disrupting the competitive balance between stock and mutual companies also exist. These provisions

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1/It is apparent from the Senate hearings on the Act (S. Rpt. 291, supplemental views of Sens. Douglas and Gore) that the triggering limits for Phase III tax were not likely to ever be reached. See also Robert C. Clark supra note 12 (pp. 1644-45) in his interview with Dr. Gerard Brannon, at the time Professor of Economics at Georgetown University, where Brannon concluded that the ". . . limitations were set so high in comparison to the companies' phase three accounts that he would not consider the phase three tax in his analyses. . . Dr. Brannon has agreed with the view that the phase three tax produces little revenue." The Congress never expected Phase III to produce revenue. See Hearings before Senate Committee on Finance, 86th Cong., 1st Sess., 26-28, 219, 588(1959).

were prompted in part by the difficulty of forming a new mutual company. The various States have imposed requirements on new mutual company formation that make it virtually impossible for a new mutual to be formed. For example, the New York Statute, one of the earliest and a model for other State laws, requires:

> If organized to do only the business of life insurance, such company shall not have less than one thousand bona-fide applications for life insurance in an amount not less than one thousand dollars each, and shall have received from each such applicant in cash the full amount of one annual premium on the policy applied for by him, in an aggregate amount at least equal to twenty-five thousand dollars in cash, and shall have an initial surplus of one hundred fifty thousand dollars in cash, and shall have and maintain at all times a minimum surplus of one hundred thousand dollars. 1/

Thus, a mutual promoter must sell in advance 1,000 policies issued by an as yet unformed company and come up with the prescribed initial surplus with no guarantee to the investors of ever receiving a return. The prospects for such a venture are not promising. Stock company formation, on the other hand, is not as difficult. What growth in numbers there has been in life insurance companies resulted primarily from the formation of new stock companies.

The Act contains certain provisions to foster continued competition between mutual and stock companies; probably the most significant allows companies to defer Federal taxes on half of the excess of their gain from operations (Phase II) over taxable investment income. Stock companies are the primary beneficiaries of this deferral. Other special provisions include the following:

In Phase II, benefitting companies writing participating business:

--deductions for policyholders' dividends, within limits, in determining taxable income.

In Phase II, benefitting companies writing nonparticipating business:

--deduction of an amount based on nonparticipating contracts.

Further, all companies benefit from:

--deductions for group life insurance and accident and health contracts;

--exemption of earnings (computed at the overall portfolio rate) from pension plan reserves (Phases I and II);

1/McKinney's Consolidated Laws of New York Anno. Insurance #191 as of January 1980.

--certain deductions in computing or changing reserves (Phases I and II); and

--a small business deduction (Phase I).

The rationale for these special provisions is stated in the House report on LICITA.

> Although it is believed desirable to subject...underwriting income to tax, it is alleged that because of the long-term nature of insurance contracts it is difficult, if not impossible, to determine the true income...otherwise than by ascertaining (it) over a long period of time ... Because of this,...(the) bill does not attempt to tax on an annual basis all (of what) might appear to be income. 1/

Group life, accident and health deduction

Companies are allowed a deduction equal to 2 percent of the premium income for these types of insurance until the cumulative deductions (for the current and all preceding taxable years) equal 50 percent of group insurance premiums for the taxable year. This deduction, like the nonparticipating policy deduction, reduces gain from operations and, for stock companies, is added to the policyholders' surplus account.

Income exemption on segregated pension plan reserves

If segregated, earnings from qualified pension plans are excluded when determining taxable investment income. These reserves may be segregated in "separate" accounts. This provision recognizes that similar pension funds held by other financial intermediaries are also tax exempt. Also, the Congress felt that this provision would help small employers who are required to set up insured pension plans.

Small business deduction

Every life company is allowed to deduct 10 percent of its investment yield for the year, limited to $25,000, as a small business deduction. This is designed to benefit small and new companies even though it is available to all life insurance companies.

Amendments to the 1959 Act

Since 1959, several amendments were enacted to correct certain inequities of the Act. Some of these amendments are substantial while others are more technical in nature. Probably the most noteworthy amendment is the 1962 Amendment that changed

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1/H. Rpt. 34, p. 4.

the method of taxing capital gains. Prior to the amendment, capital gains were taxed at a flat 25 percent rate on net long-term capital gains in excess of net short-term capital losses. This tax was imposed independently of the three-phase formula. It was therefore possible for a life company to sustain a loss from operations and still be liable for taxes on its capital gains. The 1962 Amendment provided an alternative capital gains approach for life companies that is identical to the one provided for all other corporate entities.

In 1965, the United States Supreme Court in United States v. Atlas Life Insurance Company (381 U.S. 233, 85 S. Ct. 1379) reaffirmed the proration concept mandated by the Congress in LICITA. The life insurance industry had been joined by many State and local governments in claiming that LICITA violated States' rights and impaired their ability to raise funds in the tax-exempt market. The Court held that the Treasury Department was correct in applying the proration concept and in permitting only the company's share of tax-exempt interest to be deducted.

Another important amendment to the Act was passed as part of the Tax Reform Act of 1976. The Congress felt that the ban on life companies filing a consolidated return with nonlife companies was no longer appropriate because other industries also subject to special code provisions were not subject to similar restrictions. Therefore, beginning in tax year 1981 life companies will be permitted an election to file consolidated returns with nonlife subsidiaries with certain limitations on offsetting losses.

There have been several other amendments to LICITA, some of which were intended to establish more consistent treatment among all financial intermediaries. Among these are:

--a 1962 amendment that changes the order in which certain special deductions may be taken to avoid an inadvertent triggering of Phase III tax;

--the 1964 Revenue Act that permits life insurance companies to treat market discounts on bonds the same as noninsurance corporate entities;

--a 1967 amendment and a subsequent 1969 amendment that allow life insurance companies to "spin off" a subsidiary without triggering a Phase III tax; and

--a 1974 amendment that treats life insurance companies like other financial entities in administering individual retirement accounts.

SUMMARY

It is apparent that the life insurance industry does indeed present tax problems. Compared to an ordinary corporation, there

is the problem of the blurred distinctions among the classes of customers, creditors, and shareholders. For a mutual company these classes are confused or merged. Policyholders are indeed (1) owners, since a mutual company is a cooperative-type venture, (2) customers, since they buy policies from the company, and (3) creditors, since they provide most of the funds the company receives through the premiums paid. For a stock company the customers and creditors are confused and the shareholders are distinct. This gives rise to serious tax policy questions concerning the taxability of dividends. The Congress has resolved the complexities by regarding the policyholders as customers and allowed policyholder dividends deductible (within limits) as to the life companies.

In tracing the history of the life insurance industry's taxation, two difficulties stand out: (1) what items should be included as income to the companies and (2) how reserve additions should be reflected in the tax base. Reserve additions, within certain limitations, are allowed as a deduction from taxable income, and the Congress has decided to tax all life companies on gain from operations. The tax formula accomplishes four major objectives that can be discerned: 1/

1. All companies are taxed on gain from operations rather than on taxable investment income. Prior to passage of the Act, companies with large underwriting income and small investment income (e.g., specialty companies issuing only credit life and/or credit accident and health insurance policies) escaped the Federal income tax.

2. Tax is deferred on half of the excess, if any, of gain from operations over taxable investment income. The rationale was that companies with underwriting income in excess of taxable investment income should continue to pay tax on taxable investment income plus only a partial tax on underwriting income, the balance of the tax being deferred.

3. The deferred amounts are taxed if and when the need for deferral ceases.

4. A floor on the calculation of gain from operations is provided to prevent it from falling below taxable investment income less $250,000. This was necessary because policyholders' dividends were deducted in determining gain from operations. As previously noted, for large stock and mutual companies this deduction would have brought gain from operations down to a minimal figure far below the taxable investment income base. To counter this, a limit was placed on the deductibility of policyholder dividends. For all practical purposes this limitation kept large life companies on the same tax base as the prior law, but with a $250,000 additional deduction from taxable investment income.

1/Lenrow, Milo, and Rua, Federal Income Taxation of Insurance Companies, p. 261.

CHAPTER 4

EXAMINATION OF SPECIFIC PROVISIONS OF THE 1959 ACT

Having presented an overview of LICITA in the preceding chapter, the following specific provisions of the Act will be examined:

--life company investments;

--policy and other contract liability requirements;

--interplay among the phases (including use of Section 820);

--preliminary term adjustment, Section 818(c)(2);

--deferred annuities; and

--various items defined in the Act.

INVESTMENTS

When examining the Internal Revenue Code that deals with corporate taxation a very important consideration must be the Code's effect on the investment decisions of the entity being taxed. It would appear that LICITA has affected the investment decisions of life insurance companies. Four examples of this effect follow. While other examples could have been used, these four appear to be most important given the industry's current structure and tax law. As in any other industry, it is presumed that life companies plan their investment decisions with an eye to "after tax" cash flows.

Tax-exempt securities

At the time LICITA was being debated in the House and Senate, the life insurance industry recognized that investments in tax-exempt securities (i.e., State and local issues) would no longer be fully tax exempt. 1/ The reason for this is that after adding tax-exempt interest earned to total interest earned the total tax liability increases. The increase results because the tax-exempt interest earned is prorated between the company and the policyholders, with the company receiving as tax-exempt earnings only its share of the total interest earned. The Congress and

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1/ Tax Formula for Life Insurance Companies, Hearings before the Senate Committee on Finance, 86th Cong., 1st sess. (1959) (hereinafter Senate Hearings), pp. 105-06.

the Treasury Department reasoned that the life companies should not receive 100 percent of the interest earned as tax exempt. 1/

This issue and the proration concept were litigated and resolved in the Atlas Life case in 1965 in which the Supreme Court upheld the proration concept. 2/ For this reason, tax-exempt issues are more attractive to other investors who receive the full earnings as tax exempt and are therefore willing to pay more for these issues than life companies receiving only partially tax-exempt income. As a result, they become less attractive to life companies when compared to alternative investments that are fully taxable but yield much higher returns. 3/

Discount bonds

In 1964 an Amendment to the 1959 Act provided that life insurance companies were not required to accrue as income any market discount on bond holdings purchased at a discount. 4/ Instead the discount could be treated as a capital gain when received either at maturity or, in the case of sinking fund bonds, periodically as the bonds are retired. Because of spiraling interest rates, many corporate bonds issued in the past and bearing low interest coupons have been selling at what are called "deep discount" prices. These deep discount bonds are particularly attractive to life insurance companies since the tax on the discount is deferred. When the discount is received it is taxed at the current capital gains rate of 28 percent rather than at the higher marginal tax rate on investment income of 40 percent or more.

Other life company or annuity company acquisitions

Mergers and acquisitions characterize the life insurance industry. Some of the motivating factors for mergers and acquisitions are:

--the normal investment motive of acquiring any profitable subsidiary or affiliate;

--the desire for a subsidiary/affiliate providing products and/or a sales force complementary to those of the acquiring company; and

--the potential of tax savings between the parent and subsidiary/affiliate.

1/Ibid., pp. 48-50.

2/381 U.S. 233, 85 S. Ct. 1379.

3/See table 1 (pp. 12 and 13).

4/Internal Revenue Code, Sec. 818(b).

The last factor is realized when the parent and acquired company are in different tax situations (or phases). The tax savings is accomplished by reinsurance between the two companies or by planning expense allocations. 1/ In some cases the acquiring company may save taxes by filing a consolidated return while in other cases separate returns may be preferable. 2/

Nonlife company acquisitions

Perhaps the most compelling motive for a life company to either acquire or establish a nonlife subsidiary (e.g., a casualty insurance company) is the need to have a sales force with the capacity of handling all the insurance needs of their clients. In marketing terminology this is referred to as "one stop" selling. Prior to January 1981 life companies could not file consolidated returns with their nonlife subsidiaries. This changed due to an amendment to LICITA passed as part of the 1976 Tax Reform Act. 3/ As previously mentioned in chapter 3, this amendment enables a life company to file a consolidated return with a nonlife subsidiary, under certain conditions, beginning with tax year 1981. By consolidating a subsidiary in a loss situation for tax purposes, profits of the parent life company will be offset, with ceiling limitations.

POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS

In arriving at taxable investment income, life companies begin with gross revenues. From these revenues they deduct investment expenses to derive investment yield. Three important deductions are made from this yield: (1) the reserve interest deduction, (2) the pension reserve deduction, and (3) the interest paid deduction. These three deductions are actually parts of a deduction considered necessary to meet policyholder requirements. The interest paid part of the deduction consists of interest on indebtedness incurred by the company as well as any interest on policyholder accounts not involving life contingencies

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1/For example, where the parent is taxed only in Phase I, it will not receive any tax benefit for insurance-type expenses (as opposed to investment expenses). However, if the parent has a subsidiary taxed in Phase II, the parent's lost insurance expenses (for tax purposes) can be allocated to the subsidiary, along with the functions related to the expenses, and thereby the deduction for these insurance expenses will no longer be lost entirely to the parent.

2/Where the parent is profitable and in a tax-paying situation, and the subsidiary (perhaps a newly-formed company) is not paying taxes, a consolidated return enables the parent to offset any subsidiaries' losses against its gains, thereby lowering its taxes.

3/Public Law 94-455, Sec. 1507, 90 Stat. 1739.

e.g., interest paid on dividend accumulations, premiums paid in advance, supplementary contracts not involving life contingencies, etc. While interest paid is an important part of the total deduction, it is our purpose here to address only some of the important issues involved in the first two parts of this deduction.

Reserve interest deduction

Currently, the Menge formula may be considered one of the most controversial provisions of LICITA. 1/ During the writing of the law in 1958 and 1959, there were numerous attempts to find a proper and, at the same time, practical way of measuring the deduction that should be allowed for reserve interest. Prior laws had used various methods such as fixed interest rates (e.g., 4 percent later changed to 3.75 percent), industry averages, Secretary's ratios, etc. In 1958 and 1959 some life insurance companies advocated the use of each company's own experience; i.e., the company's own investment income less their own required interest, which was called the company's "free" interest. Other life companies claimed this free interest method would be improper because the companies would be encouraged to use higher assumed reserve rates to receive a higher deduction and hence a lower tax, even though such higher rates might not be sufficiently conservative, taking into account the safety of the policyholders' funds.

The Menge formula defines taxable investment income as the excess of total investment income (net of investment expenses) over a new type of reserve interest deduction. This new reserve interest deduction was designed to approximate what the deduction would be if the company held reserves at its average earned rate and applied this average rate to the approximate reserves. 2/ Because the actuarial tables used to calculate reserves are prepared using assumed rates of interest (e.g., 3.0 percent, 3.5 percent, etc.) it would be impractical to actually recalculate the reserves on a rate that not only would be difficult to calculate but would also change each year. This is where the "10

1/Named for Walter Menge, at the time the President of Lincoln National Life Insurance Company.

2/Subsequently, some experts also have discussed an exact revaluation of reserves annually to conform to the firm's actual earnings rate. See Gerard Brannon and John Tuccillo, "An Ideal Tax on Life Insurance Companies," (an unpublished study funded by a grant to Georgetown University by the Prudential Insurance Company), p. 5-4. Other experts suggest a reserve deduction equal to the level of reserves multiplied by the assumed earnings rate. See George E. Lent, "The Tax Treatment of Life Insurance," in U.S. Congress, House of Representatives, Committee on Ways and Means, Tax Revision Compendium, vol. 3, pt. 5, (1959) p. 2001, and Clark, "The Federal Taxation of Financial Intermediaries," p. 1655.

to 1" rule came in. Based on old actuarial studies, it was found that for each 1 percent increase in the rate assumed in calculating the reserves there was an approximate reduction of 10 percent in the amount of the reserves. 1/ The formula therefore provided for reducing the reserves by 10 percent for each 1 percent by which the adjusted reserves rate exceeded the assumed reserve rate. To this reduced reserve amount the adjusted reserves rate was applied and the result is the company's reserve interest deduction.

Based on data published by the American Life Convention (ALC), the average required or assumed interest rate for all life companies reporting was 2.77 percent in 1958. 2/ The adjusted reserves rate (5-year average or current year, if less) for the same companies was 3.56 percent. The reduction factor for reserves is calculated as follows:

10(3.56 percent - 2.77 percent) = 7.9 percent

The reduced reserves were therefore 92.1 percent (100 percent - 7.9 percent) of the actual reserves. If we multiply this 92.1 percent by the adjusted earnings rate of 3.56 percent we can demonstrate that the effective rate applied to the actual reserves was 3.28 percent. This means that for 1958 the ALC member companies received an interest deduction of 18 percent more than their actual required or assumed interest (3.28/2.77). With the passage of time, the difference between the adjusted earnings rate and the average assumed rate became greater. In 1966, for example, the ALC figures were 4.37 percent and 2.82 percent respectively, and, therefore, the reserve interest deduction was actually 31 percent more than the actual statutory required interest.

For a sample of 42 of the largest life insurance companies whose tax returns were analyzed for the year 1978 (representing 72.5 percent of total industry assets), the average required or assumed rate was 2.86. 3/ The adjusted earnings rate (5-year average or current year, if less) was 6.30. 4/ As in the

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1/Taxation of Income of Life Insurance Companies, Hearings before the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, 85th Cong. 2d sess. (1958) (hereinafter House Hearings), p. 255.

2/The ALC membership in 1958 accounted for 95.5 percent of the total assets of all U.S. life companies. American Life Convention, Proceedings of the Fifty-fifth Annual Meeting of the American Life Convention (ALC, 1960), p. 81.

3/For a detailed discussion of the sample companies, see chapter 7 and appendix II.

4/The assumed rates and adjusted earnings rates for the sample companies are unweighted averages.

preceding example, calculating the reduction factor for reserves yields the following:

10(6.30 percent - 2.86 percent) = 34.4 percent

The reduced reserves were therefore 65.6 percent of the actual reserves. As in the preceding example, multiplying this 65.6 percent by the adjusted earnings rate of 6.30 demonstrates that the effective rate applied to the actual reserves was 4.13 percent. This means that in 1978 our sample companies received an interest deduction of 44 percent more than the required or assumed interest. It seems clear from the preceding calculations that with the adjusted earnings rate increasing much more rapidly than the required or assumed rate the reserve interest deduction has considerably exceeded the required or assumed interest.

The relationship between the reserve deduction that is allowed under the 10 to 1 approximation and the interest deduction based on the assumed rate is a portion of a parabolic curve, starting from 100 percent when the two rates are equal and increasing to a maximum (halfway between the assumed rate and 10 percent) and then decreasing to 100 percent again when the adjusted earnings rate equals 10 percent. However, the curve does not stop there. For adjusted earnings rates in excess of 10 percent, the reserve deduction allowed by the Menge formula actually becomes less than 100 percent of the required interest until it disappears entirely, if and when the adjusted earnings rate exceeds the assumed rate by 10 percent or more (see figure 1). Many large life insurance companies are approaching the peak of the curve.

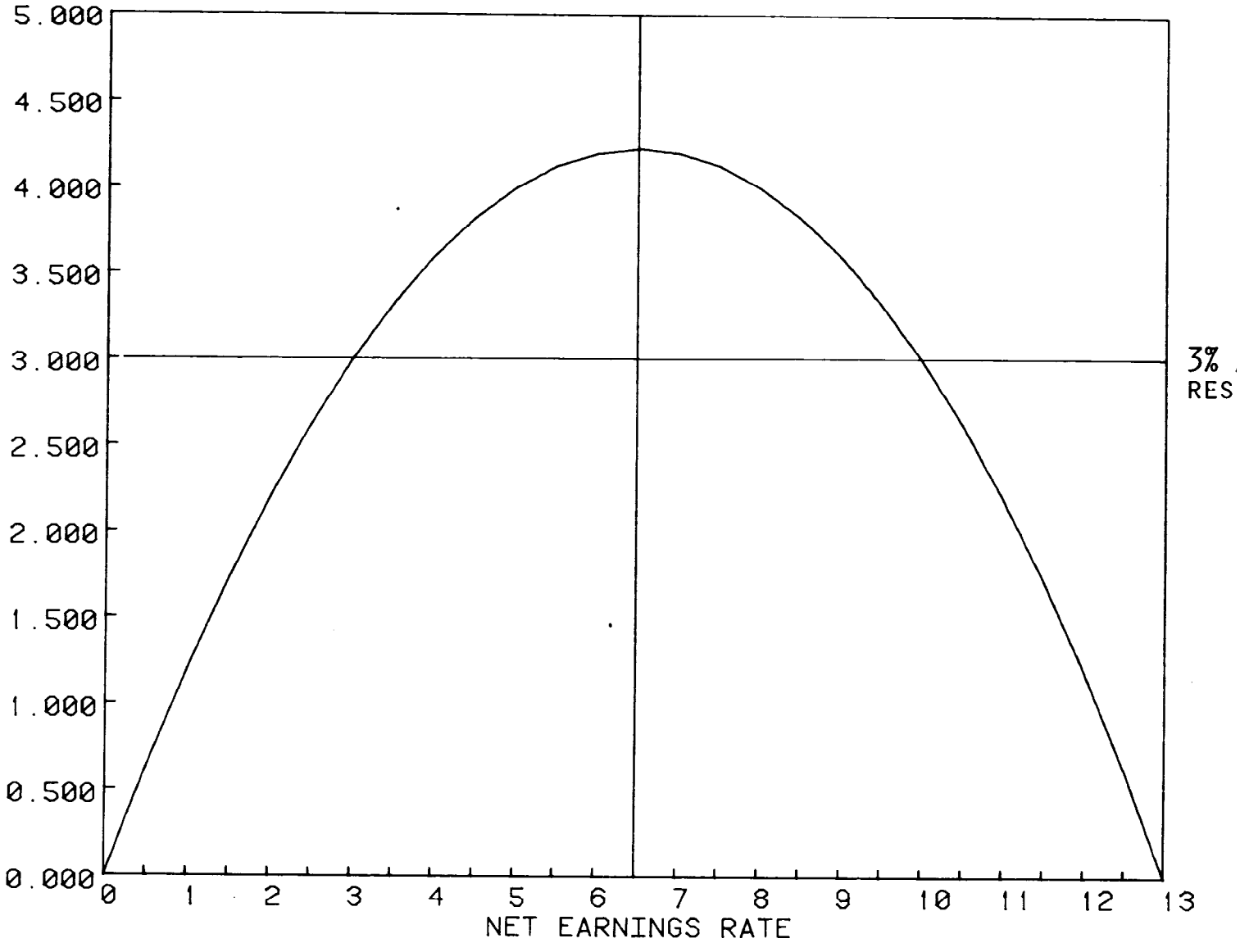
The 10 to 1 rule appears to have been sufficiently accurate at the time it was adopted because the two interest rates were relatively close to each other and the mix of business among whole life, term, endowment, annuities, etc., was not greatly different from the basis used in the actuarial studies from which the 10 to 1 approximation was derived. 1/ However, as previously pointed out, the passage of time and the increasing disparity between the two rates has made the formula unsatisfactory. Add to this the change in the mix of business sold, with term becoming much more important, and it becomes apparent that the formula is not a permanent answer to the problem of determining the proper policyholder reserve interest deduction. The awareness of this lack of permanency is clear in the dissenting views of Senators Douglas and Gore in the 1959 Senate report on LICITA. 2/ They were aware that the formula would cease to function satisfactorily if interest rates increased.

1/Senate Hearings, p. 23.

2/S. Rpt. 291, p. 127.

FIGURE 1

EFFECTIVE RESERVE INTEREST DEDUCTION RATE
MENGE FORMULA WITH AN ASSUMED RESERVE RATE OF 3.0%



The Senate Finance Committee's report in 1959 indicated that the Committee rejected the ". . .use of assumed rates, either the company's own individual rate or the industry average, in determining the policyholder's (sic) share of the investment income." 1/ The language justifying the method adopted was:

> Your committee concluded that it was appropriate to determine the reserve interest rate used in determining the policyholder's share of the investment income on the basis of each company's average investment earnings rate because of the view that the competitive pressures within the industry will in the long run force various companies to build into their price structure for their policies a credit for interest on something like this basis. 2/

This raises the issue of whether the competitive pressures within the industry have in fact forced various companies to build into their price structure a credit for interest on the basis allowed by the law. If the policyholder is given the benefit of interest earnings roughly equal to the adjusted earnings rate, either by increased dividends in a mutual company or by reduced premiums in a stock company, an "adjusted earnings rate" type of interest deduction might be justified--assuming of course that a proper substitute for the 10 to 1 rule could be found. Conversely, if it cannot be established that policyholders receive the full benefit of interest at the adjusted earnings rate, then it would appear that the Senate Finance Committee's 1959 conclusion should be carefully reviewed.

Even if the companies can show that policyholders are, in effect, credited or paid interest amounts roughly equivalent to the adjusted earnings rate, it seems another important issue must be addressed. Life insurance companies have long enjoyed the sales advantage of the tax-deferred nature of the "inside build-up", the interest in the calculation of cash values in permanent insurance. This has been justified because this build-up accomplishes a social good by encouraging individuals to provide life insurance benefits for dependents in the event of early death. On the other hand, an argument can be made that this interest should be taxed as earned, either at the policyholder level or at the company level.

As the framers of LICITA recognized, it would be difficult to tax the earnings on this savings build-up. Should the tax be withheld at the company level and then annually credited and taxed to the individual? Should individuals be assessed with additional taxable income annually that they may not actually receive? Or, should a tax be imposed on the investment earnings

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1/Ibid., p. 5.

2/Ibid.

at the time benefits are paid? Administratively, it would be difficult, if not impossible, for any such tax schemes to function. Of greater importance, the Congress, when framing LICITA, decided to explicitly favor individual saving through life insurance by stating the advantages of the inside build-up.

The important question here is whether a tax formula allowing an adjusted earnings rate type of interest deduction is carrying the tax deferral of interest earnings beyond the inside build-up feature to the point where other types of interest earnings (e.g., interest earnings on bank or savings and loan savings accounts) that do not have this deferral feature are being discriminated against. The Congress intended that the inside build-up be tax free; however, a quick reference to figure 1 indicates that when the assumed rate is 3 percent companies can receive up to 4.225 percent tax free rather than the 3.0 percent assumed (the top portion of the parabolic curve between a net earnings rate of 3.0 percent and 10.0 percent peaks at 4.225 percent). This may be the typical situation of most large companies. It appears that this would be an appropriate issue for the Congress to consider and, once a decision is made, any changes needed in the basic method of determining a proper policyholder reserve interest deduction can be made.

At least two developments affecting the operation of the 10 to 1 rule have occurred in the industry. One was the advent of the dual interest rate policy. Life companies writing this type of policy typically use a reserve basis for the first 20 years at 3.5 percent and 2.5 percent thereafter. Companies have begun writing such policies in order to offer lower cash values (and therefore lower premiums) in the early years of the contract but still have a competitive cash value (based on reserves of 2.5 percent) at the end of the 20-year period. The question raised by this development is what interest rate should be used as the assumed rate, both during the first 20 years and thereafter. It can be argued that since the reserve is somewhere between 3.5 percent and 2.5 percent during the first 19 years of the contract that some "in between" rate should be used. On the other hand, it can also be argued that this is a 3.5 percent contract, and that this rate should be used even though the reserve is higher than a 3.5 percent reserve. The Congress, in any reexamination of LICITA, should address this question and legislate the appropriate rate to be used.

The other development was that some life companies have begun to offer their policyholders the right to elect to convert their life policies to a higher face amount with no additional premium. This is accomplished by revaluing this old business to a higher assumed rate. By doing this, the policyholder gets a new policy with the same premium but for a higher amount obtained

by equating the cash values on the old and new reserve basis. 1/ The company does incur additional mortality liability, but saves on the lower taxes that are based on the recalculation of the assumed rate. Even if the tax savings and the additional mortality liability were exactly offsetting, the company would still be in an excellent competitive position. This development will undoubtedly become more widespread in the industry and the Congress may wish to address this issue.

Pension reserve interest deduction

At the time the 1959 Act was being considered, the Congress agreed with the industry that special treatment was needed for pension reserve interest. 2/ The industry made the argument that they were at a disadvantage compared with self-insured plans having assets held by bank trust departments. The companies pointed out that they were taxed on interest earned by pension reserves while banks were not. They also made the point that it was small businesses that needed insured plans. In accepting these arguments, the Congress made special provisions in LICITA for qualified pension reserve interest as follows:

--the 10 to 1 rule for adjusting reserves would not be used for pension reserves; and

--the current earnings rate would be used instead of the 5-year average rate (the current rate is higher than the 5-year average when interest rates are rising).

These special provisions for pensions worked fairly well until the early 1960s when pension buyers became interested in having their funds invested in common stocks. At this point the law, as well as insurance regulations, were changed to permit companies to set up separate accounts and get the benefit of the full interest deduction as well as realized capital gains, provided the policies in the separate account did not guarantee any investment results. Again, the equality of tax treatment between insurance companies and trusteed plans was established.

With the passage of time the interest available on long-term bonds became such that the companies were no longer competitive without using the new money or investment year approach. 3/

1/Patricia Ancipink, "Getting More Out of Life at Northwestern Mutual," Best's Review - Life/Health Edition, vol. 80, no. 12 (April 1980), p. 10. For a more detailed discussion, see Thomas E. Dyer, James J. Murphy, and James F. Reiskytl, "Updating Existing Life Insurance Policies, TSA, vol. 32 (1981), pp. 601-36.

2/Senate Hearings, p. 346.

3/The investment year approach is a method of allocating interest earnings on assets to the year in which they were earned as

However, companies that did not segregate pension plans could deduct only their current earnings rate (on the whole portfolio).

By either eliminating mortality guarantees or limiting them to not more than, say 5 years, the companies are able to treat the total interest allowed on the pension funds as interest paid--either interest on indebtedness or amounts in the nature of interest. To the extent that this was done, companies were able to get a tax deduction for the full amount of interest credited to the pension funds. However, certain types of pension contracts necessarily provide annuity guarantees, such as individual contract pension trust plans. For these contracts, companies still have to treat the reserves as pension reserves and, even though the 10 to 1 adjustment is not used, they still get the benefit of only their current portfolio rate. To the extent that they must allow more interest than this to stay competitive, the excess can be lost as a tax deduction.

PHASE I AND PHASE II INTERPLAY

A typical life company can find itself in at least four common tax situations. These are:

--taxable income equals taxable investment income less $250,000 (Phase I);

--taxable income equals taxable investment income plus half of the excess of gain from operations over taxable investment income (Phase II positive);

--taxable income equals gain from operations, where gain from operations is less than taxable investment income by more than $250,000 (Phase II negative); and

--taxable income equals gain from operations where gain from operations is less than taxable investment income by less than $250,000 (corridor).

During the hearings conducted by the House Ways and Means subcommittee chaired by Mr. Wilbur Mills, it was apparent that one portion of the industry, primarily the stock companies, wished to continue to be taxed on an "investment income only" basis. Another portion of the industry, primarily the mutual companies, desired some type of total net income approach that included underwriting gains. The law, as it was adopted, was a compromise between these two viewpoints. This compromise resulted in taxable income being essentially taxable investment income plus half of the excess of gain from operations over taxable investment income.

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opposed to using the portfolio rate which is a composite of total historical earnings.

The deferral of half of the spillover (the excess of gain from operations over taxable investment income), when positive, has been justified by the difficulty of determining the total gain from operations on a yearly basis. Also, because of this difficulty, it was felt necessary to set aside the half not currently taxed to provide a cushion to meet future adverse contingencies.

The law provides that if the gain from operations is less than the taxable investment income then such lesser gain from operations is the tax base. There is a provision, however, for a maximum deduction for dividends, group life and accident and health policies, and nonparticipating policies. The result is that the real net gain from operations can be the tax base only where the deduction for dividends, etc., is less than the maximum allowed and the gain is still less than the taxable investment income.

As a result of the law's operation, almost all mutuals and many of the stock companies issuing participating insurance have paid taxes on the "nominal" gain from operations. This nominal gain from operations--by reason of the maximum level set for dividends, etc., and the statutory allowance of $250,000--is equal to the taxable investment income less $250,000. For large companies, LICITA's effect will depend not on the form of organization but on a particular company's mix of business. For example, a large stock company issuing participating policies and having qualified pension plans will be affected by the Act in much the same way as a large mutual company with similar lines of business.

Some stock companies find that they have a spillover, as previously defined, and pay tax on a base equal to investment income plus half of the spillover. Still other companies, usually smaller and newer stock companies, pay on a gain from operations that is less than the taxable investment income--and in some cases there is a loss from operations--with no tax being paid and the loss being carried over to future years.

From the above it is evident that the tax situation a company finds itself in can vary considerably, and management decisions take account of this. For example, a mutual company taxed on taxable investment income less $250,000 can ordinarily receive no tax deduction for expenses that cannot be considered investment expenses. Therefore, this company would endeavor to allocate its expenses so that it receives the greatest possible tax deduction. Sometimes this allocation of expenses can be accomplished by using a subsidiary that is assigned to certain types of work, and the subsidiary, finding itself in one of the other tax situations, can use these expenses against its gain from operations. A company taxed in Phase I could encourage expansion of nonparticipating lines of business, generating lower reserves and higher underwriting gains. In this way the

company would seek to convert an additional dollar of investment income into an additional dollar of underwriting gain. 1/

Another way in which taxes among the various phases have been shifted is through the use of reinsurance. That reinsurance transactions are a necessary and integral part of the insurance business is recognized; however, a question arises as to whether or not there is a real shifting of risk from the reinsured company to the reinsurer company.

One type of reinsurance is called coinsurance, in which the ceding company pays to the reinsuring company a part of the premium the ceding company receives from the policyholder. The part of the premium the ceding company pays to the reinsuring company is proportionate to the part of the policy reinsured. In return, the reinsuring company assumes all obligations under the reinsured portion of the policy to pay claims, cash values, dividends, etc. A variation of this type of reinsurance is called modified coinsurance. Under this type of reinsurance the ceding company reinsures part or all of a specific group of policies but retains the assets held against the reserves (unlike regular coinsurance). It pays a premium based on the amount of investment income it earned on the assets retained. Without Internal Revenue Code Section 820, modified coinsurance could have resulted in the ceding company paying tax on the investment income it earned, and the reinsuring company would also have paid tax on this amount as underwriting income. Section 820 was adopted so that the two companies involved could elect to have the modified coinsurance taxed in the same manner as regular coinsurance and thus avoid any possible double taxation. The end effect of this is that the ceding company removes the investment income from its Phase I tax base. The reinsuring company receives the payment from the ceding company as a premium (a Phase II item of income) and pays claims and whatever share of the expenses the two companies agree upon. It then returns all, or an agreed upon portion of the balance, to the ceding company as an experience refund. This experience refund comes back to the ceding company as "other income," which is in the Phase II tax base. If the ceding company (as is usually the case) is in Phase I (taxable investment income less $250,000) the payment coming back to it is not taxed. The amount of tax paid by the reinsurer is on the excess of the premium received over the claims, expenses, and experience refund. In most, if not all, cases the tax paid is considerably less than the tax the ceding company would have paid if there had been no reinsurance transaction.

Modified coinsurance, accompanied by the section 820 elections, was useful for companies that could not get an adequate reserve deduction on their pension business. With the use of

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1/For a simulation of the favorable impact of LICITA on non-participating insurance, see Andrew F. Whitman and Howard E. Thompson, "The Impact of the 1959 Income Tax Act on Stock and Mutual Companies: A Simulation Study," Journal of Risk and Insurance, vol. 34 (December 1967), p. 215.

modified coinsurance, most of the interest earned on their pension assets came to them tax free since they were in Phase I.

In recent years the possibilities of tax saving through modified coinsurance have been recognized by many life insurance companies. The practice is no longer confined to pension business. It appears that more and more companies are ceding modified coinsurance to shift income from a taxable Phase I basis to a nontaxable Phase II basis. 1/ It is apparent that the use of modified coinsurance by many companies has effectively thwarted the three phase system of taxing total life insurance company income.

Apparently there is a feeling in the life insurance industry itself that Section 820 will probably not continue in its present form. An industry executive noted recently, "[t]he Section 820 election to treat modified coinsurance as regular coinsurance for tax purposes was designed to avoid double taxation of investment income. Under some circumstances, it has been used to avoid all tax on investment income. It will likely be revised or eliminated." 2/

An additional issue in this general area deserving consideration is the adequacy or redundancy of the 50 percent deferral of the spillover mentioned previously. We could find no evidence to indicate that this 50 percent amount was selected other than arbitrarily. Has this amount of deferral actually been needed for the safety factor for which it was intended? Should the deferral be changed to 25 percent, or can it be shown that a larger deferral of say 75 percent is needed?

PRELIMINARY TERM ADJUSTMENT--SECTION 818(c)

It is clear that the Congress in 1958 and 1959 was cognizant of the differences between reserves held on a preliminary term

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1/For example, "Prudential Insurance Company of America, the nation's largest insurance company, paid $380.2 million in federal income taxes in 1979. Last year, despite the growth of its business, Prudential's tax bill plummeted to $120 million, less than one-third of the 1979 total . . . The tax magic is accomplished through transactions . . . known as 'modified coinsurance.' Richard V. Minck, . . . [an executive of the] industry's chief trade group . . . says he believes that the tax loss to the federal government from [modified coinsurance transactions] runs in the billion or billion-and-a-half range." Daniel Hertzberg, "Life Insurers Cut Federal Income Taxes Using Special Reinsurance Arrangement," Wall Street Journal, May 20, 1981, p. 14. For a further discussion of the use of modified coinsurance to reduce Federal income taxes, see Herbert E. Goodfriend, "Odd Men Out," Barron's, January 12, 1981, p. 28.

2/Society of Actuaries. Record, vol. 6, no. 1, Hartford Meeting Number, April 14-15, 1980 (Chicago, Ill., 1980), p. 117.

basis and reserves held on the net level premium basis. 1/ In an attempt to aid small and new companies, the Congress provided all companies the privilege to elect to revalue reserves on an approximate basis which puts them closer to the net level basis for tax purposes. A smaller, new company would prefer to hold its reserves on the preliminary term basis for annual statement purposes (because it produces a larger surplus than the net level basis) but would elect to convert its reserves to the net level basis for tax purposes (because it results in a higher reserve deduction).

In effecting this revaluation, the Congress permitted life companies to use either an approximate method or an exact revaluation method. How life companies revalue reserves is important because it can significantly reduce their tax liability. This results because in calculating the revalued reserves there is a direct effect on the size of the reserve deduction. The approximate revaluation allows an increase of $21 per thousand dollars of the amount at risk for permanent plans of insurance. Such an allowance is not appropriate as it results in unwarranted reserve deductions. 2/

This again was an attempt to aid small and new companies that would likely find it difficult and expensive to make an actual revaluation on the net level basis. The Congress mandated that if the approximate revaluation method was elected it would be accomplished by adding to reserves $21 per each $1,000 of the amount at risk for permanent policies and $5 for each $1,000 of the amount at risk for term policies of more than 15 years (referred to as "21-5" additions). 3/

Today, the appropriateness of this method is questionable in light of the following developments.

1. Since 1959, graded reserve methods have become widely used. Under these methods the reserves start out low and increase gradually to equal the net level reserves at 10-20 years.

1/House Hearings, p. 132.

2/Peter W. Plumley, "Federal Income Taxation of Life Insurance Companies in the 1980s," TSA, (forthcoming). This portion of Mr. Plumley's paper deals with tax savings resulting from a revaluation of existing business to a basis involving a higher assumed reserve interest rate. In his example, the 15th year net level reserve is calculated using the approximate 818(c)(2) adjustment, and the actual net level of reserve is also shown. The approximate net level reserve of the example is $2,785.76, "The actual NLP reserve would be $228.76 x 11.856, or $2,712.18, indicating the overstatement in the approximate revaluation formula permitted under Section 818(c)."

3/Internal Revenue Code, Sec. 818(c)(2).

If the 21-5 additions provided in the law were accurate for the methods commonly used in 1959, are they still appropriate for use with these graded reserve methods and their higher reserves? If a policy has reserves on a graded method, should the 21-5 additions be added even after the reserves are equal to the net level reserves? Our analysis, discussed in appendix III, indicates that $15 is a more appropriate amount.

2. The sale of decreasing term policies and riders has increased. Using preliminary term methods on these policies can in some instances produce higher reserves than the net level premium method would.

Under the law as written in 1959, these policies (if the term of the contract is longer than 15 years) would be entitled to use the "5" addition. Is this provision appropriate? 1/

Another problem with using the $5 per $1,000 amount at risk for term policies involves the application to yearly renewable term policies. The most commonly issued term plan now is the Yearly Renewable Term (1-year term). Under the current law the $5 per $1,000 of the amount at risk adjustment does not apply to this plan since by definition it is not greater than 15 years. A number of companies, however, provide for these policies to be renewable for at least 16 years and contend that because of this renewable feature the reserves can be adjusted upward by using the Code's $5 provision. Actually, some yearly renewable term plans are written as whole life plans with the premium increasing annually for 15 years and then leveling out for the rest of the policy at a whole life level with cash values available from the 16th year. On the surface these plans could be considered permanent plans and therefore eligible for the $21 adjustment instead of the $5 adjustment.

Arguments could be made that, because of the interpretations mentioned above, the approximate method should not be permitted at all, and companies wishing to revalue from preliminary term to net level should be required to use exact net level reserves. With this requirement there would be no gross overstatement of reserves on term contracts either by adding the $5 to term contracts that actually should not be eligible for it or by using the $21 addition for contracts which, while labelled "whole life," do not actually become permanent plans (with cash values) for periods as long as 16 years. However, since a requirement of exact net level revaluation might place a hardship on the smaller companies--because of the necessity to make two separate valuations each year--we feel it would not be feasible to eliminate entirely the approximate revaluation option.

Alternatively, we feel that the descriptions of the plans, which allows two different amounts of additions to be used,

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1/For further discussion of this, see appendix III.

should be tightened. For example, it could be provided that the $5 term policy addition could not be used with yearly renewable term plans, even though such plans might provide for renewal for 16 or more years. For the permanent plan addition it might be provided that it would not be available for any plan whose premium does not reach its ultimate level in 10 years or less. This could also be combined with a requirement, for example, that the premium must never be less than 2 or 3 times the yearly renewable term premium. The exact description would have to be carefully worded so that it would not interfere with the use of the permanent plan adjustment for such contracts as graded premium life policies. On these plans the initial premium is something like 40 or 50 percent of the ultimate premium. The ultimate premium is reached by uniform additions each year for 5, 9, or 10 years. These plans, unlike the "whole life" plans that use term premiums for as long as 16 years or more, usually provide for cash values, albeit small, during the period for which the premium is graded.

It would appear that the industry is aware that Section 818(c)(2) requires some adjustment. An industry executive, for example, recently noted that:

> "Solutions being considered for non-pension reserves problems include: . . .
>
> b. An elimination or modification of the Section 818(c)(2) approximation formula used to revalue preliminary term reserves to net level premium reserves." 1/

DEFERRED ANNUITIES

The taxation of earnings associated with deferred annuities presents several issues that we feel deserve careful study. Deferred annuities are contracts that defer the "pay out" of the annuity to some future time. These contracts may be either single premium annuities with a lump sum paid by the annuitant to the company at the beginning of the contract or they may be annual premium deferred annuities with periodic payments made to the company during the "pay-in" period. As with permanent life insurance, there is a deferral of at least part of the tax on interest earned on the funds during the pay-in period. During the past decade, there have been indications that deferred annuities were being sold as investment contracts, perhaps with no idea of ever using the contracts' annuity feature. In addition, the Securities and Exchange Commission is interested in regulating the marketing of these contracts if they are primarily investment vehicles rather than annuities.

1/Society of Actuaries, Record, p. 117.

At the present time, certain companies are packaging deferred annuity contracts with decreasing term contracts in such a way as to provide benefits at a lower cost than is possible with a whole life insurance policy. The lower cost is primarily, although not exclusively, the result of the more favorable tax situation applicable to deferred annuities as compared with permanent life insurance.

We mentioned above the two types of deferred annuities--single premium and annual premium. A common type of annual premium deferred annuity now being issued is called the flexible premium annuity. Under this contract, premium payments, with a few restrictions, may usually be made on an unscheduled basis, both as to time of payment and amount of payment. The State laws on minimum required reserves stipulate a 4.5 percent maximum interest rate for annual premium life insurance and annual premium deferred annuities, but allow 7.5 percent for reserves for all single premium immediate annuities and single premium deferred annuities, if issued on a group basis. We understand that the flexible annuities, mentioned above as being part of the "decreasing term-deferred annuity" package, are in some cases considered to be a series of single premium deferred annuities with each premium payment under the flexible contract considered to be purchasing a separate single premium policy. It is our further understanding that by means of a master trust arrangement the contracts are considered to be group single premium deferred annuities and thus qualify for the 7.5 percent reserve interest rate rather than the 4.5 percent applicable to annual premium deferred annuities and annual premium life insurance. This can have a considerable effect on the amount of the reserve deduction allowable for tax purposes.

An additional phase of this tax situation results from some companies using not only a 7.5 percent reserve but the full amount of interest added to the account during the year for tax deduction purposes. This interest could easily be in excess of 10 percent. This practice would of course make these contracts extremely competitive relative to the usual life insurance products that have no similar tax situation. This undoubtedly accounts for much of the concern of the sales forces of those companies that would like to continue to sell permanent life insurance but find that the Government subsidy, by way of lower taxes, makes it more and more difficult to compete with the "decreasing term-deferred annuity" combinations currently used by a relatively small number of companies.

The growth figures shown in the 1980 Best's Insurance Reports indicate the success that some of the companies are having with this marketing approach. Table 13 shows the figures for three of the leading companies in this category. That this growth in premium income has come from the sale of annuities can

be seen in table 14, distribution of 1979 premium income, again taken from the 1980 Best's Insurance Reports. In the case of the first two companies, the Best's figures show that there was a large increase over the period in the amount of term insurance placed (see table 15). In the case of company C there was no such indication. However, there is another company associated with company C that is a leader in the sale of term insurance, and if their annuity sales involved the sale of term insurance, the latter was undoubtedly placed in the affiliate company. Company A is a subsidiary of a large holding company (principally in the insurance business) and, according to the 1980 edition of Best's, introduced single premium deferred annuities in the latter part of 1974. Table 13 indicates that the total premium income went from $9.975 million in 1974 to $365.222 million in 1979, an increase of 3,561 percent over the 5-year period. Company B is a subsidiary of a large diversified conglomerate and, according to Best's, is a leading writer of deferred annuities. Quoting Best's, it "uses a nationwide marketing force which encompasses many of the nation's most prestigious N.Y. Stock Exchange member firms." Its total premium income went from $58.982 million in 1974 to $365.307 million in 1979, a 519 percent increase in five years.

Company C began to offer single premium deferred annuities in 1978. According to Best's, Company C specializes in investment-oriented life products that are marketed primarily through the security broker dealers that sell products for the financial services company with which it is affiliated. Its growth in total premium income was from $2.237 million in 1974 to $219.095 million in 1979, an increase of 9,964 percent over the 5-year period. The increase for the year 1979 over 1978 is even more striking, from $27.642 million to $219.095 million in just one year after they commenced issuing the single premium deferred annuities.

In our opinion these figures indicate that this is a situation that involves investment-type contracts designed to take advantage of the current high interest rates available and the very favorable tax situation currently applicable to them. We believe this matter merits the continued interest of the IRS and, if necessary, the Congress, in order that the deferral of tax now available to the interest earned under deferred annuity funds is not abused.

DEFINITIONS UNDER LICITA

One of the greatest difficulties of operating under LICITA has been the lack of clear and explicit definitions in a number of areas. In general, most of these difficulties have arisen because of changes either in the industry or in interpretations of the Act. In addition to the definition of a life insurance company (discussed in chapter 5), it appears that the greatest difficulties involve the definitions of assets, life insurance reserves, and investment expenses.

Table 13

Total Premium Income for Three Leading Life Companies, 1974-79
(000 omitted)

Year	Company A	Company B	Company C
1974	$ 9,975	$ 58,982	$ 2,237
1975	46,433	108,887	2,270
1976	172,846	190,231	2,591
1977	351,597	304,114	12,884
1978	343,901	246,806	27,642
1979	365,222	365,307	219,095

Table 14

1979 Distribution of Premium Income for Three Leading Life Companies
(000 omitted)

	Life and A&H	Annuities	Total
Company A	$25,212	$340,010	$365,222
Company B	60,198	305,110	365,307
Company C	3,281	215,814	219,095

Table 15

Face Amount of New Life Insurance Placed for Three Leading Life Companies, 1979
(000 omitted)

	Company A		Company B		Company C	
Year	Perm.	Term	Perm.	Term	Perm.	Term
1974	$ 2,578	$ 173,453	$ 86,467	$ 89,140	$ 6,921	$78,034
1975	1,255	190,658	76,060	95,867	6,650	60,325
1976	2,611	225,915	104,618	141,753	12,044	65,749
1977	1,727	349,084	179,805	407,781	21,985	70,557
1978	2,794	546,971	159,579	841,344	14,293	58,793
1979	11,084	1,431,633	173,371	1,295,898	8,037	42,851

The basic definition of assets is found in Section 805 of the Act. Essentially the definition is "...all assets of the company (including non-admitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business." Almost immediately after the Act was passed, this definition gave rise to differences relating to what was used in carrying on an insurance trade or business. Companies claimed a number of types of assets as being used in their trade or business, e.g., agents' balances, due and deferred premiums, etc. Regulations were published in an attempt to clarify the subject, but nevertheless arguments and litigation continued. The most persistent differences involved: (1) escrow funds (particularly where the amounts were commingled with the company's regular bank accounts) and (2) due and deferred premiums.

Because assets are an important factor in the calculations determining taxable income, it seems that an attempt should be made to be more specific in listing the assets to be included. 1/ This would not preclude further disagreements but should vitiate such problems in the future.

The definition of life insurance reserves is a part of the law's Section 801 that deals with determining whether or not a company qualifies as a life insurance company to be taxed under LICITA. Basically, life insurance reserves must be ". . .computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. . ." and ". . . which are set aside to mature or liquidate...future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts. . ." and ". . .must be required by law." 2/

The companies and IRS have had many differences of opinion, mainly at the point of audit by agents, as to what reserves should be included for the purpose of calculating the reserve interest deduction. The ". . .must be required by law" part of the definition causes problems because many of the reserves are set up at the request of the various State insurance departments and may not be acceptable under strict interpretation of "required by

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1/The policyholder reserve interest deduction is a function of the adjusted reserves rate which is usually the 5-year average of a company's current earnings rate. The current earnings rate is derived as follows:

$$\frac{\text{Investment Yield}}{\left[\frac{\text{Assets beginning of year} + \text{Assets end of year}}{2}\right]}$$

2/Internal Revenue Code, Sec. 801(b)(1) and (2).

law". Other reserves for practical reasons are approximated or estimated, and in some cases they also can be criticized as not fitting the requirement of being "computed or estimated on the basis of recognized mortality tables."

The law mentions investment expenses in Section 804 but provides no definition. A maximum for these expenses is spelled out in the event that a part of the general expenses is included in this amount. As might be expected, there have been many disagreements on this subject, some which are:

--should a portion of charitable gifts be charged to investment expenses;

--should a portion of investment expenses applicable to tax-exempt investments be disallowed as an investment expense in Phase I because the interest is tax exempt;

--should a portion of agents' commissions attributable to policies with loan provisions be considered an investment expense since policy loans are classified as investments; and

--should part or all of a company's tax expenses and tax-related legal expenses be considered investment expenses because investment income is all or a large part of the tax base?

CHAPTER 5

CREDIT LIFE REINSURANCE

INTRODUCTION

In general, reinsurance is a method whereby one insurer transfers all or a portion of its risks under an insurance policy or group of policies to another insurance company. Some major objectives of such agreements can include providing: (1) surplus relief for a company whose statutory surplus is becoming dangerously low; (2) front-end statutory income to enable a company to use tax loss carryforwards, which otherwise would expire unused; or (3) life insurance reserves to enable a company to qualify as a life insurance company for Federal income tax purposes. 1/

We are concerned here only with the third objective and its relation to credit life reinsurance. Credit life insurance is term insurance, generally decreasing in amount as a loan is repaid. It protects the borrower's family, as well as the lender, against the unpaid debt that may be left at death. It is commonly a part of consumer contracts. Life companies generally issue credit insurance through lenders such as banks, auto dealers, finance companies, credit unions, and retailers, who in turn make arrangements with borrowers. It is only one of several kinds of insurance sold through lenders in connection with their loan and charge account businesses. Others are credit accident and health, which cover payments if the borrower becomes disabled, and credit property insurance, which covers the loss of or damage to the items a consumer buys on credit.

Lenders are highly successful in selling credit insurance to their borrowers. Estimates of the percentage of borrowers who buy credit insurance from lenders vary considerably. One study by the Federal Reserve Board indicates that the percentage of borrowers who buy the coverage ranged from a low of 39.9 percent of borrowers from retailers/dealers to a high of 74.8 percent of borrowers from finance companies, for an average of 62.2 percent of all borrowers. 2/

A large portion of the credit insurance premium paid by the borrower is paid to the lender as a sales commission. Commissions on credit insurance typically run 40 percent or more of premiums. The Chief Examiner of the Arizona Department of

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1/Peat, Marwick, Mitchell & Co., Federal Taxation of Life Insurance Companies (New York: Peat, Marwick, Mitchell 1971), p. 59.

2/Board of Governors of the Federal Reserve System, 1977 Consumer Credit Survey (FRB, 1978), p. 47.

Table 18

Comparison of Sample with Industry 1978
(000,000 omitted)

	U.S. Life Companies	Sample			
		Stock	Mutual	Total	Percent of Industry
Number of Companies	1,824	18	24	42	2.3
Assets	$ 399,000	$ 66,729	$ 222,199	$ 288,925	72.5%
Insurance in Force	3,150,000	548,592	1,396,812	1,945,403	62.6
New Insurance Issued	521,800	69,936	173,620	243,552	46.6
Premiums	78,760	16,875	34,452	51,330	65.2

a/These numbers may not precisely match data collected by other sources, e.g. there are relatively minor differences in data collected by Flow of Funds, Best's Reports and the ACLI.

Sources: All numbers for assets, insurance in force, and new insurance issued taken from Best's Review Statistical Study, June 1979.

Figures for the number of companies and premiums are taken from Fact Book 1979.

Sample totals for premiums were computed from data in Best's Insurance Reports, 1979 edition.

Assets

In 1978 the total value of admitted assets held by U.S. life insurance companies amounted to nearly $400 billion, an increase of $38 billion over 1977. 1/ Of this total, $342 billion (85.8 percent of all assets) were concentrated in the top 100 companies with the remaining 14.2 percent distributed among the smaller 1,700 firms. The sample of 42 companies used in this study had assets of $289 billion, equalling about 72 percent of all U.S. life insurance industry assets and 85 percent of all assets held by the top 100 firms (see figure 2).

1/Admitted assets for a life insurance company are "...[a]ssets of an insurer permitted by a state to be taken into account in determining its financial condition." Dictionary, p. 9.

life insurance company if its life insurance reserves constitute more than 50 percent of its total reserves. 1/ There has been a problem, however, in using reserves as a measure to determine life insurance company status when credit reinsurance companies are involved. An insurance company with only incidental life business can obtain preferential treatment as a life insurance company by arranging with another company to hold its nonlife reserves through reinsurance arrangements. Assuming a valid business purpose in such arrangements, Section 801 does not preclude such a company from meeting the 50 percent reserve test.

The unearned premiums reserve is the basic insurance reserve for companies whose main business is reinsuring credit accident and health policies. Unearned premiums are those amounts paid in advance by the policyholder to cover future costs of the insurance policy. "Since policyholders typically pay the full premium in advance, the premium is wholly 'unearned' when the primary insurer initially receives it" and the only reserve necessary is the unearned premium reserve. 2/ Although a reinsurer usually assumes full liability on insurance policies for which the unearned premiums have been paid, the reinsurer may arrange with the primary insurer to maintain the reserve on the basis that premiums have not yet been earned.

Under Section 801 for purposes of the 50 percent reserve test, only total reserves and not life insurance reserves include the unearned premiums reserve for nonlife policies (other than noncancellable A & H policies). Credit A and H policies are typically for a 2- or 3-year term and are considered nonlife policies under Section 801. Thus, a company that reinsures mostly nonlife policies will fail the 50 percent reserve test unless it arranges for the primary insurer to hold the unearned premium reserves on their credit A and H policies. According to an official of the Arizona Department of Insurance, this is a common practice among Arizona credit reinsurance companies and, if it were not done, he believes that very few, if any, of the approximately 400 companies would qualify as life insurance companies.

THE CONSUMER LIFE CASE

The issue of life insurance company status for credit reinsurers has been the subject of controversy. The IRS has contended in several court cases that unearned premium reserves on A and H policies must be included in the reinsurer's total reserves for purposes of the 50 percent reserve test, and the issue eventually reached the Supreme Court for a decision in United States v. Consumer Life Insurance Co. (430 U.S. 725 [1977]). The Court held in favor of Consumer Life.

1/Internal Revenue Code, Sec. 801.

2/United States v. Consumer Life Insurance Company, 430 U.S. 725, 729 (1977).

The background of Consumer Life Insurance Company is typical of Arizona credit reinsurance companies. In 1957, Southern Discount Corporation was operating a successful consumer finance business. Its borrowers typically purchased term life insurance and term A and H insurance at the time they obtained their loans. Prohibited from operating in Georgia as an insurer itself, Southern served as a sales agent for American Bankers Life Insurance Company, receiving in return a sizable commission for its services. With a view to participating as an underwriter and not simply as an agent in this profitable credit insurance business, Southern formed Consumer Life Insurance Company as a wholly owned subsidiary incorporated in Arizona. Although Consumer Life's low capital precluded it from serving as a primary insurer under Georgia law, it was nonetheless permitted to reinsure the business of companies admitted in Georgia. 1/

At this point, for illustrative purposes, an example might be helpful. 2/ Let us assume that under a reinsurance agreement Company A is the reinsurer (which is what Consumer Life Company was) and that Company B is the primary insurer or ceding company (which is what American Bankers was). Assume that on January 1 that an individual purchases from Company B a 3-year credit life policy as well as a 3-year credit A and H policy, with a premium of $360 for each policy paid on January 1. On February 1, Company B is obligated to pay Company A an agreed upon percentage (e.g., 85 percent) of $360 for reinsurance of the life policy. This payment represents the total agreed upon amount to be paid Company A for the life contract, and no further payments between the companies will be made on this policy. For the A and H policy, Company B would pay on February 1 only the agreed upon percentage of the $10 that would have been earned during the preceding month (i.e., a 36-month A and H policy allocated @ $10 per month). Company B would pay the same amount on March 1 for the coverage provided during February, and these payments will continue for the duration of the policy.

Therefore, Company B transferred all of its life insurance reserves related to this policy to Company A on February 1; however, it retained the unearned premium reserves on the A and H insurance. Because Company B held the unearned A and H premium, it set up an unearned premium reserve equivalent to the full value of the premiums (less the $10 already earned). Company A, since it had not yet received any unearned premiums on the A and H policy, had no reason to enter in its books any unearned premium reserve for A and H business. This is precisely what occurred between Consumer Life and American Bankers, and this is typical of credit reinsurance agreements. The annual statements filed in Arizona and Georgia by both companies were accepted without challenge.

1/430 U.S. 731-32 (1977).

2/Ibid., pp. 732-33.

Consumer Life computed its 50 percent reserve test based on its booked reserves, which did not include any unearned premium reserves. According to the figures booked, Consumer Life qualified as a life insurance company for tax purposes. A comparative example of how this reserve test calculation works is presented in table 16.

Table 16

A Comparative Example of the Reserve Test Calculation

	With Unearned A&H Reserves a/	Without Unearned A&H Reserves b/
Cumulative life insurance reserves	$ 200	$ 200
Unearned premiums on life policies	800	800
Total qualified reserves-numerator	$1,000	$1,000
Unearned premiums on A&H reserves	1,200 c/	-0- d/
Total reserves - denominator	$2,200	$1,000

a/Since the ratio of the amount on the third line is less than 50 percent (i.e., $1,000 divided by $2,200 = 45 percent), the company does not meet the definition of a life insurance company for tax purposes. This is the position Consumer Life would have been in if it had held A&H premium reserves.

b/Since the ratio is more than 50 percent (i.e., $1,000 divided by $1,000 = 100 percent) the company meets the definition of a life company for tax purposes. This is the position of Consumer Life with its A&H reserves held by American Bankers.

c/If held by Consumer Life.

d/These reserves were actually held by American Bankers.

The Internal Revenue Commissioner felt that the A and H reserves held by American Bankers should in fact be attributed to Consumer Life, thereby disqualifying Consumer Life for taxation as a life insurance company.

The IRS felt that the unearned premium reserve should have been booked by Consumer Life rather than American Bankers for two reasons:

--Consumer Life bore substantially all of the insurance risks; and

--Section 801 of the 1959 Act embodies a rule that the "insurance reserves follow the insurance risk" of the related insurance policies. 1/

Consumer Life paid the deficiency assessed by the Commissioner and brought suit for a refund. The Court of Claims held for Consumer Life.

The case was appealed to the Supreme Court which held that the reinsurance agreement served a valid and substantial business purpose and would therefore be recognized by the Court for tax purposes. The Court acknowledged that tax considerations may have played a significant role in the agreement, but stated that "even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction." 2/ The Court further held that neither the express language nor the legislative history of Section 801 suggest that the Congress intended a "reserves follow the risk" rule to govern the allocation of unearned premium reserves. The Court also felt it significant that the State insurance regulatory bodies accepted the financial statements of the companies involved. 3/

In a dissenting opinion, Mr. Justice White, joined by Mr. Justice Marshall, wrote:

> The Court today makes it possible for insurance companies doing almost no life insurance business to qualify for major tax advantages Congress meant to give only to companies doing mostly life insurance business. I cannot join in the creation of this truckhole in the law of insurance taxation. . .
>
> This rule would permit an A&H insurance company to qualify for preferential treatment as a life insurance company by selling a few life policies and then arranging, by means similar to those employed here, for a third party to hold the A&H premiums and the corresponding reserves. Under the majority's rule, these reserves held by the third party to cover risks assumed by the A&H company would not be attributed to that company; its total reserves for purposes of Sec. 801 would consist almost entirely of whatever life insurance reserves it held; and the company would satisfy the reserve-ratio test. [footnote omitted] I cannot believe that Congress intended to allow an insurance

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1/430 U.S. 736, 739-40 (1977).

2/Ibid., p. 739.

3/Ibid., p.750.

company to shelter its nonlife insurance income from taxation merely by assuming an incidental amount of life insurance risks and engaging another company to hold its reserves. . .

The majority observed that it was merely interpreting the legislation enacted by the Congress and that, if changes are in order, it is the job of the Congress and not the Court to make them. 1/

SUMMARY

Credit reinsurance companies writing predominantly nonlife insurance business have qualified for tax advantages intended for companies writing predominantly life insurance. These companies represent approximately 25 percent of all life insurance companies. Lenders (banks, finance companies, and auto dealers) have established their own reinsurance companies to capture a larger share of the credit insurance business. Under Section 801 of the Code, an insurance company will qualify as a life insurance company for tax purposes if its nonlife reserves are less than 50 percent of total reserves. Credit reinsurance companies have maintained their nonlife reserves below the 50 percent level by arranging for another company to hold their nonlife unearned premium reserves, even though they assumed all risk on the policies for which the premiums had been paid. The IRS has contested this in several court cases which eventually reached the Supreme Court in United States v. Consumer Life Insurance Company. The Court's ruling in favor of Consumer Life was largely due to the fact that Section 801 did not appear to prohibit this practice.

In chapters 4 and 5 we examined certain specific provisions of LICITA. In chapter 6 we analyze the alternatives and effects of changing the law.

1/Ibid., 750.

CHAPTER 6

CHANGING THE LAW: ALTERNATIVES AND EFFECTS

The major concerns about the 1959 Act appear to center on changing the controversial 10 to 1 rule for determining the policyholder reserve interest deduction. This and other specific changes in the 1959 Act are analyzed in this chapter.

TAX BURDENS

Prior to examining alternative changes in LICITA and their effects, we will attempt to examine the tax burden of the life insurance industry. 1/

Table 17 indicates the changing Federal income tax burden of life insurance companies, both in terms of absolute dollars as well as of a percentage of all life company assets. The absolute dollar amount of the industry's tax burden indicates a steadily rising trend over time, and life companies' taxes as a percent of assets have generally risen since 1960.

If the life insurance industry tax burden is compared to the income tax burden of the banking industry, it would appear that banks have significantly reduced their tax burden in terms of tax as a percentage of all bank assets. (See table 17.) Banks have reduced their percentage of income taxes to assets from 0.45 percent in 1960 to 0.13 percent in 1976. Life insurance policyholders pay little if any tax at the individual level on their investment income in insurance. Bank customers, on the other hand, do pay tax at the individual level on their investment income in bank deposits.

THE SAMPLE PROFILE

To study the effect of any changes in the tax law on revenues, the tax returns of 42 of the largest (by asset size) U.S. life insurance companies were analyzed. Sample size was limited

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1/The appropriate comparison of tax burdens should be the effective tax rate on net income. However, "[i]n the case of insurance companies, the measure of taxable income provided in the Internal Revenue Code is so highly specialized it cannot be adjusted to reflect normal concepts of enterprise income. . ." See U.S. Department of the Treasury "Effective Income Tax Rates Paid by United States Corporations in 1972," (May 1978), p. 3.

by the number of companies whose returns were available for the 5-year period 1974-78. The Internal Revenue Service provided these returns. While small in number, this sample represents a large portion of the industry's assets, premiums received, new business issued, and insurance in force. The revenue effects of any changes in the law would certainly be reflected by these companies. We also analyzed taxpayer returns for categories of life companies segregated by asset size including a detailed analysis of 1,254 life companies with assets of less than $25 million (appendix IV). This was done to ensure that all life company categories were fairly represented.

Table 17

Comparative Income Tax Burdens of Life Insurance Companies and Banks

Year	Life Insurance Companies		Banks	
	As % of All Life Companies' Assets	Income Taxes Before Credits (000 omitted)	As % of All Bank's Assets	Income Taxes Before Credits (000 omitted)
1976	0.66%	$2,119,001	0.13%	$1,779,916
1975	0.66	1,918,644	0.12	1,503,334
1974	0.70	1,883,107	0.13	1,578,659
1973	0.69	1,754,849	0.14	1,529,419
1972	0.64	1,550,125	0.14	1,307,908
1971	0.58	1,300,054	0.18	1,412,488
1970	0.60	1,250,774	0.23	1,575,839
1965	0.47	760,941	0.22	973,395
1960	0.44	529,409	0.45	1,363,459

Table 18 provides figures demonstrating the importance of the 42 sample companies in the industry in terms of assets, premiums received, new business issued, and insurance in force.

Table 18

Comparison of Sample with Industry 1978
(000,000 omitted)

	U.S. Life Companies	Sample			
		Stock	Mutual	Total	Percent of Industry
Number of Companies	1,824	18	24	42	2.3
Assets	$ 399,000	$ 66,729	$ 222,199	$ 288,925	72.5%
Insurance in Force	3,150,000	548,592	1,396,812	1,945,403	62.6
New Insurance Issued	521,800	69,936	173,620	243,552	46.6
Premiums	78,760	16,875	34,452	51,330	65.2

a/These numbers may not precisely match data collected by other sources, e.g. there are relatively minor differences in data collected by Flow of Funds, Best's Reports and the ACLI.

Sources: All numbers for assets, insurance in force, and new insurance issued taken from Best's Review Statistical Study, June 1979.

Figures for the number of companies and premiums are taken from Fact Book 1979.

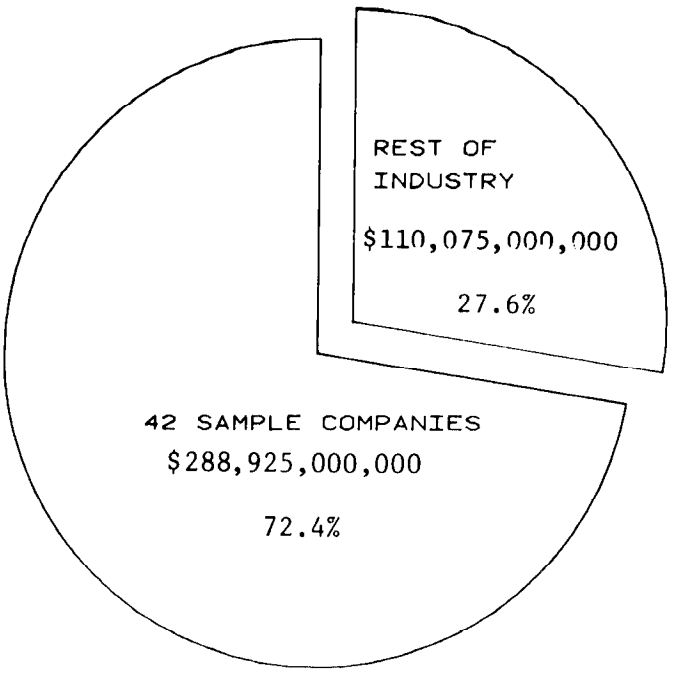
Sample totals for premiums were computed from data in Best's Insurance Reports, 1979 edition.

Assets

In 1978 the total value of admitted assets held by U.S. life insurance companies amounted to nearly $400 billion, an increase of $38 billion over 1977. 1/ Of this total, $342 billion (85.8 percent of all assets) were concentrated in the top 100 companies with the remaining 14.2 percent distributed among the smaller 1,700 firms. The sample of 42 companies used in this study had assets of $289 billion, equalling about 72 percent of all U.S. life insurance industry assets and 85 percent of all assets held by the top 100 firms (see figure 2).

1/Admitted assets for a life insurance company are "...[a]ssets of an insurer permitted by a state to be taken into account in determining its financial condition." Dictionary, p. 9.

FIGURE 2



ASSETS HELD BY SAMPLE COMPANIES
COMPARED TO REST OF INDUSTRY

When viewed by type of organization, it is clear that the mutual companies are generally much larger than the stock companies. Twelve of the 15 largest life companies (as measured by assets) are mutuals. Although stock companies represent 92 percent of the number of U.S. life companies, they hold only 40 percent of total industry assets. In the sample of 42 firms, the proportion of assets held by mutuals is even higher, accounting for 77 percent or $222 billion of total assets of the 42 companies.

Insurance in force

Insurance in force, the face value of all outstanding policies, amounted to over $3.1 trillion at the end of 1978. Each of the six largest companies had insurance in force of over $100 billion and together accounted for more than $1 trillion of insurance in force. This was nearly one-third of the industry total and 42 percent of the $2.4 trillion insurance in force of the top 100 firms. The nearly $2 trillion of insurance in force of the sample companies (63 percent of the U.S. life insurance company total and 79 percent of the top 100 life insurers) was composed of $1.4 trillion by mutuals and $0.5 trillion held by stock companies.

Insurance issued

In 1978 total insurance issued (exclusive of increases, revivals, additions, and reinsurance) by all companies totaled $522 billion. Each of the top 100 companies issued over $1 billion of insurance during the year, and in aggregate issued a total of $371 billion, representing 71 percent of the U.S. life company total. The $244 billion of insurance written by the 42 sample companies equals 46 percent of the industry total and 65 percent of the amount issued by the top 100 companies.

Here again the dominance of the large company category by the mutuals is evident. Although the mutuals represent approximately 57 percent of the companies in the sample, they wrote 71 percent of the insurance issued by the sample companies.

Premiums received

Premium receipts accounted for 73 percent of the total revenues of U.S. life insurance companies, with revenues from investments comprising the other 27 percent. Total premium receipts of $78.8 billion can be divided into annuity considerations, health insurance premiums, and life insurance premiums, which presently constitute slightly less than one-half of all premium receipts for life insurance companies. Premium receipts of $51.3 billion by the sample companies represent 65 percent of the U.S. life insurance industry total.

Sample company income and tax trends

To study trends in both income and Federal income taxes, we analyzed the tax returns of our sample companies for 1974-78. We used gain from operations as the measure of annual income, since this is the tax base. Gain from operations represents a total income approach that attempts to make taxation of life insurance companies comparable to other corporations. While this income measure may not be precise, it does reflect income after a deduction for the increase in reserves as well as deductions reflecting the costs of doing business. For purposes of our analysis, the special deductions allowed life insurers (i.e., policyholder dividends, group A and H, and nonparticipating deductions) are not subtracted from gain from operations. Also, this income measure does include all policyholder dividends, some of which reflects redundant premiums. Even with these flaws, gain from operations should reflect growth trends in the life insurance industry.

As indicated in table 19, life insurance companies' income has risen since 1975. The rate of growth was especially rapid for stock companies, although the level of mutual company income was, of course, much higher. This may in part reflect the failure to deduct the redundant premium portion of policyholder dividends.

Table 19

Gain from Operations Before Special Deductions
42 Sample Life Companies
1974-1978
(000 omitted)

	1974	1975	1976	1977	1978
24 Mutuals	$4,839,182	$4,640,932	$5,168,156	$5,799,152	$6,618,943
Percent change		(4.10)	11.36	12.21	14.14
18 Stocks	1,403,681	1,309,900	1,691,913	2,286,500	2,526,721
Percent change		(6.68)	29.16	35.14	10.29
42 Companies Combined	6,242,863	5,950,832	6,860,069	8,085,652	9,145,664
Percent change		(4.68)	15.28	17.87	13.11

After the decline in income in 1975, stock companies rebounded rather rapidly, with income rising 29.16 percent in 1976 and 35.14 percent in 1977. Mutual companies, by contrast, experienced a more steady rise in income in the years since 1975. The growth in income levels of both stock and mutual companies indicates their financial health and stability.

Using gain from operations (as specified here) as the tax base in calculating effective tax rates, no discernible pattern of growth in the effective tax rates on income for the industry can be drawn (see table 20). Further, when examining trends of effective rates for individual companies over the same period (1974-78), no substantive pattern of growth is observed. While the effective income tax rate on mutual companies is generally somewhat lower, due primarily to the inclusion of policyholder dividends in income, the differences in effective tax rates between stock and mutual insurers appears relatively insignificant.

Table 20

Effective Tax Rates a/
On Gain from Operations Before Special Deductions

	1974	1975	1976	1977	1978
24 Mutuals	22.44	23.69	23.79	24.40	23.98
18 Stocks	26.97	30.27	25.58	25.98	28.81

a/These rates are taxes before credits. The rates reported are averages over the 24 mutual/18 stock companies that are not weighted, i.e., each company's tax rate is given equal weight.

THE POLICYHOLDER RESERVE INTEREST DEDUCTION

As demonstrated in chapter 4, the 10 to 1 rule operates in a manner to initially increase and then decrease the reserve interest deduction as the difference between the actual and assumed earnings rates widens. In recent years, because of rising interest rates, investment earnings have been climbing steadily (see table 21). Consequently, the gap between the actual earnings rate and the assumed rate has also been widening. The assumed rates, because of State statutes, normally have a low ceiling (currently 4.5 percent for ordinary life insurance reserves). In the case of some large companies, this gap between the actual earnings rate and the assumed earnings rate has widened to a point where the reserve deduction may have reached the maximum and begun to fall. 1/ A fall in the reserve deduction implies that tax liabilities rise

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1/The maximum deduction according to the 10 to 1 rule occurs when the net earnings rate is 5 percent plus half the assumed rate.

at an increasing rate. Thus, the marginal tax rate on investment income rises as the increasing interest rates widen the spread between the actual and assumed rates. 1/

Table 21

Net Rate of Return on Investments of U.S. Life Insurance Companies

Year	Rate a/
1965	4.61%
1966	4.73
1967	4.83
1968	4.97
1969	5.15
1970	5.34
1971	5.52
1972	5.69
1973	6.00
1974	6.31
1975	6.44
1976	6.68
1977	7.00
1978	7.39

a/Excluding separate accounts.

Source: Fact Book 1979, p. 61.

Consider as an illustration of the rising marginal tax rates a firm with $100 million in assets and $80 million in reserves resulting from the use of a 3 percent assumed rate. Furthermore, assume this company is a typical, large, mutual or stock company taking the full $25,000 small business deduction and calculating its taxable income on the gain from operations, which is $250,000 less than taxable investment income (Phase I). To simplify, the marginal tax rate is considered to be the rate imposed on the last $1 million of investment income. The figures presented in table 22 indicate a marginal tax rate increasing with increasing adjusted reserves rates, reaching 90.1 percent for the additional $1 million of investment income generated when the earnings rate

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1/The marginal tax rate is defined as the tax rate applicable to the last dollar of income. In the case of a large life insurance company, the income referred to is usually investment income. The marginal tax rates increase until the spread between the actual and assumed rates reaches a ceiling of 10 percent. After the spread exceeds 10 percent, marginal rates no longer rise above the statutory corporate level.

rate rises from 12 to 13 percent. However, even at this high marginal tax rate, for this particular exposition, the ratio of income tax to investment income is 44.9 percent, compared to the statutory rate of 46.0 percent. For earnings rates greater than or equal to 13 percent there is no reserve interest deduction and a tax is levied on all investment income, although some of this income is needed to meet future policyholder claims.

Apparently the authors of the 1959 Act did not anticipate the precipitous rise in the actual earnings rate and the consequent rise in marginal tax rates. In fact, the 10 to 1 rule was adopted to eliminate the inequities to some companies of using an industry-wide average earnings rate--the Secretary's Ratio. 1/ It has been contended that marginal tax rates are rising very rapidly and have caused severe hardship. 2/

EFFECT OF ALTERNATIVE METHODS OF COMPUTING THE RESERVE DEDUCTION

Several alternative solutions have been discussed for replacing the 10 to 1 rule used in determining the reserve interest deduction. The three analyzed here are (also see appendix II):

--substituting the actual required interest based on assumed rates for the 10 to 1 adjustment--the free interest method,

--replacing the 10 to 1 rule with a reserve deduction based on a geometric approximation,

--substituting a 4.5 percent maximum for the average earnings rate with either the 10 to 1 reserve adjustment or with the geometric reserve adjustment.

1/For a discussion of the Secretary's Ratio see chapter 3. The Secretary's Ratio was considered inequitable because the use of an industry-wide earnings rate for all companies neither adequately rewarded firms using conservative reserve practices nor encouraged other firms to use an assumed rate reflective of the actual market rate.

2/Thus, one industry executive notes that if overall yields on his portfolio should exceed 12 percent, every bit of additional yield would be taxed 100 percent or more. See Carol J. Loomis, "Life Isn't What it Used to be," Fortune, July 14, 1980, p. 87.

Table 22

An Exposition of Rising Marginal Tax Rates a/

(Col 1) Adjusted Reserves Rate	(Col 2) Investment Income $ mill	(Col 3) Reserve Adjustment Factor	(Col 4) Adjusted Reserves $ mill	(Col 5) Reserve Interest Deduction b/ $ mill	(Col 6) Taxable Investment Income c/ $ mill	(Col 7) Taxable Income d/ $ mill
3%	3	100%	80	2.400	.575	.325
4	4	90	72	2.880	1.095	.845
5	5	80	64	3.200	1.775	1.525
6	6	70	56	3.360	2.615	2.365
7	7	60	48	3.360	3.615	3.365
8	8	50	40	3.200	4.775	4.525
9	9	40	32	2.880	6.095	5.845
10	10	30	24	2.400	7.575	7.325
11	11	20	16	1.760	9.215	8.965
12	12	10	8	.960	11.015	10.765
13	13	0	0	0	12.975	12.725
14	14	0	0	0	13.975	13.725

a/This example assumes there are $100 million in assets, $80 million in re
assumed earnings rate.
b/(Col.1) x (Col.4)
c/(Col.2)-(Col.5)-$25000
d/(Col.6)-$250,000
e/[(Col.7)x.46]-$19250
f/(Col.8)/(Col.2)
g/d(Col.8)/d(Col.2), change in column 8 for each increase of 1 in column 2

The free interest method

The reserve interest deduction under the 10 to 1 rule is divorced from the interest required (assumed) to meet future obligations. Consequently, the first option is eliminating the 10 to 1 rule and substituting for it the required interest. The assumed interest is computed by multiplying the assumed interest rate by the amount of reserves. Figures in table 23 indicate that this formula would result in a 36.0 percent increase in 1978 tax liabilities (from $2,112 million to $2,869 million) for the 42 sample companies. Further, the marginal tax rates on investment yield fall and could never reach the anticipated heights possible under the 10 to 1 rule; that is, the maximum marginal tax rate under this alternative can rise up to the maximum statutory rate but cannot exceed that rate. 1/

The increased revenue generated by this deduction is $757 million. The industry contends that a deduction in excess of the assumed interest is necessary to meet future obligations. This contention results from the industry's practice of setting premiums at a level lower than that which is consistent with a low assumed rate. Therefore, the industry claims the larger deduction permitted is necessary.

The geometric approximation rule

An alternative approximation has been suggested that reduces the rapid rise in marginal tax rates on investment yield. This suggested approximation uses a term from a geometric progression to calculate the policyholder reserve deduction. It assumes that for a difference of "n" percent between the actual and assumed earnings rates the level of reserves decreases by 0.9 to the nth power. For example, an earned rate 2.0 percent higher than the assumed rate adjusts reserves to 81 percent (0.9 squared multiplied by 100 percent) of actual reserves. These adjusted reserves are then multiplied by the actual earnings rate to obtain the reserve interest deduction. It has been contended that this geometric approximation is an alternative method of adjusting reserves in a manner more consistent with the actual earnings rate, considering the current gap that exists between the assumed and actual earnings rate. 2/

1/The method for calculating the marginal tax rates here is derived by Fraser, "Mathematical Analysis of Phase I and Phase II," pp. 51-138.

2/For example, see Peter W. Plumley, "Certain Inequities in the Life Insurance Company Income Tax Act of 1959," TSA, vol. 28 (1976), p. 25. See also Society of Actuaries, Record, pp. 117-135.

Table 23

Impact of Suggested Changes in LICITA
on 42 Companies for 1978 a/

	24 Mutual	18 Stock	Combined
Current Earnings Rate (Avg %)	6.69%	6.97%	6.81%
Total Tax-Current Law ($ mill)	$ 1,562	$ 550	$ 2,112
Total Tax-Free Int. ($ mill)	$ 2,205	$ 664	$ 2,869
Percent Change from Current (%)	41.0%	21.0%	36.0%
Total Tax-Geometric Rule ($ mill)	$ 1,439	$ 525	$ 1,964
Percent Change from Current (%)	-8.0%	-5.55%	-7.0%
Total Tax-4.5% and 10 to 1 ($ mill)	$ 1,738	$ 584	$ 2,322
Percent Change from Current (%)	11.0%	6.0%	10.0%
Total Tax-4.5% and Geometric ($ mill)	$ 1,725	$ 583	$ 2,308
Percent Change from Current (%)	10.0%	6.0%	9.0%

a/These figures do not represent actual liabilities shown on tax returns because segregated accounts are excluded. Thus, the figures reflect tax liabilities as though only the general accounts of the company were taxed.

However, the results of applying this approximation provide for a larger reserve deduction than the 10 to 1 rule for differences between the actual and assumed earnings rates of greater than one percent. Furthermore, the reserve deduction reaches a maximum at an actual earnings rate of approximately 9.49 percent, irrespective of the assumed rate, but it never falls to zero. The fall in the magnitude of the deduction after the maximum is reached occurs slowly. For example, at an assumed rate of 3.0 percent the deduction is 4.78 percent of reserves when the actual earnings rate is 9.0 percent, 4.74 percent of reserves at an actual earnings rate of 11.0 percent, and 4.24 percent of actual reserves at an actual earnings rate of 15.0 percent. The deduction for required interest under the geometric formula will only asymptotically reach zero for infinite actual earnings rates. Figure 3 provides the effective reserve interest deduction with an assumed reserve rate of 3.0 percent.

To illustrate the effect of substituting the geometric rule for the 10 to 1 rule, the total tax liability of the 42 sample companies for 1978 was calculated using this formula. The results of this calculation appear in table 23. The figures indicate that for 1978 the use of the geometric rule would have reduced the 42 companies' tax liabilities by a total of 7.0 percent, from $2,112 million to $1,964 million. Under this alternative industry tax liabilities would decrease immediately and then not rise as rapidly as they would under the current law if earnings rates continue to rise and the gap between assumed and actual rates continues to widen.

Substituting a 4.5 percent maximum for the earnings rate

The first alternative, which grants a deduction only for assumed reserve interest and eliminates the 10 to 1 rule altogether, taxes income of life companies that is not currently taxed. On the other hand, the alternative of using the geometric approximation permits a larger reserve interest deduction. Between these two extremes some other arbitrary measure for the reserve interest deduction may also be considered. One such measure, a 4.5 percent maximum, which can be substituted for the adjusting reserves rate in the current 10 to 1 rule, would result in a deduction that falls between the two extremes and avoids the increasing marginal tax rates currently facing the industry. Figure 4 illustrates and compares the three alternatives.

Figure 3

A Graphic Presentation of Effective Reserve Interest Rate - Geometric Formula with an Assumed Reserve Rate

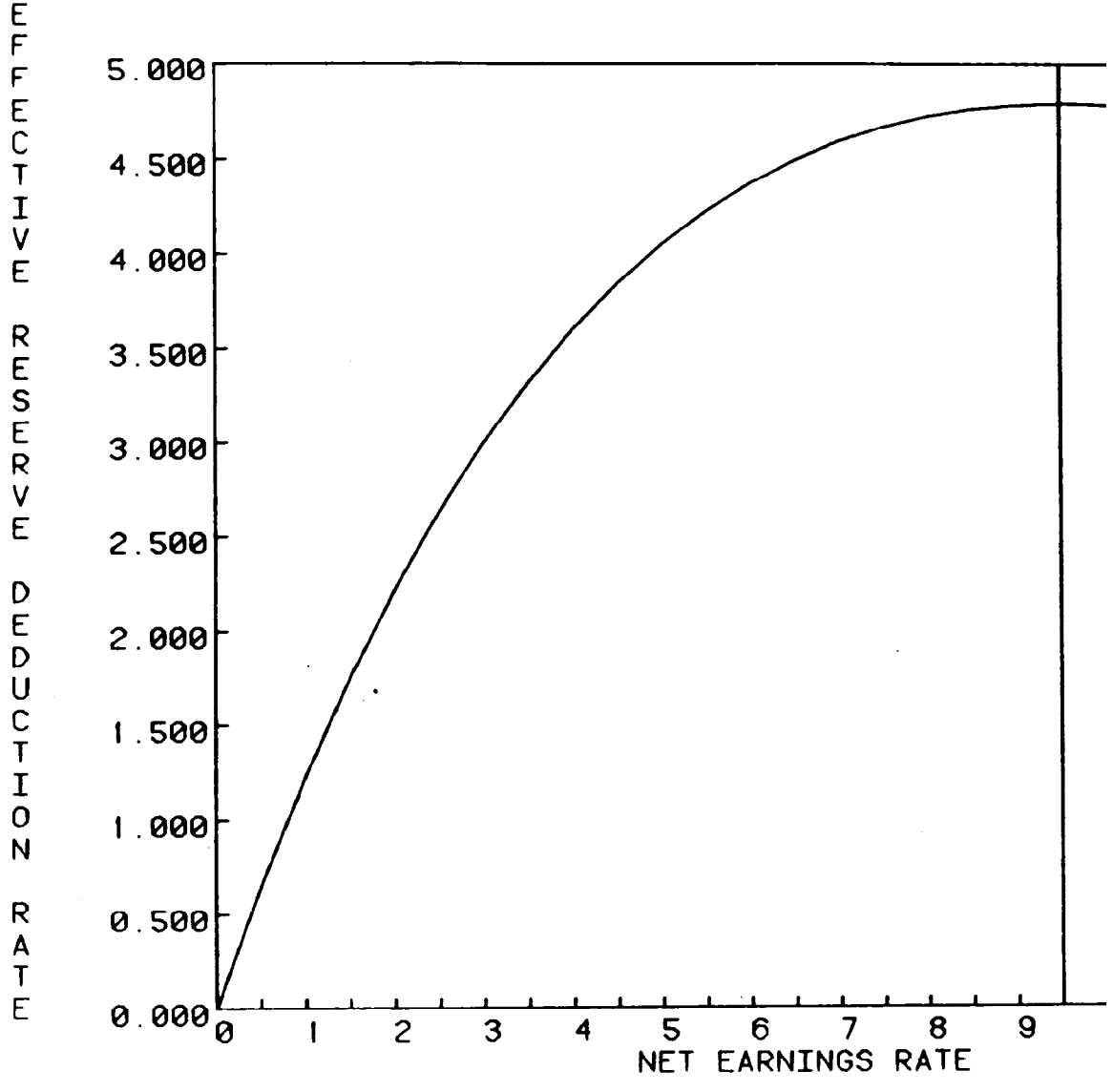
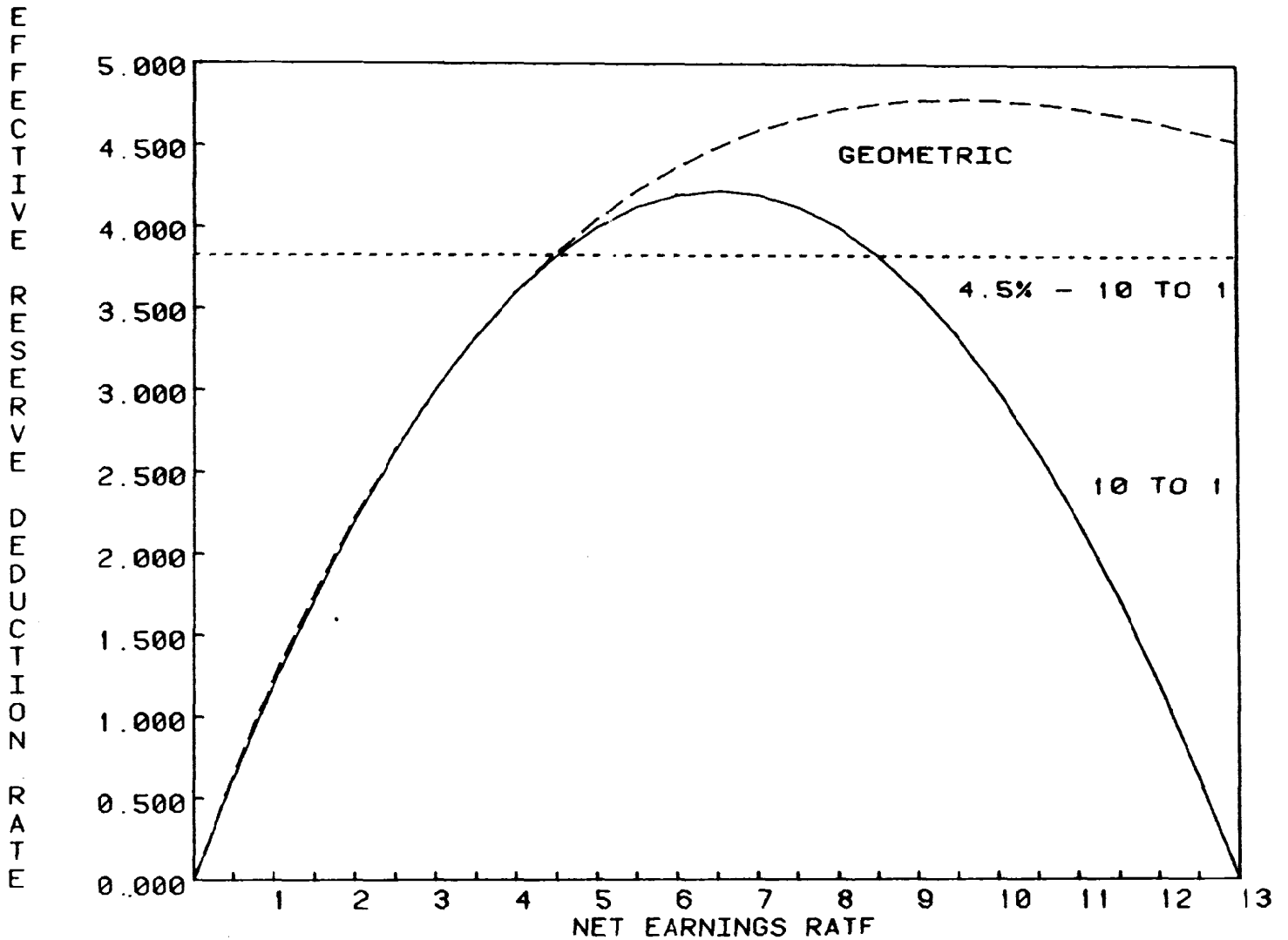


Figure 1

A Graphic Presentation of Effective Reserve Interest Deduction Rate - A Comparison of Three Alternatives - Assumed Rate 3.0%



Using the 4.5 percent rule and adjusting reserves by the 10 to 1 method

Basically, this alternative permits each company to adjust reserves to a 4.5 percent basis. Though the selection of 4.5 is arbitrary, as any specific number selected would be, this assumed rate is the maximum rate permitted in most States for ordinary life insurance. Under this method, the reserve interest deduction is obtained by substituting the 4.5 percent for the adjusted reserves rate in the 10 to 1 rule for reserve adjustment and then applying the 4.5 percent rate to adjusted reserves.

Results of applying the 4.5 percent rule to 1978 tax return data are shown in table 23. For the 42 companies examined that year, tax liabilities would have increased from $2,112 million to $2,322 million or 10 percent, assuming the 10 to 1 rule was retained for the adjustment of reserves to the 4.5 percent rate.

Using the 4.5 percent rule and adjusting reserves with the geometric approximation

If desired, either the 10 to 1 rule or the geometric rule could be used to adjust reserves to the 4.5 percent rate with each producing similar results. If reserves were adjusted to the 4.5 percent rate using the geometric rule, tax liabilities for the 42 companies in 1978 would have increased to $2,308 million or 9.0 percent. It makes little difference if either the 10 to 1 or the geometric rule is used to adjust reserves since the difference between 4.5 percent and the assumed rate for each company is small.

Although this method of calculating the reserve interest deduction still provides for a deduction in excess of assumed reserve interest, it does offer the following advantages:

--If the assumed rate rises to 4.5 percent, this method of calculating the reserve interest deduction becomes equivalent to the free interest approach.

--Each company uses its own assumed rates, actual reserves, and investment yield in calculating the deduction thereby preserving the individual company's incentive to remain conservative and earn the highest rates.

--A need to calculate the current earnings rate for this purpose would no longer exist; and because the determination of assets would be unnecessary, the controversy surrounding the inclusion of due and deferred premiums need not be reopened for this purpose. 1/

1/See "Yeres on Life Insurance Taxation and the Standard Life Case," Tax Notes, vol. 9 (October 8, 1979), pp. 459-68.

--The marginal tax rate on investment yield levels off at the statutory corporate rate of 46 percent.

The results of all four reserve deductions are depicted in figures 5 and 6 for each of the years 1974-78. Figure 5 is a bar graph that shows the tax revenue levels of the alternative formulations. Clearly, using the free interest method results in a large increase in tax liabilities to these companies (and hence the industry), while the geometric approximation results in a reduced tax burden. This is more evident when figure 6 is examined. In this figure, the percent change in tax liabilities is shown for each of the alternatives. Once again, it can be seen that liabilities rise the most when the required interest deduction is substituted for the reserve interest deduction as calculated by the 10 to 1 rule.

EFFECT OF CHANGES ON OTHER FEATURES OF THE 1959 ACT

In the preceding section we analyzed four possible changes to the 10 to 1 rule the Congress may wish to consider. In this section we turn to two other provisions in the Act that should also be examined. These are:

--the 50 percent deferral of underwriting gains, and

--the adjustment of preliminary term reserves.

Fifty percent deferral of underwriting gains

The provision permitting the deferral of half of underwriting gains was devised to compensate for the uncertainty believed inherent in the life insurance business. According to the Treasury Department, the deferral ". . .takes account of the point on which the life insurance industry has insisted that it is difficult, if not impossible, to establish with certainty the true net income of a life insurance company on an annual basis." 1/ However, underwriting losses

> may be offset in full against the investment income tax basis, even though, if there were a gain from the underwriting operations, only one-half of this would be taxed currently. This is likely to be more beneficial to small and new businesses than to their well established competitors, because such companies generally are incurring large expenses (such as agents' commissions) in attempting to expand the business on the books. 2/

1/Senate Hearings, p. 24.

2/S. Rpt. 291, p. 9.

Figure 5

A Comparison of Revenues Produced by 3 Alternatives to the Current Law
Based on a Sample of 42 Companies

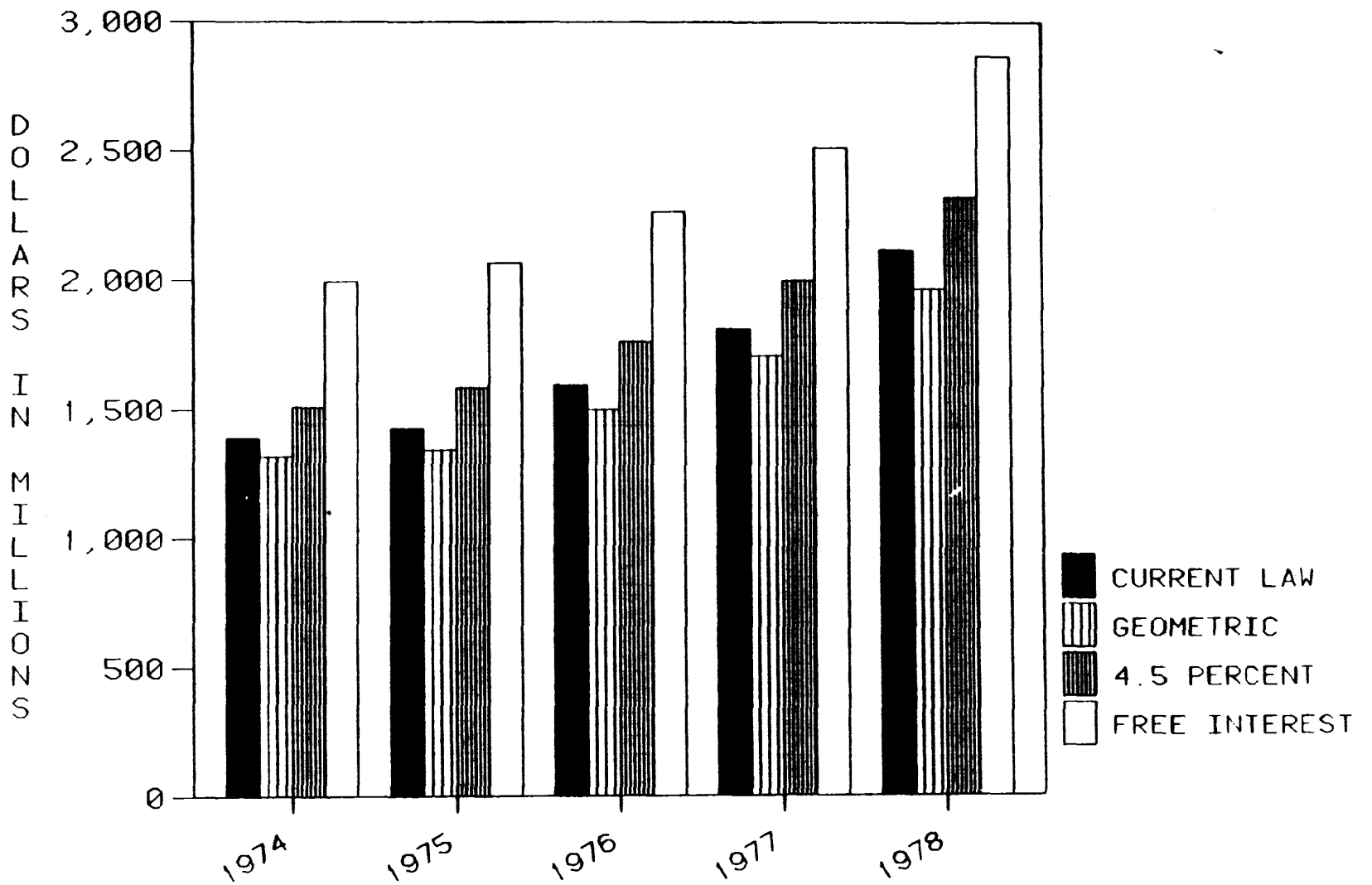
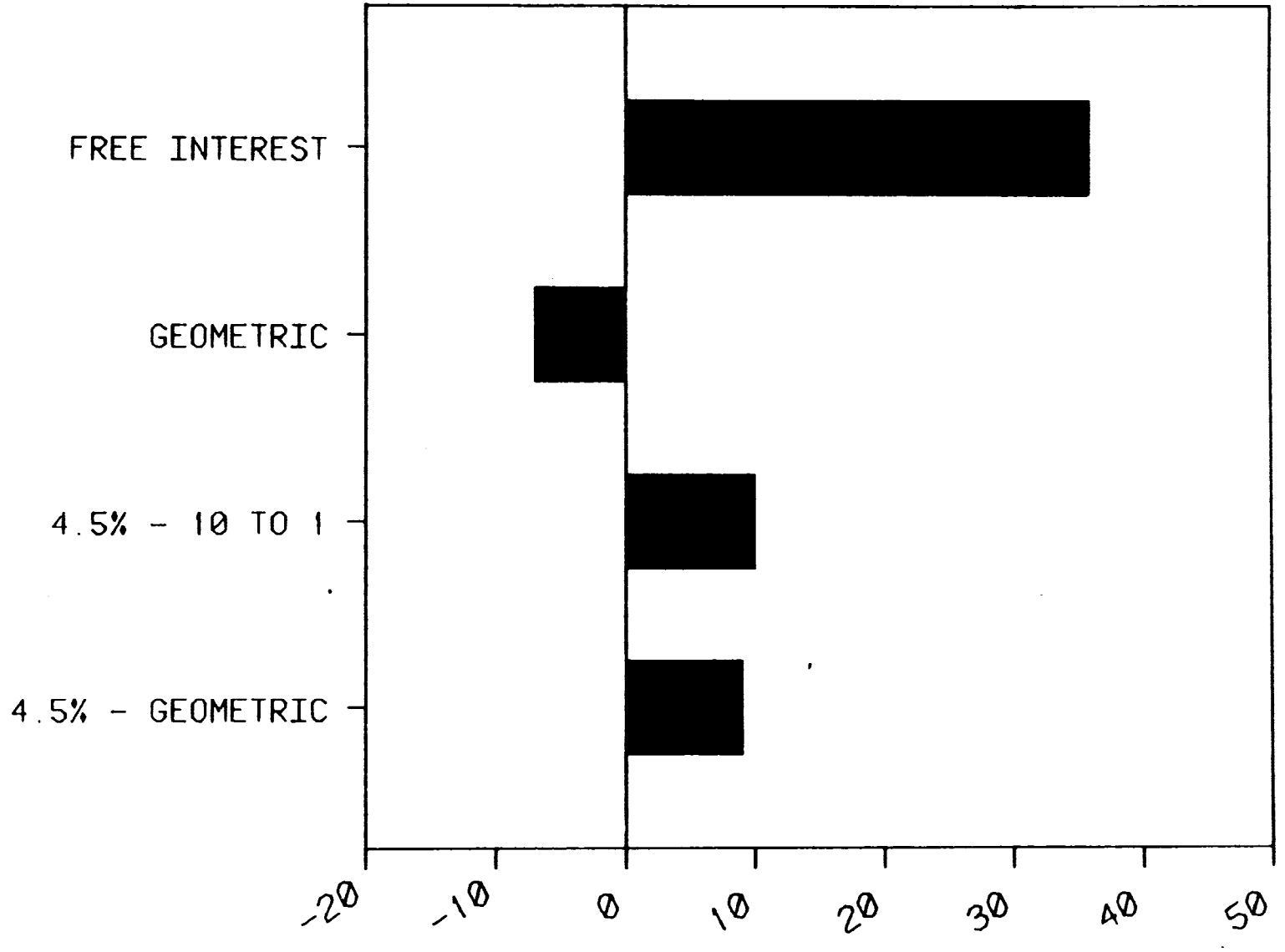


Figure 6

A Comparison of Percent Change in Tax Liabilities Under 3 Alternatives to the Current Law - Based on 42 Sample Companies for 1978



The deferral of half of the excess of underwriting gains over taxable investment income is of principal benefit to stock companies, although in the early years of the law's existence some mutual companies may have taken advantage of this provision. Along with this deferral additional deductions can be made for group life and A and H and nonparticipating contracts. These have also helped stock companies considerably in deferring taxes on part of their operating income.

It must be remembered that eliminating this provision results in an increased liability for many stock companies not included in the sample. Since only those companies in a Phase II positive situation are affected, many of the companies that would incur an additional liability would be credit life reinsurance companies having a low level of reserves and meager investment income compared to their underwriting gains.

Even for those insurance companies with deferred underwriting gains, the limitation on deferrals has been of no practical consequence. This is because the limit is set at levels such that it has rarely been surpassed. In confining stockholder distributions generally to nondeferred income, companies have largely avoided paying taxes under Phase III. The tax on distributions provides life companies with a powerful incentive to retain earnings. By following a conservative dividend policy, a firm's deferred taxes can continue indefinitely.

Over time the industry's performance has proven predictable. Mortality experience, operating expenses, premium receipts, and investment yields have all been favorable.

> the [rate] . . . of mortality has been going down. This improvement has been phenomenal. During the past decade, the mortality of medically insured risks has been improving at about 2% a year.

Age Adjusted Death Rate Per 1000	
1930	12.5
1940	10.8
1950	8.4
1960	7.6
1965	7.4
1970	7.1
1975	6.4
1977	6.1

. . . Operating expenses as a percentage of premiums (15.7%) have stayed fairly level." 1/

In periods of abnormal claims, life companies have found their incomes more than sufficient to meet unanticipated events. At the depth of the Great Depression in 1933 the cash inflows of 45 large companies, holding 85 percent of all life insurance company assets, were nearly double the total of that year's disbursements. 2/ Of course, the experience of individual companies may have been less favorable.

Phase III tax deferment, together with other tax provisions relating to nonparticipating policy reserves and group life contracts, were intended to provide stock life companies with a reduced tax burden relative to mutual companies. Such treatment may have been warranted when the industry was dominated by a few giant mutuals; however, since 1959 the stock company sector of the industry has grown at a more rapid pace than the mutual sector.

As the framers of the 1959 Act stated, special consideration should be given to new companies, which are invariably stock companies that have not had a chance to build up surplus funds for contingencies. Though the Act recognizes new companies' needs, this provision extends the deferral to all companies. Since overall industry performance has been quite predictable, the Congress may wish to consider phasing out the 50 percent deferral provision.

We analyzed the returns of the stock companies in our sample to ascertain the size of their policyholders surplus accounts. On December 31, 1976, the total policyholders surplus accounts for these 18 companies stood at $1,648,359,717. This represented 3.1 percent of their assets at that time. A year later on December 31, 1977, the total of the accounts had grown to $1,837,410,272 or 3.2 percent of assets. If this amount had been taxed currently as it was being built up, the tax would have been approximately $900 million. We realize, of course, that the deferral of 50 percent of the "spillover" is not the only amount that is used to build up the policyholders surplus--the special deductions have also contributed to the build up of the fund.

The same returns of the 18 stock companies show that as of December 31, 1976, the shareholders surplus accounts amounted to $2,248,881,818 or 4.2 percent of assets, and as of December 31, 1977, they were $2,620,202,335 or 4.5 percent of assets. The figures shown above, in our opinion, indicate that the larger

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1/Melvin L. Gold, "The Future Course of the Life Insurance Industry," Best's Review Life/Health Insurance Edition, vol. 81, (April 1981) p. 20.

2/Lent, "Tax Treatment of Life Insurance" p. 2008.

companies, with their moderately large shareholders surplus accounts, do not need the extra cushion provided by the deferral portion of the policyholders surplus account. Even with this removed they would still have the benefit of the special deductions.

Only companies with an excess of underwriting gains would bear the burden of this change, and at this time there is no way of securing aggregate industry figures and analyzing the full revenue effect of this change on all firms. For the year 1978, 3 of the 18 stock companies in the sample were in the 50 percent deferral situation. If these amounts had not been deferred, the total additional tax revenues accruing to the Treasury from just these three companies would have been approximately $5.6 million or about a 0.26 percent increase in sample company revenues.

Preliminary term reserve

As noted previously, the Congress, in an attempt to aid new and small companies, included in LICITA a provision allowing companies that established reserves on a preliminary term basis to convert these reserves to the net level premium basis. This provision was appropriate in 1959 when most large companies established reserves only on the net level premium basis, and generally small (mostly stock) companies established reserves using the preliminary term basis. This situation has changed and now many large companies are using preliminary term basis for new business. These companies are now electing under Section 818(c) to convert these reserves to the net level premium basis, using for the conversion the previously discussed 21-5 method.

The returns of our 42 company sample for 1977 indicate that 28 companies exercised the 818(c) election, 15 of the electing companies were mutuals and 13 were stock companies. From the data available it could not be determined whether any of the remaining 14 companies had made similar elections. Of the companies that did elect to convert reserves under Section 818(c), about half specifically indicated they were using the approximate method in the conversion. We believe it is correct to assume that most, if not all, of the other companies converting also used the approximate method. The flaws in the 21-5 method of converting reserves have already been pointed out in chapter 4. In light of graded reserve methods, it would appear that the current approximation method of converting reserves to net level is no longer appropriate. Rather than using the 21-5 approach, it would be more accurate today to use $15, a little more than two-thirds of the figure now specified in the law, to approximate additions to preliminary term reserves for permanent life policies. For term policies with a duration of 15 or more years the continuation of the $5 per $1,000 amount at risk called for in the current law appears appropriate. 1/

1/See appendix III.

SUMMARY

Some of the issues analyzed indicate changes in the Act may be needed in light of a changed economy and industry since 1959. These include:

--the 10 to 1 rule,

--the fifty percent deferral of underwriting gains, and

--the adjustment of preliminary term reserves.

The 10 to 1 rule for calculating the reserve interest deduction on life insurance reserves particularly needs to be changed. Recommendations for specific changes in the Act follow in the next chapter.

CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

As indicated earlier in this report, we performed extensive analyses not only of the industry as a whole but of a sample of 42 of the largest life insurance companies. We also conducted numerous interviews with industry representatives, Government officials, academic and actuarial experts, and a variety of other experts on insurance. Our conclusions and recommendations are based on the cumulative results of our work.

We have concluded that there are three specific issues of particular importance that the Congress should consider changing:

--the method by which the reserve deduction is calculated,

--the definition of taxable income, and

--the method of calculating the revaluation of reserves.

There are six additional portions of the Act that merit the consideration of the Congress. Because of time constraints and limited availablity of data, we are unable to make specific recommendations for changes in these areas; however, because of the extensive litigation arising from these issues, we feel certain that the Congress will wish to study them further. The three specific changes will be presented first, followed by a brief discussion of the six additional problem areas.

RESERVE DEDUCTION

A substantial portion of a life company's current earnings is put aside in reserves to meet future obligations. The method by which a life company calculates its reserve deduction is crucial in determining its tax liability.

GAO found

Due to the inflationary spiral, changes in product mix, and increasing earnings rates, the current method of calculating the reserve deduction is no longer appropriate. If the gap between the current earnings rate and the assumed rate continues to widen, the reserve deduction will first become larger and then smaller because of the 10 to 1 approximation.

GAO concludes

The portion of the Code specifying the calculation of the reserve deduction should be revised to reflect the changes in the industry and the economic environment over the past 20 years.

GAO recommends

The 10 to 1 adjustment as currently made should be replaced. The following considerations should be taken into account in determining the reserve interest deduction:

--the assumed earnings rate used by the companies in determining reserves,

--the inflationary environment in which the industry has operated in recent years, and

--the practice approved by the Congress in 1959 of allowing life companies to deduct amounts in excess of the interest implied in the assumed rates.

Three basic alternatives to the 10 to 1 rule have been discussed in this report. The alternatives are:

--substituting the interest based on assumed rates for the 10 to 1 adjustment--the free interest method,

--replacing the 10 to 1 rule with a reserve deduction based on a geometric approximation that provides a larger reserve deduction in the current economic environment,

--substituting a 4.5 percent maximum for the average earnings rate with either the 10 to 1 reserve adjustment or with the geometric reserve adjustment.

The Congress should consider selecting one of the above alternatives to replace the 10 to 1 rule for adjusting reserves.

TAXABLE INCOME

The importance of the method used by life companies in determining their taxable income is paramount. This results because any flaws in the method of determining the tax base will directly affect the amounts of revenue that flow from that tax base.

GAO found

In 1959 the Congress decided that life companies should be allowed to defer half of underwriting gains. Prior to LICITA, life companies were not taxed on underwriting gains at all. With the passage of LICITA the Congress adopted the total income approach; however, a large number of insurance companies were small and new companies and therefore the Congress provided a "cushion" in the event of catastrophic losses. The Congress allowed all companies to defer tax on half of underwriting gains. This deferral for all companies cannot be justified today. The industry's operations over the past 20 years reflect a high degree of predictability, and stock life companies have accumulated

a considerable amount of surplus from this one-half deferral. Since experience has proven this cushion is not needed and because many large stock companies have accumulated considerable amounts of surplus in these tax-deferred accounts, the Code should be revised to reflect current realities.

GAO concludes

There should be no automatic deferral of half the excess of gain from operations over taxable investment income for all life insurance companies; however, eliminating this deferral should be gradual and indexed according to the age of the individual company.

By indexing the implementation of the deferral to individual company age, the Congress could include provisions continuing the deferral for new companies that would limit the availability of the cushion to those companies actually requiring this relief. This deferral would be 50 percent for new life companies for 15 years and then phased out for them as well as for the companies already in existence for 15 years or more by decrements of 10 percent per year over a period of the next 5 years. The graduated implementation of this revision would afford adequate time to older companies to adjust their long-range planning to accommodate the revision.

GAO recommends

Sections 802(b) and 815(c)(2)(A) be amended to reflect the current condition of the life insurance industry. Legislative language for phasing out the one-half deferral of underwriting gains is presented in appendix VI.

RESERVE REVALUATION

The method by which life companies revalue reserves is important because it can significantly reduce their tax liability. This results because in calculating the revalued reserves there is a direct effect on the size of the reserve deduction.

GAO found

The current law provides two methods of revaluing reserves: (1) exact revaluation or (2) approximate revaluation. The latter allows an increase of $21 per thousand dollars of the amount at risk for permanent insurance plans. Such an allowance is no longer appropriate as it results in unwarranted reserve deductions.

GAO concludes

The $21 per thousand dollars of amount at risk is greater than what is actuarially needed. A lower allowance is more

appropriate today because of changes in product offerings and reserve methods prevalent in the industry.

GAO recommends

Only $15 per thousand dollars of the amount at risk be allowed in revaluing reserves for permanent insurance plans. Legislative language amending Section 818(c)(2)(A) is provided in appendix VI.

RECOMMENDATIONS FOR STUDY OF SIX PROVISIONS

There are six additional provisions of LICITA that we feel merit further consideration by the Congress. The six provisions concern:

--deferred annuities,

--the definition of a life company,

--the definition of life insurance reserves,

--the deduction for investment expenses,

--the definition of assets, and

--the use of modified coinsurance for tax avoidance.

Section 805(e)--deferred annuities

The major consideration with deferred annuity contracts is the appropriateness of the interest deduction that companies writing this business are permitted. These investment type contracts are designed to take advantage of current high interest rates. The favorable tax treatment currently applicable to these contracts merits the consideration of the Congress, which should decide either to specifically legislate the continued favorable treatment of this business or to legislate that favorable tax treatment at the Federal level is unwarranted. When considering this issue, the Congress must once again decide the issue of taxation at the corporate or individual levels.

Section 801(a)--life insurance company defined

The primary problem arising from this provision is the qualification of credit reinsurance companies for taxation under the provisions of LICITA. It does not seem appropriate for a company whose primary source of income is credit A and H reinsurance to be taxed under provisions of the Code intended for life insurance companies. The issue lies in the nature of the company's reserves. Basic changes in the language of this provision are required.

Section 801(b)--life insurance reserves defined

As with the previous section, the issue here is the nature of a company's reserves. The language in this section states that reserves must be "required by law," but there have been differences of opinion as to what this means. If a State insurance department requests a company to set up specific reserves, do these reserves qualify as required by law? It is possible that further research will indicate that the problems with this section can appropriately be resolved administratively.

Section 804(c)(1)--investment expenses

As noted previously, this section of the law mentions investment expenses but does not provide a specific definition. It appears that this section will require amendment if only to provide a definition.

Section 805(b)(4)--assets

It would appear that clarifying the definition of assets would reduce litigation.

Section 820--modified coinsurance

Nobody questions that reinsurance transactions are a necessary and integral part of the insurance business. However, it is a fact that possibilities exist for tax avoidance through unnecessary or questionable reinsurance. Further research is required to determine the extent of any abuses of reinsurance, and we recommend that the Congress examine this section carefully in any evaluation of LICITA.

HOW THE LAW WORKS: AN ILLUSTRATION

The following is a detailed explanation of how the tax formula works and an illustrative case example showing how taxable income is computed.

The formula for computing taxable income is conventionally divided into three parts, commonly referred to as Phases I, II, and III. The formula recognizes not only investment income but also underwriting income and capital gains in computing tax liability.

PHASE I: TAXABLE INVESTMENT INCOME

A company will have taxable income if the investment yield is greater than the amount needed by the company to meet future contractual requirements. Figure 7 shows how taxable investment income is calculated.

Taxable investment income is an amount, not less than zero, equal to:

--the company's share of each item of investment income, plus

--the excess of the net long-term capital gain over the net short-term capital loss, less

--the company's share of tax-exempt interest and the dividends received deduction, and less

--the small business deduction.

To calculate the Phase I taxable investment income, certain deductions are permitted as reductions from gross investment income. The resulting figure is called net investment income or investment yield.

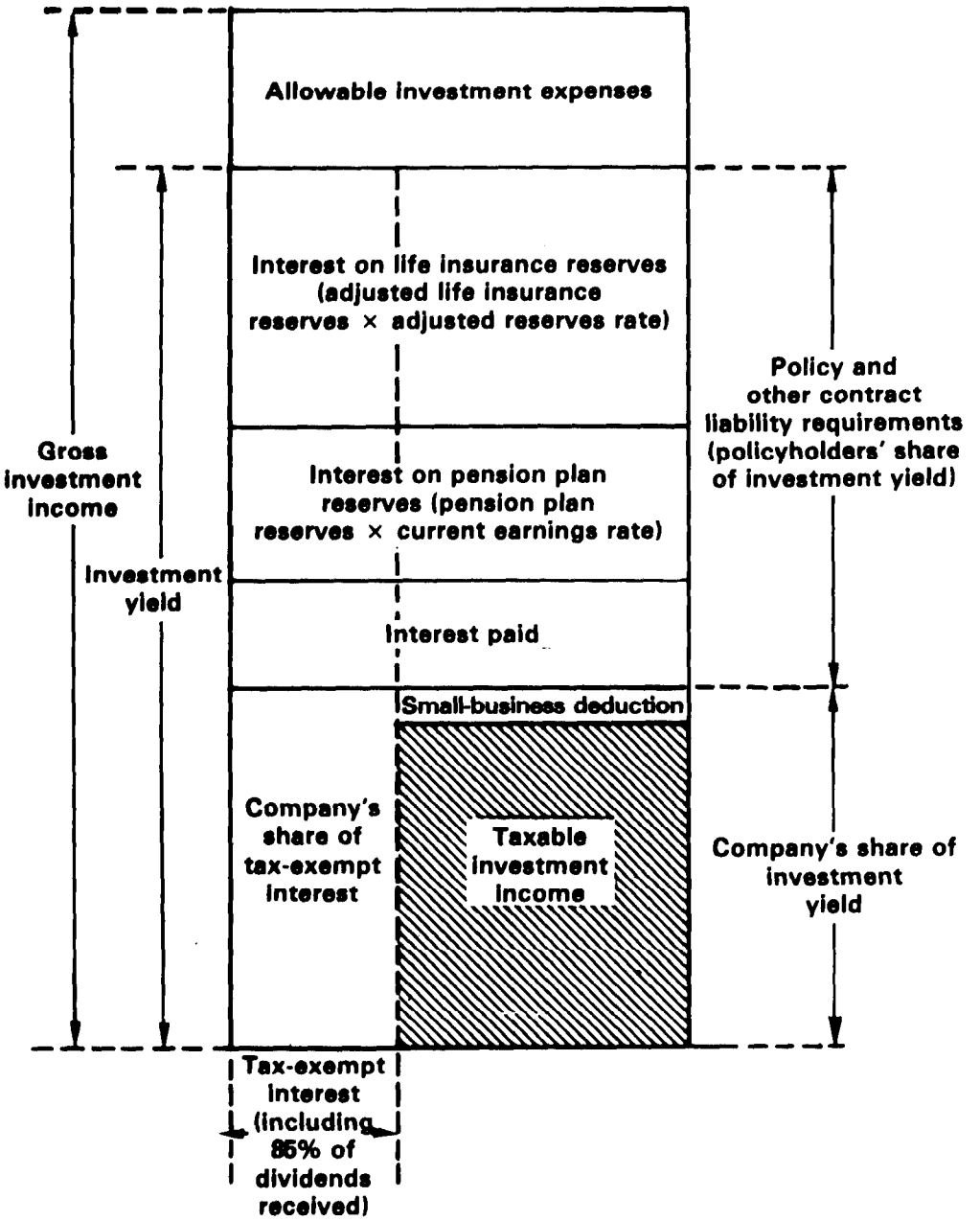
Net investment income is divided between the policyholders and the company. The company's share, after certain deductions, is taxable investment income (Phase I).

The eleven-step process for calculating taxable investment income is explained here using a hypothetical company as an example. 1/

1/This example was adapted from Stuart Schwarzschild and Eli Zubay, Principles of Life Insurance, (Homewood, Ill.: Richard D. Irwin, 1964), vol. 2, pp. 203-7.

FIGURE 7

CALCULATION OF TAXABLE INVESTMENT INCOME



Source: Peter W. Plumley, "Certain Inequities in the Life Insurance Company Income Tax Act of 1959," TSA, vol. 28, (1976), p. 14.

Step 1. Compute the investment yield.

Gross Investment Income:

Taxable interest	$1,600,000	
Tax-exempt interest	60,000	
Dividends received (subject to an 85 percent deduction; see Step 9 below)	40,000	
Rental income	200,000	
Short-term capital gain	50,000	
Total gross investment income		$1,950,000

Deductions:

Salaries of investment department	$50,000	
Service fees paid for collecting mortgage interest	50,000	
Investment services, etc.	10,000	
Tax on rental property	20,000	
Other investment expenses	20,000	
Total deductions		150,000
Investment yield		$1,800,000

Step 2. Determine the current earnings rate on the invested assets of the company. If, for example, a company had beginning and ending invested assets as shown, the current earnings rate would be computed as follows:

Invested Assets at beginning of year	$29,000,000
Invested Assets at end of year	31,000,000

$$\text{Mean Invested Assets} = \frac{\$29,000,000 + \$31,000,000}{2} = \$30,000,000$$

$$\frac{\text{Investment yield (from Step 1)}}{\text{Mean invested assets}} = \text{Current Earnings Rate}$$

$$\frac{\$\ 1,800,000}{\$30,000,000} = 0.06 \text{ or } 6.0 \text{ percent}$$

Step 3. Determine the average earnings rate over the current year and preceding four years.

Year	Current Earnings Rate (percent)	Average Earnings Rate (percent) for 5-year Period
1978 (current taxable year)	6.0	
1977 (first preceding year)	6.1	30.5
1976 (second preceding year)	6.1	5 = 6.1
1975 (third preceding year)	6.1	
1974 (fourth preceding year)	6.2	
Total	30.5	

Step 4. Determine the adjusted reserves rate by selecting the lower of the current earnings rate (Step 2) or the average earnings rate (Step 3). The adjusted reserves rate is used to compute the deduction for interest needed to maintain reserves.

Continuing with the illustration, the adjusted reserves rate would be the 6.0 percent current earnings rate since it is lower than the average earnings rate of 6.1 percent.

Step 5. Compute the average interest rate assumed that the company uses on its reserves. This computation is illustrated for various blocks of reserves that might be held.

(a) Assumed Rate (Percent)	(b) Reserve Dec. 31 1977	(c) Reserve Dec. 31 1978	(d) Mean Reserves b + c / 2	(e) Product of Rate x Mean Reserve (a x d)
3.5	$ 9,000,000	$11,000,000	$10,000,000	$350,000
3.0	4,000,000	6,000,000	5,000,000	150,000
2.5	8,000,000	12,000,000	10,000,000	250,000
	$21,000,000	$29,000,000	$25,000,000	$750,000

$$\text{Average Interest Rate Assumed} = \frac{\text{Product of Rate x Mean Reserves}}{\text{Mean Reserves}}$$

$$= \frac{\$750,000}{\$25,000,000} = .03 \text{ or } 3.0 \text{ percent}$$

Step 6. Calculate the adjusted life insurance reserves. The mean of the life insurance company's reserves for the current year, other than pension plan reserves, is reduced by 10 percent for each 1 percent that the adjusted reserves rate exceeds the average interest rate assumed.

Adjusted reserves rate (Step 4)	6.0 percent
Average interest rate assumed (Step 5)	3.0
Difference	3.0 percent

Therefore, the reserves must be adjusted downward by 30 percent because the adjusted reserves rate exceeds the average interest rate assumed by 3.0 percent.

Adjusted life insurance reserves = mean of life insurance reserves x rate of adjustment

= $25,000,000 (Step 5) x (1.00 - .30)

= $25,000,000 x .70

= $17,500,000

Step 7. Compute the reserve interest deduction allowed for the year by multiplying the adjusted life insurance reserves ($17,500,000) by the adjusted reserves rate (0.06) which will equal the reserve interest deduction allowed ($1,050,000).

Step 8. Next, the allowable reserve interest deduction ($1,050,000) is subtracted from the investment yield ($1,800,000), leaving the company's share of the investment yield ($750,000).

Step 9. The company is allowed further deductions for its share of tax-exempt interest in the investment yield and for a part of the dividends received deduction.

The ratio of the company's share of the investment yield to total investment yield is:

$$\frac{\text{Company's share of investment yield}}{\text{Investment yield}} = \frac{\$\ 750,000}{\$1,800,000} = 0.42$$

The tax-exempt interest received was $60,000 (Step 1). Therefore:

Tax-exempt interest received	$60,000
Company's share of investment yield	x0.42
Company's share of tax-exempt interest	$25,200

The dividends received were $40,000 (Step 1). Therefore:

Dividends received subject to 85 percent deduction	$40,000
Company's share of investment yield	x0.42
Company's share of dividends	$16,800
	x0.85
Dividends-received deduction	$14,280

Step 10. The next step on the way to determining taxable investment income is to subtract the company's share of tax-exempt interest and the 85 percent dividends received deduction from the company's share of investment yield.

Company's share of investment yield (Step 8), less:		$750,000
Company's share of tax-exempt interest (Step 9)	$25,200	
85 percent of company's share of dividends received (Step 9)	14,280	39,480
		$710,520

Step 11. One further reduction is available to all companies, the small business deduction. This deduction is equal to 10 percent of the company's share of investment yield up to a maximum of $25,000.

Calculation from Step 10	$710,520
less: Small Business deduction (maximum $25,000)	25,000
Taxable investment income (Phase I income)	$685,520

PHASE II: GAIN (LOSS) FROM OPERATIONS

The other part of taxable income is gain from operations, which is the sum of income from all sources, including the company's share of investment yield (calculated, however, without adjusting reserves, as is done in the Phase I computation). This amount is equal to:

--the company's share of all items of investment income,

--the excess of net long-term capital gains over net short-term capital losses,

--the gross amount of all premiums and other considerations on insurance and annuity contracts,

--the net decrease in certain reserves,

--any other amounts deemed to be gross income but not otherwise taken into account, less

--the deductions allowed by the Internal Revenue Code.

In other words, gain from operations is income that results when the aggregate premiums received and the company's share of investment yield exceed the amounts paid for claims and expenses and the special deductions. Three special deductions are allowed and the sum of the three is limited to $250,000 plus the excess of the gain from operations over the taxable investment income. These special deductions are permitted in the following order:

--dividends paid to policyholders,

--2 percent of the group life insurance premiums and accident and health premiums, and

--the larger of 10 percent of the increase in reserves for nonparticipating contracts or 3 percent of the premiums attributable to nonparticipating contracts issued or renewed for a period of 5 or more years.

If the gain from operations exceeds the taxable investment income (Phase I), half of the difference is recognized as Phase II taxable income and is added to taxable investment income (Phase I) to produce the tentative total taxable income. The other half is deferred for possible tax under Phase III. The taxable amount is still tentative because the company may be subject to Phase III taxes on previously deferred income.

Continuing with the illustration, assume the company had a gain from operations of $1,500,000. The tentative taxable income after Phases I and II would be:

Gain from operations,	$1,500,000
less Taxable investment income (Phase I)	685,520
	$ 814,480
Phase II	
1/2 x $814,480 difference	407,240
Tentative taxable income:	
Taxable investment income (Phase I)	685,520
1/2 gain from operations (Phase II)	407,240
Total	$1,092,760

PHASE III: SHAREHOLDERS' AND POLICYHOLDERS' SURPLUS ACCOUNTS

For Federal income tax purposes, the surplus of a company is divided into two memorandum accounts, a Shareholders' Surplus Account and a Policyholders' Surplus Account. These two accounts, which are not balance sheet items, apply only to stock life insurance companies and have no relationship to the accumulated earnings and profits of the company for other than Federal income tax purposes.

The amount in the Shareholders' Surplus Account is an accumulation of amounts of surplus on which taxes have been paid and certain other tax-exempt income. The Policyholders' Surplus Account is an accumulation of taxable income that has been deferred from taxation and will be subject to tax before being distributed or made available to stockholders.

Shareholders' Surplus Account

For stock life insurance companies, the Shareholders' Surplus Account was established, by law, with a zero balance as of January 1, 1958.

Additions to this account include:

--life insurance company taxable income (not counting deductions from the Policyholders' Surplus Account);

--deductions for dividends received;

--tax-exempt interest;

--small business deduction;

--the excess of net long-term capital gain over short-term capital loss; less

--Federal income taxes for the year (not counting taxes on reductions of the Policyholders' Surplus Account).

Amounts are also added to the account when:

--the company elects to transfer amounts from the Policyholders' Surplus Account, or

--a reduction in the Policyholders' Surplus Account is required because the limitation on the maximum amount in the account is exceeded.

Reductions in the account consist of distributions to shareholders during the year. The distributions are limited in that they cannot reduce the account balance below zero.

For tax purposes, any distributions to shareholders are considered to come from the Shareholders' Surplus Account as long as the account has a positive balance and then from the Policyholders' Surplus Account.

Policyholders' Surplus Account

Stock companies were required to establish a Policyholders' Surplus Account with a zero balance as of January 1, 1959.

The balance in the account consists of income on which tax has been deferred, plus other special deductions. A tax is imposed on any amounts distributed from the account.

Additions to the account include:

--50 percent of the amount by which the gain from operations exceeds taxable investment income,

--the deduction allowed for certain nonparticipating contracts, and

--the deduction allowed for accident and health and group life insurance contracts.

Reductions in the account are considered to be made in the following order:

--actual distributions to shareholders that are deemed to be paid from this account plus Federal income taxes imposed on the distribution,

--any amount the company elects to transfer to its Shareholders' Surplus Account,

--amounts that are required to reduce the balance in the account to the maximum permitted by law, and

--amounts resulting at the termination of life insurance company status.

LICITA limits the balance in the account to the greater of:

--50 percent of the net premiums and other considerations for the year, or

--15 percent of the life insurance reserves at the end of the year, or

--25 percent of the excess reserves at the end of the year over such reserves at the end of 1958.

Deductions from the Policyholders' Surplus Account must be "grossed up" by the amount of Federal income tax that is imposed under Phase III. For example, suppose the company wished to distribute $54,000 to its shareholders from the Policyholders' Surplus Account. Assuming a 46 percent corporate tax rate, $100,000 would have to be deducted from the account.

TOTAL TAX LIABILITY

To conclude our illustration, the total tax liability in all three phases for a hypothetical company is summarized as follows.

Taxable Income:

Phase I	$ 685,520
Phase II	407,240
Phase III	100,000
Total	$1,192,760

APPENDIX I

Income Tax Liability:

17% x $	25,000 =	$ 4,250
20% x	25,000 =	5,000
30% x	25,000 =	7,500
40% x	25,000 =	10,000
46% x	1,092,760 =	$502,670
Totals	$1,192,760	$529,420

EFFECT OF ALTERNATIVE CHANGES ON SAMPLE COMPANIES, 1974-1978

This appendix provides the summary results of our simulation of the revenue effects of various alternative changes to LICITA on our 42 sample companies. These changes, presented in the five tables which follow, include:

--substituting the actual required interest for the 10 to 1 approximation with the actual requirement based on assumed rates;

--replacing the 10 to 1 rule with a reserve deduction based on a geometric approximation;

--substituting a 4.5 percent maximum for the average earnings rate with the 10 to 1 reserve adjustment or with the geometric reserves adjustment; and

--eliminating the one-half deferral of underwriting gain.

APPENDIX II

Table 24

Impact of Some Suggested Revisions of LICITA on a Sample of 42 Companies

1974

	24 MUTUAL	18 STOCK	COMBINED
Current Earnings Rate (Avg %)	5.8098	6.0522	5.9137
Assumed Rate (Avg %)	2.6736	2.9064	2.7877
Total Tax - Current Law (millions)	$1,059	$ 322	$1,381
Total Tax - Free Interest (millions)	$1,587	$ 409	$1,996
Percent change from current law	+50%	+27%	+45%
Total Tax - Geometric (millions)	$1,004	$ 314	$1,318
Percent change from current law	-5%	-3%	-5%
Total Tax - w/o 50% Deferral (millions)	$1,059	$ 326	$1,385
Percent change from current law	0%	+1%	0%
Total Tax - 4.5 percent & 10-1 (millions)	$1,167	$ 343	$1,510
Percent change from current law	+10%	+7%	+9%
Total Tax - 4.5 percent & Geometric (millions)	$1,153	$ 341	$1,494
Percent change from current law	+9%	+6%	+8%

Table 25

Impact of Some Suggested Revisions of LICITA on a Sample of 42 Companies

1975

	24 MUTUAL	18 STOCK	COMBINED
Current Earnings Rate (Avg %)	5.9035	6.2476	6.0510
Assumed Rate (Avg %)	2.7089	2.9118	2.7959
Total Tax - Current Law (millions)	$1,091	$ 334	$1,425
Total Tax - Free Interest (millions)	$1,651	$ 422	$2,073
Percent change from current law	+51%	+26%	+46%
Total Tax - Geometric (millions)	$1,022	$ 322	$1,344
Percent change from current law	-6%	-4%	-6%
Total Tax - w/o 50% Deferral (millions)	$1,091	$ 343	$1,434
Percent change from current law	0%	+3%	+1%
Total Tax - 4.5 percent & 10-1 (millions)	$1,219	$ 364	$1,583
Percent change from current law	+12%	+9%	+11%
Total Tax - 4.5 percent & Geometric (millions)	$1,205	$ 357	$1,562
Percent change from current law	+11%	+7%	+10%

Table 26

Impact of Some Suggested Revisions of LICITA on a Sample of 42 Companies

1976

	24 MUTUAL	18 STOCK	COMBINED
Current Earnings Rate (Avg %)	6.1032	6.4320	6.2442
Assumed Rate (Avg %)	2.7234	2.9277	2.8083
Total Tax - Current Law (millions)	$1,212	$ 380	$1,592
Total Tax - Free Interest (millions)	$1,789	$ 477	$2,266
Percent change from current law	+48%	+26%	+42%
Total Tax - Geometric (millions)	$1,131	$ 366	$1,497
Percent change from current law	-7%	-4%	-6%
Total Tax - w/o 50% Deferral (millions)	$1,212	$ 388	$1,600
Percent change from current law	0%	+2%	+1%
Total Tax - 4.5 percent & 10-1 (millions)	$1,353	$ 407	$1,760
Percent change from current law	+12%	+7%	+11%
Total Tax - 4.5 percent & Geometric (millions)	$1,339	$ 405	$1,744
Percent change from current law	+11%	+7%	+10%

APPENDIX II

Table 27

Impact of Some Suggested Revisions of LICITA on a Sample of 42 Companies

1977

	24 MUTUAL	18 STOCK	COMBINED
Current Earnings Rate (Avg %)	6.3671	6.5841	6.4601
Assumed Rate (Avg %)	2.7410	2.9524	2.8316
Total Tax - Current Law (millions)	$1,337	$ 470	$1,807
Total Tax - Free Interest (millions)	$1,938	$ 574	$2,512
Percent change from current law	+45%	+22%	+39%
Total Tax - Geometric (millions)	$1,236	$ 450	$1,686
Percent change from current law	-8%	-4%	-7%
Total Tax - w/o 50% Deferral (millions)	$1,337	$ 477	$1,814
Percent change from current law	0%	+2%	0%
Total Tax - 4.5 percent & 10-1 (millions)	$1,494	$ 500	$1,994
Percent change from current law	+12%	+6%	+10%
Total Tax - 4.5 percent & Geometric (millions)	$1,480	$ 499	$1,979
Percent change from current law	+11%	6%	+10%

APPENDIX II

Table 28

Impact of Suggested Revisions
of LICITA on a Sample of 42 Companies

1978

	24 MUTUAL	18 STOCK	COMBINED
Current Earnings Rate-(Avg %)	6.6854	6.9649	6.8052
Assumed Rate (Avg %)	2.7704	2.9773	2.8591
Total Tax - Current Law (millions)	$1,562	$ 550	$2,112
Total Tax - Free Interest (millions)	$2,205	$ 664	$2,869
Percent change from current law	+41%	+21%	+36%
Total Tax - Geometric (millions)	$1,439	$ 525	$1,964
Percent change from current law	-8%	-5%	-7%
Total Tax - w/o 50% Deferral (millions)	$1,562	$ 555	$2,117
Percent change from current law	0%	+1%	0%
Total Tax - 4.5 percent & 10-1 (millions)	$1,738	$ 584	$2,322
Percent change from current law	+11%	+6%	+10%
Total Tax - 4.5 percent & Geometric (millions)	$1,725	$ 583	$2,308
Percent change from current law	+10%	+6%	+9%

RESERVE REVALUATION

SECTION 818(c)(2)

RESERVE REVALUATION

Two methods of valuing reserves are commonly used by U.S. life insurance companies--the net level premium method and the preliminary term method. The distinction between the two methods stems from the high proportion of expenses associated with an individual policy that occur in the first year of the contract. Agents are ordinarily paid a large commission upon the issuance of a policy and smaller commissions when the policy is renewed in subsequent years. Also, the cost of medically examining a potential policyholder--investigating his or her acceptability as an insurance risk, underwriting expenses, and related clerical costs--add up to large expenses that are payable out of the first year's premium. During the early years of a life contract, the company may actually incur a deficit since expenses and claims plus the allocation to reserves can surpass the initial premiums received.

An older, well-established life company can cover such a deficiency out of retained surplus, but a newer less-established company could easily exhaust its resources or inhibit its potential for future growth. Because of this problem the preliminary term method was developed. The company using this method reduces its initial allocation to reserves. The first year allocation to reserves might average $2.50 per $1,000 of the amount of a whole life contract as compared to a net level allocation of $18-$19. Thereafter, companies using preliminary term make a larger allocation to reserves than required, if a net level were used, until the two reserves become equal at some future time.

As mentioned earlier, all life insurance companies are permitted an election to revalue reserves computed on the preliminary term basis. The revaluation is permitted primarily to benefit small and new companies that prefer to calculate reserves on the preliminary term basis. They prefer using preliminary term because it produces a larger surplus on company books than if they had used the net level premium basis.

The Code permits this revaluation under two methods:

--exact revaluation, which for some companies might be expensive and difficult to calculate; or

--approximate revaluation, which is accomplished by adding to reserves $21 per thousand dollars of the amount at risk for permanent policies and $5 per thousand dollars of the amount at risk for term policies of more than 15 years.

The latter method of revaluation is herein referred to as the "21-5" addition. As stated in chapter 7, we found that while the $5 per thousand dollars of the amount at risk was appropriate for term insurance of more than 15 years, the $21 per thousand dollars addition for permanent insurance resulted in unwarranted reserves. The purpose of this appendix is first to document the reasons why the $21 figure is inappropriate and second to support the appropriateness of the $5 figure.

RESERVE REVALUATION FOR PERMANENT POLICIES

The following factors influence the amount of the adjustment:

--the mortality table used for reserves,

--the interest rate assumed for reserves,

--the preliminary term method used,

--the particular plan of insurance,

--the policyholder's age and sex at issuance of the policy, and

--the length of time the policy has been in force.

The reserve basis used in this appendix is the 1958 Commissioners Standard Ordinary (CSO) Table, 3.5 percent Commissioners Reserve Valuation Method (CRVM) (continuous functions). In our analysis we used six representative ages at issue for the whole life plan for male lives. For the policy year we used years 1,3,5,7, . . . to 25, plus the years 30, 35, and 40. We combined the figures to get the effect of a model office, using an adaptation of the figures from the Fact Book 1980 to obtain the weighting by age at issue. The weighting by policy year was done by assuming that each policy year after the first would have a weight of 90 percent of the previous year in order to allow for the effect of both lapses and lower levels of sales in prior years.

Despite the fact that graded reserve methods are relatively common since 1959, we used the CRVM. Graded reserve methods likely do not yet represent a majority of the preliminary term business in force and probably not even a majority of the current business issued. Also, the use of a graded method would result in a much lower adjustment figure. For our purposes in arriving at a single figure to be applied in all situations, however, we felt that the CRVM with its larger adjustments was appropriate.

Issue age weights are very important because the differences between net level and preliminary term reserves increase greatly as the issue age increases. In order to arrive at a figure as representative of the industry as possible, we used data from the Fact Book 1980 (p. 14) representing the distribution of the 1978 issued business by age. A distribution of the business in

force by issue age would have been preferable, but these figures were not available. The distribution figures from the Fact Book were adapted to fit the six ages selected for our study.

Table 29 presents the net level mean reserves for each of the six ages, the CRVM mean reserves, and the differences between them

Table 30 shows the amount at risk for each issue age and policy year combinations. This amount is obtained by subtracting the CRVM reserve from $1,000. The differences between the two types of reserve (shown in table 1) are next divided by the amount at risk figures (on a unit basis) to put them on an amount at risk basis.

Table 31 shows the factors used to weight, first by policy year and then by issue age, the reserve differences presented in table 2. This table also shows a percentage distribution of the figures needed to obtain the policy year weights.

Table 32 takes the amount at risk basis reserve differences and multiplies them by the policy year weights (shown in column 1, which is reproduced from table 3). These products are shown for each policy year and issue age combination and are summed by issue age. The issue age weights from table 3 are then applied to derive a single weighted figure for each issue age. The sum of the six issue age figures represents the appropriate adjustment figure per $1,000 amount at risk based on this methodology and assumptions.

In our recommendations, we have put forth $15 per thousand dollars of the amount at risk as a more reasonable method of revaluing reserves using an approximate method. The $15 figure was selected rather than the precise $14.50 derived in our calculations because it was felt to be a reasonable approximation, considering that our calculations are based on assumptions that will usually vary from company to company.

RESERVE REVALUATION FOR TERM POLICIES

The approximate revaluation for term policies of more than 15 years is currently $5 per $1,000 of the amount at risk. Studies similar to those outlined for whole life policies were done for term plans. The CRVM reserve basis was used as representing the preliminary term, and differences between CRVM and net level mean reserves were calculated. The ages at issue used were 15, 25, 35, 45, and 55. The selection of a plan of term insurance to be used was more difficult than in the case of the whole life studies. This difficulty arises because term plans greater than 15 years are not issued now to the same extent that they were in 1959 when the Act was passed.

Table 29

Differences Between Net Level & CRVM Mean Reserves Per $1000
1958 CSO 3 1/2% Continuous Functions
Whole Life-Male
(All amounts below are dollars)

Year	Age at issue--15			Age at issue--25			Age at issue--35		
	Net Level	CRVM	Diff.	Net Level	CRVM	Diff.	Net Level	CRVM	Diff.
1	6.72	.85	5.87	9.59	1.15	8.44	14.42	1.58	12.84
3	19.22	13.42	5.80	27.78	19.50	8.28	41.99	29.51	12.48
5	32.36	26.64	5.72	47.19	39.08	8.11	70.95	58.86	12.09
7	46.27	40.63	5.64	67.88	59.95	7.93	101.17	89.48	11.69
9	61.09	55.54	5.55	89.90	82.16	7.74	132.59	121.31	11.28
11	76.92	71.47	5.45	113.31	105.77	7.54	165.17	154.33	10.84
13	93.85	88.50	5.35	138.07	130.74	7.33	198.85	188.45	10.40
15	111.93	106.68	5.25	164.08	156.97	7.11	233.50	223.56	9.94
17	131.18	126.05	5.13	191.21	184.34	6.87	268.95	259.48	9.47
19	151.68	146.67	5.01	219.42	212.79	6.63	305.09	296.09	9.00
21	173.47	168.60	4.87	248.68	242.31	6.37	341.77	333.26	8.51
23	196.51	191.78	4.73	278.92	272.81	6.11	378.84	370.83	8.01
25	220.73	216.13	4.60	310.03	304.19	5.84	416.07	408.56	7.51
30	285.74	281.54	4.20	390.72	385.59	5.13	508.40	502.11	6.29
35	356.58	352.80	3.78	473.96	469.55	4.41	596.19	591.05	5.14
40	431.69	428.37	3.32	556.87	553.17	3.70	675.52	671.44	4.08

Source: Reserve tables, Society of Actuaries.

APPENDIX III

Age at issue--45			Age at issue--55			Age at issue--65		
Net Level	CRVM	Diff.	Net Level	CRVM	Diff.	Net Level	CRVM	Diff.
21.76	3.22	18.54	33.22	7.52	25.70	51.67	17.97	33.70
61.35	43.57	17.78	88.13	63.90	24.23	124.07	92.99	31.08
102.07	85.08	16.99	143.28	120.55	22.73	193.83	165.27	28.56
143.74	127.56	16.18	198.34	177.10	21.24	260.45	234.30	26.15
186.21	170.84	15.37	252.97	233.21	19.76	324.40	300.56	23.84
229.33	214.79	14.54	306.83	288.52	18.31	386.52	364.93	21.59
272.89	259.20	13.69	359.40	342.52	16.88	446.72	427.31	19.41
316.66	303.81	12.85	410.04	394.53	15.51	503.76	486.42	17.34
360.35	348.34	12.01	458.41	444.22	14.19	556.53	541.10	15.43
403.71	392.54	11.17	504.85	491.90	12.95	604.99	591.31	13.68
446.44	436.10	10.34	549.96	538.22	11.73	650.00	637.95	12.05
488.16	478.61	9.55	593.66	583.11	10.55	692.70	682.19	10.51
528.35	519.58	8.77	635.07	625.65	9.42	734.45	725.45	9.00
621.59	614.62	6.97	725.17	718.19	6.98	845.01	840.01	5.00
706.92	701.60	5.32	802.57	797.68	4.89	1007.98	1008.88	-.90
778.42	774.47	3.95	882.83	880.12	2.71			

Table 30

Adjustment of Differences to Amount at Risk Basis

Policy Year	Age 15		Age 25		Age 35		Age 45		A
	Col. 1a/	Col. 2b/	Col. 1a/	Col. 2b/	Col. 1a/	Col. 2b/	Col. 1a/	Col. 2b/	Col.
1	999.15	5.87	998.85	8.45	998.42	12.86	996.78	18.60	992.
3	986.58	5.88	980.50	8.44	970.49	12.86	956.43	18.59	936.
5	973.36	5.88	960.92	8.44	941.14	12.85	914.92	18.57	879.
7	959.37	5.88	940.05	8.44	910.52	12.84	872.44	18.55	822.
9	944.46	5.88	917.84	8.43	878.69	12.84	829.16	18.54	766.
11	928.53	5.87	894.23	8.43	845.67	12.82	785.21	18.52	711.
13	911.50	5.87	869.26	8.43	811.55	12.81	740.80	18.48	657.
15	893.32	5.87	843.03	8.43	776.44	12.80	696.19	18.46	605.
17	873.95	5.87	815.66	8.42	740.52	12.79	651.66	18.43	555.
19	853.33	5.87	787.21	8.42	703.91	12.79	607.46	18.39	508.
21	831.40	5.86	757.69	8.41	666.74	12.76	563.90	18.34	461.
23	808.22	5.85	727.19	8.40	629.17	12.73	521.39	18.32	416.
25	783.87	5.87	695.81	8.39	591.44	12.70	480.42	18.25	374.
30	718.46	5.85	614.41	8.35	497.89	12.63	385.38	18.09	281.
35	647.20	5.84	530.45	8.31	408.95	12.57	298.40	17.83	202.
40	571.63	5.81	446.83	8.28	328.56	12.42	225.53	17.51	119.

a/Col. 1 shows amount at risk per $1000.
b/Col. 2 shows the differences in reserves per 1000 divided by the amount at risk p

APPENDIX III

Table 31

Weights Used in Calculating Approximate Method Preliminary Term Adjustment

Policy year

Policy Year n	Business in force Adjustment $.90^{n-1}$	% Dist
1	1.0000 a/	.1995
3	.8100	.1616
5	.6561	.1308
7	.5314	.1060
9	.4304	.0858
11	.3487	.0695
13	.2824	.0563
15	.2288	.0456
17	.1853	.0370
19	.1501	.0299
21	.1216	.0243
23	.0985	.0196
25	.0798	.0159
30	.0471	.0094
35	.0278	.0055
40	.0164	.0033
	5.0144	1.0000

Issue age

Issue Age	%Weighting
15	5%
25	30%
35	32%
45	18%
55	10%
65	5%
	100%

a/Assumes lapses at end of the year.

Source: Adapted from Fact Book 1980, p. 14.

APPENDIX III

Table 32

Calculation of Weighted Adjustment
per $1,000 Amount at Risk

Policy Year	% Dist. by Pol. Year	15 %Dist. x	25 Difference	35 in	45 reserves per	55 $1000 amt.	65 at risk
1	.1995	$1.17	$1.69	$2.57	$3.71	$5.17	$6.85
3	.1616	.95	1.36	2.08	3.00	4.18	5.53
5	.1308	.77	1.10	1.68	2.43	3.38	4.47
7	.1060	.62	.89	1.36	1.97	2.74	3.62
9	.0858	.50	.72	1.10	1.59	2.21	2.92
11	.0695	.41	.59	.89	1.29	1.79	2.36
13	.0563	.33	.47	.72	1.04	1.45	1.91
15	.0456	.27	.38	.58	.84	1.17	1.54
17	.0370	.22	.31	.47	.68	.94	1.24
19	.0299	.18	.25	.38	.55	.76	1.00
21	.0243	.14	.20	.31	.45	.62	.81
23	.0196	.11	.16	.25	.36	.50	.65
25	.0159	.09	.13	.20	.29	.40	.52
30	.0094	.05	.08	.12	.17	.23	.29
35	.0055	.03	.05	.07	.10	.13	---
40	.0033	.02	.04	.04	.06	.07	---
TOTAL ALL YEARS		$5.86	$8.42	$12.82	$18.53	$25.74	$33.71
APPLYING ISSUE AGE WEIGHTS		x .05	x .30	x .32	x .18	x .10	x.05
		$ .29	$2.52	$ 4.10	$ 3.34	$ 2.57	$ 1.69

TOTAL ALL ISSUE AGES AND POLICY YEARS ---------$14.51

Table 33

Differences Between Net Level & CRVM Mean Reserves Per $1000
1958 CSO 3 1/2% - Continuous Functions
Male-Term to 65 (20 Y.T. For Age 55)

	Age at issue--15			Age at issue--25			Age at issue--35		
Year	N.L.	CRVM	NL-CRVM	N.L.	CRVM	NL-CRVM	N.L.	CRVM	NL-CRVM
1	3.46	.77	2.69	4.68	1.03	3.65	6.85	1.36	5.49
3	9.09	6.45	2.64	12.51	8.96	3.55	18.44	13.19	5.29
5	14.84	12.25	2.59	20.78	17.33	3.45	30.17	25.18	4.99
7	20.81	18.27	2.54	29.48	26.14	3.34	41.76	37.04	4.72
9	27.08	24.59	2.49	38.58	35.37	3.21	52.99	48.56	4.43
11	33.72	31.30	2.42	48.08	44.99	3.09	63.63	59.52	4.11
13	40.76	38.40	2.36	57.83	54.88	2.95	73.37	69.57	3.80
15	48.19	45.90	2.29	67.60	64.80	2.80	81.74	78.28	3.46
17	55.98	53.77	2.21	77.13	74.48	2.65	88.18	85.09	3.09
19	64.13	62.00	2.13	86.18	83.70	2.48	92.05	89.34	2.71
21	72.59	70.55	2.04	94.52	92.21	2.31	92.52	90.23	2.29
23	81.24	79.29	1.95	101.82	99.70	2.12	88.55	86.70	1.85
25	89.85	88.00	1.85	107.62	105.69	1.93	78.70	77.31	1.49
31	112.88	111.35	1.53	109.74	108.46	1.28			
37	125.13	123.98	1.15	67.63	67.14	.49			
43	110.79	110.10	.69						

	Age at issue--45			Age at issue--55		
Year	N.L.	CVRM	NL-CRVM	N.L.	CVRM	NL-CRVM
1	9.70	2.81	6.89	22.28	6.98	15.30
3	23.68	17.33	6.35	53.70	39.65	14.05
5	36.54	30.76	5.78	82.70	69.94	12.76
7	47.72	42.56	5.16	108.26	96.85	11.41
9	56.62	52.09	4.53	129.10	119.09	10.01
11	62.45	58.61	3.84	143.49	134.94	8.55
13	64.21	61.10	3.11	148.91	141.93	6.98
15	60.54	58.22	2.32	141.72	136.43	5.29
17	49.64	48.18	1.46	117.13	113.73	3.40
19	29.16	28.65	.51	69.20	67.98	1.22

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Term plans currently being issued for a period longer than 15 years are almost always of the decreasing term variety usually used for mortgage protection. The reserves for these plans vary by the actual schedule of amounts of insurance by policy year duration, among other things. These schedules of amounts of insurance by policy year duration vary from company to company, and no published tables of reserves were available. Because of this, we used for our test the longest term plan available to us, i.e., the level term to age 65 plan. For age 55 we used 20 years since the term to 65 at this age is only a 10 year plan and therefore not eligible for the $5 addition.

Because term plans are subject to an additional source of termination by conversion and since term plans normally have higher rates of termination than permanent plans, we assumed that the weighting for each year after the first would be 85 percent of the previous year (as compared with the 90 percent we used for testing the $21 adjustment for permanent plans).

The tables (33, 34, 35, and 36) calculated using the assumptions just outlined and the methodology used for the tables for permanent insurance shown in this appendix indicate that a figure of approximately $5.00 would be appropriate. We concluded that the $5 adjustment should not be changed.

Table 34

Adjustment of Differences in Reserves to Amount at Risk Basis

Policy Year	Age 15		Age 25		Age 35		Age 45		Age 55	
	Col. 1	Col. 2	Col. 1	Col. 2	Col. 1	Col. 2	Col. 1	Col. 2	Col. 1	Col. 2
1	.99923	2.69	.99897	3.65	.99864	5.50	.99719	6.91	.99302	15.41
3	.99355	2.66	.99104	3.58	.98681	5.36	.98267	6.46	.96305	14.59
5	.98775	2.62	.98267	3.51	.97482	5.12	.96924	5.96	.93006	13.72
7	.98173	2.59	.97386	3.43	.96296	4.90	.95744	5.39	.90315	12.63
9	.97541	2.55	.96463	3.33	.95144	4.66	.94791	4.78	.88091	11.36
11	.96870	2.50	.95501	3.24	.94048	4.37	.94139	4.08	.86506	9.88
13	.96160	2.45	.94512	3.12	.93093	4.08	.93890	3.31	.85807	8.13
15	.95410	2.40	.93520	2.99	.92172	3.75	.94178	2.46	.86357	6.13
17	.94623	2.34	.92552	2.86	.91491	3.38	.95182	1.53	.88627	3.84
19	.93800	2.27	.91630	2.71	.91066	2.98	.97135	.53	.93202	1.31
21	.92945	2.19	.90779	2.54	.90977	2.52				
23	.92071	2.12	.90030	2.35	.91330	2.03				
25	.91200	2.03	.89431	2.16	.92269	1.61				
31	.88865	1.72	.89154	1.44						
37	.87602	1.31	.93286	.53						
43	.88990	.78								

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Table 35

Weightings Used in Calculating Approximate Preliminary Term Adjustment
(For Term Plans Greater Than 15 Years)

Policy year

Policy Year n	Business in force Adjustment	$.85^n$	% Dist.
1	1.0000		.2808
3	.7225		.2029
5	.5220		.1466
7	.3771		.1060
9	.2725		.0765
11	.1969		.0553
13	.1422		.0399
15	.1028		.0289
17	.0743		.0209
19	.0536		.0150
21	.0388		.0109
23	.0280		.0074
25	.0202		.0057
31	.0076		.0021
37	.0029		.0008
43	.0011		.0003
	3.5625		1.0000

Issue age

Age	%Weighting
15	.05
25	.20
35	.30
45	.40
55	.05

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Table 36

Calculation of Weighted Adjustment Factors per $1,000 Amount at Risk

Policy Year	Percent Distribution By Policy Year	15 Percent Distribution Multiplied by Difference in Reserves per $1,000 Amount at Risk	25	35	45	55
1	.2808	$.76	$1.02	$1.54	$1.94	$4.33
3	.2029	.54	.73	1.09	1.31	2.96
5	.1466	.38	.51	.75	.87	2.01
7	.1060	.27	.36	.52	.57	1.34
9	.0765	.20	.25	.36	.37	.87
11	.0553	.14	.18	.24	.23	.55
13	.0399	.10	.12	.16	.13	.32
15	.0289	.07	.09	.11	.07	.18
17	.0209	.05	.06	.07	.03	.08
19	.0150	.03	.04	.04	.01	.02
21	.0109	.02	.03	.03	-	-
23	.0074	.02	.02	.02	-	-
25	.0057	.01	.01	.01	-	-
31	.0021	-	-	-	-	-
37	.0008	-	-	-	-	-
43	.0003	-	-	-	-	-
Total of all years		$2.59	$3.42	$4.94	$5.53	$12.66
Applying issue age Weightings		x .05	x .20	x .30	x .40	x .05
		$ .13	$ .68	$1.48	$2.21	$ .63

TOTAL OF ALL ISSUE AGES AND POLICY YEARS-------$5.13

AN EXAMINATION OF SMALL LIFE INSURANCE COMPANIES' TAXATION

This appendix examines the special case of taxation of small life insurance companies. We will discuss the nature and role of small life companies in the industry, special deductions in LICITA intended for small companies, the minor effect of the Act on small companies, and the effect of inflation on the 10 to 1 rule as it affects small companies.

THE NATURE AND ROLE OF SMALL COMPANIES

Since World War II there has been a phenomenal expansion in the number of life insurance companies that continues on a lesser scale today. The majority of these new companies are small stock companies, smaller than $25 million in asset size, and located principally in southern and western States that have minimal capital and surplus requirements. More than one-third of these companies are domiciled in Arizona and Texas. 1/

Growth in the number of Texas life insurance companies was at its peak during the 1950s. As shown in table 37, the number increased from 55 in 1945 to 363 in 1955, but has declined to 188 in 1978.

Table 37

Texas Life Insurance Companies

Year	Total Companies	Texas	
		Number	Percent of Total
1945	463	55	11.9%
1950	650	118	18.2
1955	1,059	363	34.3
1960	1,439	300	20.8
1965	1,624	248	15.3
1970	1,819	225	12.4
1975	1,797	197	11.0
1978	1,821	188	10.3

Source: Fact Book, various years.

Several factors contributed to the growth of life companies in Texas, including State government incentives such as the Robertson investment law and low capital and surplus requirements, and favorable economic conditions within the State. The Robertson investment law, passed by the Texas legislature in 1907, required

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1/Fact Book 1980, p. 90.

that three-fourths of the reserves on all life insurance policies be invested in Texas securities. This tended to discourage out-of-state companies from selling life insurance in Texas and permitted local businesses to flourish. In 1955, when the number of life companies had peaked, Texas required only $25,000 in capital and $12,500 in surplus to start a life company. 1/

An additional factor contributing to the growth of life companies can be attributed to the favorable tax treatment of life companies at the Federal level. The 1959 Congressional Quarterly Almanac suggests that:

> [Before the 1959 Act] the tax treatment of life insurance companies had encouraged the creation of companies for no other purpose than to avoid taxes. Although the evidence is conjectural, industry sources believe that this explains, in large part, the growth of the number of life insurance companies. . . . Wealthy individuals who placed their assets in a stock company which had to pay tax on only 15 percent of its net investment would derive sizable tax benefits. 2/

The explosive growth in Arizona companies is shown in table 38. At present approximately 25 percent (up from 0.2 percent in 1945) of all life companies are domiciled in Arizona. The growth in Arizona began in the late 1950s and continues at a slower pace today.

Table 38

Arizona Life Insurance Companies

Year	Total Companies	Arizona	
		Number	Percent of Total
1945	463	1	0.2%
1950	650	3	0.5
1955	1,059	24	2.3
1960	1,439	108	7.5
1965	1,624	172	10.6
1970	1,819	346	19.0
1975	1,797	403	22.4
1978	1,821	436	23.9

Source: Fact Book, various years.

1/McKeever, Charles A., "A 20-year Look at the New Companies of the 1950s," Best's Review, March 1979, p. 12.

2/1959 Congressional Quarterly Alamanac, background on the Life Insurance Company Income Tax Act of 1959 (H.R. 4245), p. 203.

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As of 1978, about 89 percent of life insurance companies domiciled in Arizona were credit reinsurance companies, primarily due to the low capital and surplus requirements. These requirements totaled only $50,000 until raised to $150,000 in 1978. 1/ The business of these companies is almost entirely credit insurance issued out of state, not locally to Arizona residents (63 of these companies do not even have an Arizona mailing address). 2/

According to the Chief Examiner of the Arizona Department of Insurance, new life company starts, other than credit reinsurers, rarely occur in Arizona for two reasons. First, the initial cost of developing new business is discouraging, and second, Arizona life companies are often associated negatively in the public mind with the credit reinsurance business.

SPECIAL DEDUCTIONS IN LICITA

Although LICITA increased the tax burdens of life insurance companies substantially, the Congress tried very hard to ensure that this increase in tax burden would not impede the growth of small and new life insurance companies. In particular, the Senate Report accompanying the 1959 Act spells out the following eight features especially designed to benefit small and new businesses. 3/

(1) In arriving at the tax base, 10 percent of the investment yield (gross investment income less investment expenses) up to a maximum of $25,000 is allowed as a special deduction.

(2) In determining the policyholders' share of investment income, a downward adjustment is made to the policyholders' reserves to the extent that the interest rate used exceeds the assumed rate. This reserve adjustment is calculated by reducing the reserve by 10 percent for every 1 percent the interest rate used is above the assumed rate. Because the business of small and new companies has not matured, this adjustment in reserves is much more generous for them than it is for well-established companies.

(3) If underwriting operations produce a loss, the loss (with certain limitations) may be offset in full against the investment income tax base even though, if there

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1/Statement by the Chief Examiner, Department of Insurance, State of Arizona, record of discussion held with GAO representative on March 25, 1980.

2/Annual Report 1978-1979, Department of Insurance, Arizona, pp. 15-56.

3/S. Rpt. 291, pp. 9-10.

were a gain from underwriting operations, only half of this gain would be taxed currently. This was intended to be more beneficial to small and new businesses that, in attempting to expand their businesses, are incurring large expense items.

(4) In general, policyholder dividends, the deduction for 10 percent of additions to certain reserves on non-participating contracts (or 3 percent of premiums on these policies) and the deduction for 2 percent of group premiums, are not available as deductions to the extent that they may result in an underwriting loss and therefore generally may not be offset against the investment income tax base. However, LICITA permits the deduction of such items where they result in an underwriting loss up to a maximum of $250,000. This will primarily benefit smaller companies.

(5) Net operating losses may be carried forward from 1955, 1956, and 1957. New and small companies were more likely to experience losses during these years, and, therefore, they were the primary beneficiaries of this provision.

(6) The law originally provided for an 8-year carryforward of net operating losses incurred by new businesses in the first 5 years of their existence. This was amended, effective for taxable years ending after December 1, 1975, to allow for a 10-year carryforward during the first 7 years of their existence.

(7) In the case of the one-half of underwriting gains that is tax deferred, the Act requires payment of tax if the cumulative amount with respect to which the tax was deferred exceeds whichever of the following is the greatest:

(A) 15 percent of life insurance reserves at the end of the taxable year,

(B) 25 percent of the amount by which life insurance reserves at the end of the taxable year exceeds the life insurance reserves at the end of 1958, or

(C) 50 percent of the net amount of the premiums and other considerations taken into account for the taxable year.

Alternative B should benefit new and small business more than companies having well-established reserves prior to 1959.

(8) Those companies with reserves established on a preliminary term basis may elect to convert those reserves

for tax purposes to the more liberal net level premium basis. This is of primary importance only to smaller companies since they are the predominate users of preliminary term.

It is important to realize that all life insurance companies can use these eight special provisions. However, they were intended to be relatively more benefical to small and new companies than to older, well-established companies. For purposes of our analysis, all companies with assets less than $25 million are grouped and defined as small companies. As illustrated in table 39, the percentage of small companies reporting no taxable income ranged between 39 percent and 64 percent.

As presented in table 39, 57.5 percent of companies 21 years or older reported no income, compared to 39.5 percent for new companies (5 years or less).

Table 39

Small Companies with Taxable Income by Age of Company

	Age of small company (in years)					
	5 or less	6 to 10	11 to 15	16 to 20	21 or more	All ages
Credit reinsurance	168	91	28	20	6	313
--with no taxable income	36	21	7	4	2	70
--percent of subtotal	21.4	23.1	25.0	20.0	33.3	22.4
All other small companies	103	125	208	153	352	941
--with no taxable income	71	72	144	90	204	581
--percent of subtotal	68.9	57.6	69.2	58.8	58.0	61.7
Total small companies	271	216	236	173	358	1254
--with no taxable income	107	93	151	94	206	651
--percent of total	39.5	43.1	64.0	54.3	57.5	51.9

Source: Unpublished data supplied by the Internal Revenue Service.

One of the issues raised by the NALC was that small companies have difficulties because the industry is becoming more competitive and capital intensive, with increasing reliance on economies of scale. The feeling was that a new company, in most cases, will not report any income for tax purposes for approximately the first 10-15 years, and when it does begin to show a profit the amount is usually small. This results largely because of high initial costs in attempting to expand business. It was the general feeling of these industry representatives that LICITA provided little benefit to small and new companies with the exception of the loss carryforward provision, which they felt should be extended to at least 15 years from its present 10 years.

These views were expressed in the summary of a questionnaire prepared by the NALC, which represents approximately 300 small and medium size companies. Although the consensus of the member companies responding was that the ". . .1959 Act is working very well overall,. . ." they also felt that the Act had only a minor effect on their operations. The responding members identified several problem areas, including the Atlas decision, that they believe have caused life companies to purchase fewer municipal bonds than they would otherwise.

Table 40 shows that both credit reinsurers and other small companies, as well as larger companies, took advantage of the deferral of one-half of underwriting income. However, the percentage of credit reinsurers using the deferral was 3.5 times greater than the others. This is apparently due to small companies relying more heavily on underwriting income than larger companies and, among small companies, the proportion of credit reinsurers that have taxable income is three times greater than for other small companies. Furthermore, in practice, this is essentially a permanent tax-free deferral of income even though by law it is subject to taxation some time in the future. As shown in table 40, for example, only 100 of 1,719 life companies, or 5.8 percent, paid tax on phase III income in 1977 and they were almost entirely small companies. The phase III income deferral was designed to allow a stock company to accumulate a surplus to meet periods of abnormal loss experience.

THE MINOR EFFECT OF THE ACT ON SMALL COMPANIES

The features of LICITA designed to benefit small and new companies have had only a minor effect on those companies, with two exceptions. The loss carryforward and offset of underwriting losses against investment income provisions have aided small companies.

Table 40

Comparison of Use of Certain Special Provisions Between Small and Larger Companies, 1977

	All Companies	Deferred One-Half of Underwriting Income		Paid Tax on Policyholders' Surplus Account		Claimed Maximum "Small Business" Deduction		Carried Forward Operations Loss from Prior Year(s)	
		Number	Percent	Number	Percent	Number	Percent	Number	Percent
Credit reinsurers	313	223	71.2	51	16.3	11	3.5	36	11.5
All other small companies	941	204	21.7	46	4.9	391	41.6	278	29.5
Small companies a/	1,254	427	34.1	97	7.7	402	32.1	314	25.0
Larger companies	465	91	19.6	3	0.6	460	98.9	b/	b/
Total	1,719	518	30.1	100	5.8	862	50.1		

a/Companies with less than $25 million in assets.

b/No data available.

Source: Statistics of Income (unpublished data), 1977, Internal Revenue Service.

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As illustrated in table 40, approximately 25 percent of small companies carried operating losses forward to 1977. In almost every case, the company reporting a loss from operations also reported an operations loss deduction carryover. As previously mentioned, the Act contains a special deduction designed for new companies that allows them to carry losses forward for 10 years. All companies may carry losses forward for 7 years or carry back for 3 years. Thus unprofitable companies, particularly new companies, are able to offset current losses (including special deductions) against future profits.

The small business deduction provided for in the Act has benefited large and small companies alike. Although intended specifically for small companies, this deduction (10 percent of investment yield up to a maximum of $25,000) is given to all companies. As a result, 460 large and intermediate size companies (those with $25 million or more in assets) received the maximum $25,000 deduction in 1977, a total tax savings of $5.5 million. 1/

Another special provision of the Act allows companies to convert from a preliminary term reserve revaluation to a net level reserve revaluation for tax purposes. This provision was intended to be of primary importance to smaller companies, since they are predominantly the users of the preliminary term method.

THE EFFECT OF INFLATION ON THE 10 TO 1 RULE HAS NOT HURT SMALL COMPANIES

Generally, the adverse effect of inflation on the 10 to 1 rule is not a problem for small companies because they derive most of their income from underwriting operations and not investments. As previously discussed, the majority of small companies rely heavily on policies with little or no savings element and require smaller reserves than whole life contracts. The adverse effect of inflation on the 10 to 1 rule is not a major consideration for small companies because they are generally taxed in Phase II negative, if at all.

1/The $5.5 million was calculated based on a 48 percent corporate tax rate (i.e., 460 x $25,000 x 48% = $5.5 million).

AN ANALYSIS OF MUTUAL COMPANIES AS COOPERATIVES

Life insurance companies can be classified as either stock or mutual, the distinction arising from the presence or absence of shareholders. LICITA's authors grappled with this organizational distinction, and in writing the Act, the Congress attempted to maintain the competitive balance between stocks and mutuals. The Congress recognized the unique characteristics of mutual companies and treated them differently, although the Congress did develop an overall framework of taxation for both mutual and stock companies. Treating mutual companies uniquely raises important issues.

This appendix focuses on three areas of concern with mutual companies to determine if there exists some inherent distinction about mutual company earnings that warrants differential tax treatment. 1/

--A discussion of the legal status of the mutual insurance company policyholder is necessary. Is the policyholder analogous to the stockholder in an ordinary corporation or is the policyholder more like a customer?

--The nature of policyholder surplus is explored to ascertain whether it is similar in nature to the net worth of a stock company. Is the surplus eventually distributed to the policyholders as theoretically should occur in a cooperative?

--A clarification of the goals pursued by mutual company managers is discussed. Do managers seek to carry out goals of policyholders or do managers have other objectives? If management and policyholder goals differ, is the cooperative nature of the company challenged because ownership and control are separated?

CONCEPTUAL PROBLEM

No conceptual problem is presented in taxing a stock life company, which operates in a fashion similar to any conventional corporation--ideally attempting to obtain the maximum return for its owners. A mutual company, however, poses a major conceptual problem. In economic theory, a mutual company is a cooperative in which the policyholders have joined together to share risk.

1/This analysis follows closely the works of J.A.C. Hetherington, "Fact v. Fiction: Who Owns Mutual Insurance Companies," Wisconsin Law Review, vol. 1969, no. 4 and Howard E. Winklevoss and Robert A. Zelten, "An Empirical Analysis of Mutual Life Insurance Company Surplus," Journal of Risk and Insurance, vol. 40 (December 1973).

Claims and expenses are apportioned among all policyholders with any surplus distributed eventually. If a mutual operated according to this model, it would be incorrect to tax it at the company level. Instead, company earnings would properly be allocated to individual members and taxed on an individual basis. But to free such a large portion of the life industry from tax liability at the company level would confer a distinct competitive advantage to mutual organizations at the expense of stock companies.

The correct treatment of policyholder dividends poses a problem inherent to mutual forms of organization. It is often contended that a large portion of policyholder dividends represent a rebate of premium payments and should be legitimately excluded from the company's tax base. However, to an extent policyholder dividends stem from investment earnings and mortality gains that are clearly earnings at the corporate level and therefore should properly be subject to corporate taxation. The present income tax treatment of mutual companies does not adequately recognize this distinction. Policyholder dividends are permitted as a deduction against the total income base (Phase II, gain from operations) up to $250,000 below taxable investment income (Phase I). This deduction serves as a partial or complete offset to underwriting income of the mutual companies. This is also the case for stock companies to the extent they issue participating policies. As a result, operating gains are exposed to tax liability on nonparticipating business; however, the Act also provides two special deductions for nonparticipating insurance and for group life and A and H contracts. These two deductions are generally viewed as a means of maintaining the competitive balance between mutual and stock companies.

In effect, a mutual company may elimimate any liability that it might pay on underwriting gains through the distribution of policyholder dividends. The result is that mutual companies can limit their tax liability to taxable investment income minus $250,000. Most companies issuing nonparticipating policies can face additional liability arising from underwriting gains.

THE STATUS OF A MUTUAL POLICYHOLDER

This brief discussion will focus on the major issues, and identify the current legal status of policyholders. In the ordinary corporation, customers, shareholders, and creditors comprise three distinct classes whose roles overlap only in exceptional circumstances. The contribution of each to the corporate enterprise is readily identifiable. Customer payments are additions to gross revenues. 1/ Creditors and stockholders supply capital to the enterprise. Creditors have the right to demand and recover from the borrower a sum of money arising from their contracts.

1/A customer is defined as a buyer, purchaser, or patron. Nichols v. Ocean Accident & Guarantee Corporation, 27 S.E. 2d 764, 766 (Ga. 1943).

Their payments to the corporation are loans, requiring the eventual return of principal and usually some payment of interest. Stockholders, however, are the owners of the corporation. In exchange for their capital contribution, they usually receive the right to vote at stockholder meetings of the company and to share proportionately in its net profits or any distribution of assets upon dissolution after creditors are paid.

In the case of a mutual organization these three classes become confused into one: member-owners are also creditors and customers. 1/ Due to their ownership rights, policyholders resemble shareholders in conventional corporations. Theoretically they elect the directors of their companies, a function traditionally enjoyed by a company's owners. However, their "ownership" rights have little effective meaning. This is evident from the following examination of policyholder rights in terms of risk incurred, proprietary claims to company surplus, and the exercise of voting rights. Insureds enter into the life contract to obtain protection at what is perceived to be a reasonable price. They generally remain content to view themselves as customers, remaining relatively unconcerned with management.

Risk

Risk refers here to the degree of personal liability incurred by an owner in the event of company insolvency. Like a shareholder in a conventional corporation, mutual policyholders are generally not exposed to any personal liability for the debts of the corporation should insolvency occur. 2/ An exception exists in the form of assessable policies issued by a mutual. The terms of these policies permit the company to levy a charge to meet losses and administrative expenses above normal premium charges. In practice, these policies, which are not issued by the larger mutuals and are prohibited by some State statutes 3/, constitute a small percentage of outstanding participating policies. 4/ Therefore, as a practical matter, the policyholders' risks are confined to the principal on their policies, in other words, to their portion of company ownership. The greater the policy size,

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1/For a discussion of this, see Clark, pp. 1657-58.

2/When neither the constitution or bylaws of, nor the policy issued by, the mutual company authorizes the levying of an assessment to meet unanticipated losses, an insured is not held to be liable. See Beaver State M.M.F. Insurance Association v. Smith, 192 P. 798, (1920).

3/For example, see West's Wisconsin Statutes Annotated 206.25.

4/Assessable policies are issued only during the formative stages of a mutual life company. See J.A.C. Hetherington, "Facts vs. Fiction: Who Owns Mutual Insurance Companies."

the larger the risk, which will differ depending on whether the policy is term or ordinary life. This fact implies that a mutual policyholder's potential liability in default is comparable to the risk faced by the holder of corporate stock when insolvency occurs. In both circumstances, the owner's liability for the debts of the corporation is limited to this investment.

The policyholder's premium on cash value life insurance can be divided into three distinct parts. An initial portion is used to pay agent commissions and other loading expenses. A second component covers the pure insurance proceeds--the protection against death. The cost of the insurance portion depends upon the losses that the company can expect based on mortality experience. The final portion of the premium is directed toward building a retrievable investment that approximates a savings deposit in a commercial bank or a thrift institution. These three elements apply to nonparticipating and participating life insurance. For participating insurance, a fourth part of the premium, assuming a surplus, is directed toward policyholder dividends.

With regard to the pure insurance portion of premiums, the cost of mortality is unevenly distributed over the life of an average policy because a greater number of claims are made in the later rather than initial years. The premium, however, is at a constant level throughout the life of the policy and is calculated on a present value basis. 1/ For a given interest rate, and known expected expenditures throughout the life of a policy, a constant level premium can be determined. Thus, in the early years when little cash value has accrued and mortality costs are low, the premium may appear to be in excess of costs. However, the excess contributes to cash value for the savings component, which reduces the future amount of pure insurance needed.

Therefore, the typical policyholder is paying in advance for coverage and benefits. Essentially, this situation is paralleled when a consumer purchases any good or service in advance of delivery. In effect, the policyholder can be classified as a creditor of the company. As such, the policyholder should be entitled to recover the prepayment amount in the event that the contract is terminated (on the part of the seller). In the circumstances that the debtor reaches an insolvent position, the policyholder is exposed, in a fashion similar to any creditor, to the risk that the service on which a prepayment is made will never be delivered. In addition, a participating policyholder stands to lose expected dividends in the year of default, if not earlier./

To summarize, with respect to the pure insurance component of the life contract, the position of the mutual policyholder is

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1/Dividends received on participating policies are a partial return of premiums and also reflect any profit/loss. Therefore, the effective premiums paid may not be exactly equal each year because of variations in the size of premium rebates.

equivalent to that of the purchaser of a policy issued by a stock life company. In both cases the policyholder can be classified as a creditor subject to the same risk as any normal creditor.

A slight modification of this analysis is in order with respect to the savings component of the mutual life policy. As we noted, in the early years of the policy premiums will exceed the mortality risk. This excess, after deductions for operating expenses and other costs of loading, is savings that the policyholder has agreed, as a condition of the contract, to invest with the company. Typically, the rate of return on this investment has been quite low compared to the return from other forms of savings. 1/ It is with respect to these savings that we need to clarify the relation of the policyholder to the company.

Is the interest accumulated on insurance savings a return on the individual's investment, much as a dividend on a share of common stock? Or is it a payment for use of policyholder capital as in a debtor-creditor relation? When these questions are closely examined, it becomes clear that the relationship between the mutual policyholder and the company is not proprietary, but debtor-creditor. The debtor-creditor nature of this relationship is analogous to the debtor-creditor relationship generally found between a bank and its depositors as the following illustrates.

First, interest on savings is fixed at a constant rate over the duration of a policy for cash value purposes and fails to reflect the actual earnings of the mutual company. 2/ Earnings may undergo substantial fluctuation as yields on the company portfolio, mortality experience, and actual expenses change over time, yet the interest accumulated on savings will remain at its specified level. In a similar manner, an individual makes a deposit in a thrift institution or commercial bank at some rate that is largely independent of the institution's profitability and which depends upon the competitive pressures and ceiling rates imposed by regulatory authorities.

Second, policyholders have the right to cancel their policies at any time and have the savings component of the policy, called the cash surrender value, returned. Additionally, companies offer their policyholders the option to borrow against this amount. It appears that with respect to the savings component of paid-in life insurance premiums, the policyholder exercises extensive control. Again, the relationship is analogous to depositors at

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1/U.S. Federal Trade Commission, Life Insurance Cost Disclosure (FTC, 1979), pp. 1-5.

2/In practice dividends paid to policyholders can and do fluctuate with company earnings experience, although all the earnings may not necessarily be distributed to policyholders. The earnings portion of policyholder dividends is essentially analagous to dividends on common stock.

a savings institution or commercial bank who may make withdrawals from their accounts at their option.

Third, the risk of losing savings should the mutual company fail is similar to that of losing deposits due to a bank insolvency; the individual is a creditor to a debtor who has defaulted.

Proprietary rights to company surplus

There is a fundamental question concerning the policyholder's right to the surplus held by a mutual insurer, the excess of operating revenues over operating costs and reserves. Does the policyholder have an inherent right to the surplus? If not, can it be properly concluded that the principal role of the mutual policyholder is that of customer and not of investor? Does the mutual policyholder enjoy the same operational rights as policyholders in a stock company, and essentially nothing more?

In a theoretical cooperative arrangement, member-owners share proportionately in the profits or surplus from operations. If the policyholders of a life insurance mutual are the "owners" of their company, they should have a claim to any accumulation of surplus that occurs while their policy remains in effect. In reality, however, such claim is not generally based on membership per se.

The rights and interests of policyholders in the assets of a mutual life insurance company are contractual in nature and are measured by their policies and by the statutes, charter and by-laws, if any, that comprise the terms of their policies. 1/ Consequently, where a policy contains no provision giving the policyholder any right to share in the surplus, no such right exists and the surplus belongs to the company. 2/ Moreover, where the policyholders' right to surplus is subject by the policies' terms to prior ascertainment and apportionment of the surplus by the managers of the company, it is within the discretion of the managers to determine the amount of surplus and how it is to be distributed between different classes of policyholders. 3/

Until the surplus is ascertained and apportioned, policyholders cannot sue to recover their dividends. 4/ Also, because

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1/Andrews v. Equitable Life Assur. Soc., 124 F. 2d 788 (7th Cir. 1942) cert. den. 316 U.S. 682; Lubin v. Equitable Life Assur. Soc., 61 N.E. 2d 753.

2/See Pierce Ins. Co. v. Maloney, 269 P. 2d 57 (1945).

3/Cohen v. Prudential Ins. Co. of America, 155 A. 2d 305 (1959).

4/Birne v. Public Service Mut. Casualty Co., 77 N.Y.S. 2d 446 (1948); Curran v. John Hancock Mutual Life Ins. Co., 171 N.Y.S. 2d 1012 (1958).

the relationship between company and policyholder is one of debtor and creditor rather than one involving the holding of funds in trust, no past or present policyholder can obtain an accounting on the basis of a trust relationship. 1/ Like other rights of the policyholder, unless a right to an accounting is provided for in the policy, it does not exist. In Equitable Life Assurance Society of America v. Brown, 213 U.S. 25 (1909), the Supreme Court stated:

> We also think there is no ground for the contention on the part of the complainant that he, as a policyholder, had any right to an accounting, and to compel the distribution of the surplus fund in other manner or at any other time, or in any other amounts than that provided for in the contract of insurance. By that contract he was entitled to participate in the distribution of some part of the surplus, according to the principles and methods that might be adopted from time to time by the defendant for such distribution, which principles and methods were ratified and accepted by and for every person who should have or claim any interest under the policy. It has been held that under such a policy how much of the surplus shall be distributed to the policyholder and how much shall be held for the security of the defendant and its members is to be decided by the officers and management of the defendant in the exercise of their discretion to distribute, having in mind the present and future business, and, in the absence of any allegations of wrong-doing or mistake by them, their determination must be treated as proper, and their apportionment of the surplus is to be regarded prima facie as equitable. . . . 2/

Voting rights of policyholders

Many life companies have accumulated large amounts of surplus, a portion of which could be paid out in the form of increased dividends. Typically, policyholders would be expected to unseat management and elect officers who would favor increasing dividends, but such activities have been conspicuously absent. This inactivity has been particularly surprising during recent periods when returns to policyholders on the savings element of life insurance policies have lagged substantially below those available elsewhere in the economy. The explanation for this lack of activity may be attributed to the following conditions:

1/Klonick v. Equitable Life Assur. Soc., 353 N.Y.S. 2d 372 (1974). See also Lubin v. Equitable Life Assur. Soc., above; Equitable Life Assur. Soc. v. Brown, 213 U.S. 25 (1909).

2/At 47.

--the large number of policyholders, even in a medium-sized mutual;

--the limited opportunities for communication among policyholders;

--the wide geographic dispersion of the policyholders;

--the limited stake of each policyholder in the aggregate assets of the insurer; and

--the general lack of awareness among policyholders of their legal right to vote in elections of directors.

Before opposition candidates can be nominated to the board of directors, State laws require that they obtain a minimum percentage of policyholder signatures. For the largest mutuals, with millions of policyholders, these State laws require that thousands of signatures be obtained for nomination. 1/ These signatures must be obtained within a limited time period. Further, the lack of State or Federal rules compelling management to furnish a list of policyholders only contributes to the difficulty of collecting signatures. 2/

The general procedure in allocating voting rights is for each policyholder to be granted one vote, irrespective of the value or number of policies held. This practice reduces further the possibility of effective opposition. Denial of proportionate voting rights, unlike a stock company, may discourage any large policyholder's interest in his voting rights. This is not to say that a large corporate policyholder will necessarily be devoid of influence. A large policyholder, for example, a group life plan in a large corporation, may exert considerable influence on management because of the importance that their continued business has to the life insurance company. By exercising this influence

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1/Nomination requirements appear to vary widely among States. In Illinois, 0.190 percent of policyholders' signatures must be obtained (see Karen Orren, Corporate Power and Social Change: The Politics of the Life Insurance Industry (Baltimore: The John Hopkins University Press, 1974), p. 78. In New York, for companies with more than 100,000 policies or contracts in force of $1,000 or more, the signatures of one-tenth of one percent, or 500 policyholders, whichever is greater, are required to secure nomination. Thus, an opposition nomination at Metropolitan Life Insurance Company would have needed 22,093 signatures of its more than 22 million policyholders in 1967.

2/See Orren, Corporate Power and Social Change, p. 78. Contested elections are rare in a mutual. According to Hetherington, p. 1082, in recent years there has not been a contested election in a Wisconsin mutual life company.

a large policyholder may obtain representation on the board of directors. 1/

The presence of extensive barriers to effective policyholder participation is evidenced in the minimal level of voting in directorship elections. The figures in table 41 represent a tally of votes cast in 1968 in the 10 largest United States mutual life insurance companies. Since few policyholders either attend annual meetings or send proxies, the mutual company will generally be controlled by a few officers.

Table 41

Election Participation in the 10 Largest U.S. Mutual Life Companies, 1968

Name of Company	Total Number or Policyholders	1968 Policyholders Voting In Person	Mail	Proxy	Total	Total Number Voting As a Percentage of Total Eligible Voters
Prudential Life	18,704,879	592	1		593	.00317%
Metropolitan Life*	22,092,946	51	1,424		1,475	.00667
Equitable Life	3,345,479	12	35		47	.00140
New York Life	1,616,038	189	37		226	.01398
John Hancock Mutual	7,794,444	4,170		11	4,181	.05364
Northwestern Mutual	1,807,459	70	25		95	.00525
Massachusetts Mutual	1,084,364	1,086			1,086	.10015
Mutual of New York	5,058,951	450	157		607	.01199
New England Life	1,069,163	1,312			1,312	.12271
Connecticut Mutual	903,911	224		400	624	.06903

*Figures shown pertain to 1967, no data available for 1968.

Source: J.A.C. Hetherington, p. 1079.

In a mutual company, a management slate is routinely returned to office without dissent through the votes of a handful of policyholders. In a stock corporation, directors are also regularly reelected without opposition, but there have been exceptional

1/Hetherington, p. 1081.

circumstances where shareholder insurgencies have been effective. Stockholder meetings are well publicized and proxies are actively solicited so that the stock company can meet legal requirements mandating a large proportion of shares be voted, often on the order of one-third or one-half.

This analysis suggests that the relationship of the policyholder to the mutual insurance company is that of a customer buying insurance services, and not a proprietary relationship.

NATURE OF THE MUTUAL COMPANY SURPLUS

Surplus in a mutual company parallels net worth of a stock company. In a conventional corporation net worth is derived through the familiar accounting division of a corporation's financial condition into three distinct components--assets, liabilities, and net worth (owner's equity). Owner's equity, or surplus, is the residual amount after liabilities are subtracted from assets. Put another way, surplus consists of assets in excess of those required to meet the company's liabilities. If surplus is a valid concept for both stock and mutual life insurers, a convincing argument for taxing the mutual at the company level can be made.

Since a mutual has no stockholders, any excess funds are presumed ultimately distributed to policyholders. This presumption implies surplus accounts should properly be recorded as liabilities to be paid in full. Empirically, it can be determined whether mutuals employ a dividend payout policy which results each year in increased surplus.

To identify dividend payout policy, the ratio of policyholder dividends paid to each company's net gain after taxes over some extended period is examined. This approach was adopted for the five largest mutual life insurers: Prudential, Metropolitan, Equitable of New York, New York Life, and John Hancock. 1/ Each may be expected to exercise substantial control over their surplus. Excluding the effects of capital gains and losses and extraordinary items, surplus may increase or decrease contingent on whether dividends to policyholders are more or less than current annual earnings. Consequently, the five mutuals are examined for evidence of management policies resulting in an historical growth in surplus or for a pattern in which dividends occasionally fall below operating income. Since policyholder dividends assigned to a particular year on an accounting basis are determined in part by prior-year performance, the comparison to income is appropriately made for the prior year.

1/This approach was adopted from Howard E. Winklevoss and Robert A. Zelten, p. 423.

Table 42 provides policyholder dividends as a percent of net operating income before dividends but after taxes. For the 19-year interval studied, the five companies as a rule paid out less than 100 percent of annual earnings in the form of dividends. As a result, the surplus will have increased over time. Any upward movement in the payout ratio may reflect a change in corporate policy as managers have determined that their firms have attained some optimal surplus level and no longer require substantial additions.

MANAGERIAL GOALS

Organization along mutual lines provides certain advantages to managers not available in the conventional corporation. Managers are freed from the possibility of an outside takeover or stockholder revolt. Whether this freedom has been good or bad is unclear.

To the extent that company ownership may be defined as the ability to formulate and implement decisions affecting operations, the effective owners of a mutual may be its managers. Limited possibilities for removal or other outside interference places the managerial hierarchy in a position unattainable in a stock company. Perhaps the only aspect of ownership the management lacks is a proprietary right to retained surplus. This does not deny the possibility of financial gain by managers from firm growth through enhanced pension arrangements or salary increases, but in general the linkage between profitability and reimbursement is not explicit, as it would be in the case of stock options for stock company executives. On the other hand, company growth and profitability provides management important nonpecuniary rewards, including enhanced prestige and morale.

Mutual policyholders are primarily buyers of a service. Although policyholders may remain interested in managerial performance, management is left to define the operating objectives of the firm. The growth and profitability of the company, peculiarly, belong to no one individual or group of individuals. Policyholders, unlike shareholders in a conventional organization, have no interest, other than policyholder dividends, in the company beyond the right specified in their policies, and managers are unable to participate directly in company earnings.

Table 42

Policyholder Dividend Payments as a Percentage of Prior Year Net Gain After Taxes
(in percentages)

Year	Prudential	Metropolitan	Equitable of New York	New York Life	John Hancock
1978	91.43	72.70	89.67	80.57	76.02
1977	100.94	86.35	83.42	91.10	89.97
1976	100.89	106.22	124.98	84.39	95.29
1975	94.84	108.59	105.80	95.44	85.68
1974	96.95	101.41	83.10	94.10	81.60
1973	96.81	93.47	78.68	99.47	91.09
1972	95.74	97.87	119.43	103.96	91.96
1971	97.47	93.45	99.06	103.33	89.16
1970	91.62	89.00	89.79	101.30	91.80
1969	92.72	87.02	88.14	100.41	95.91
1968	91.80	85.43	83.41	97.07	104.30
1967	90.58	87.89	91.85	102.10	84.85
1966	90.58	87.84	91.72	106.82	84.04
1965	91.18	84.78	88.15	109.62	86.59
1964	89.57	81.65	96.30	100.87	81.95
1963	89.64	86.83	88.07	104.33	83.46
1962	88.84	84.03	94.12	92.20	74.10
1961	92.36	88.89	88.62	91.18	81.58
1960	89.30	89.24	91.98	91.82	87.80
Mean	93.33	90.14	93.49	97.37	87.22
Standard Deviation	3.80	8.57	11.86	7.57	7.16
Coeff. of Variation	0.04	0.10	0.13	0.08	0.08

Source: Best's Insurance Reports, Life/Health, 1961-1979, Annual Statements, various years, and Winklevoss and Zelten.

Discussions of the operating aims of mutuals in the actuarial literature point to growth as a primary objective. For example, a statement of objectives of the Equitable Life Assurance Society included the following passage: "Equitable's objective is to grow in a planned and orderly manner at the maximum rate subject to considerations of profitability, relative prices, and social purposes." 1/ It was also pointed out that "...the main attraction of a relatively large surplus is probably the power it gives

1/J. Henry Smith in "Mutual Life Insurance Companies--Their Objectives and Operating Philosophy," TSA, 18, pt. 2 (November 1971), p. D448.

management to embark on aggressive marketing and new product developments." 1/

For a mutual type of organization it is difficult to determine who, if anyone, actually owns the surplus. If a mutual were to permit all its existing policies to "run off the books" and accept no new business, a considerable surplus would remain. Theoretically, under the principle of a cooperative any such amount should not exist.

The presence of undistributed surplus demonstrates that a portion of the mutual premium was redundant, exceeding the costs of policyholder benefits and expenses of operation, implying that most mutual companies are not managed on a cooperative basis but are growth oriented.

A mutual with a large surplus is able to take advantage of growth opportunities. Unable to raise capital through the equity market, a mutual desiring to expand its product offerings, or move into a new marketing territory, can readily do so if a large surplus is available to finance these activities. Thus, the extent of the excess of assets over liabilities determines whether or not a mutual follows a growth-oriented approach to investment and underwriting.

Policyholder goals may conflict with managerial growth objectives. As a group, policyholders are consumers and are interested in maximum coverage at minimum cost, while managment is principally concerned with conservation of assets and growth maximization. Surplus accumulation and the associated growth are usually justified in terms of the supposed benefit to the policyholder. 2/ However, a managerial growth objective may actually harm the policyholder in the short term. This harm results primarily from the increase in competition among all insurers (whether stock or mutual) for new business with increased policy acquisition costs. These costs include agents' commissions, advertising, and other expenses. In recent years commissions and underwriting expenses generally absorb all of first year premiums and a large portion of second year premiums. 3/ These costs must

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1/Kenneth R. MacGregor in "Mutual Life insurance Companies--Their Objectives and Operating Philosophy," TSA, 18, pt. 2, p. D459.

2/Orren, p. 84. For example, Orren quotes one life company executive as offering the following justification for his company's growth. "This is not a defensive move on our part, but a positive approach. We're going to make money for our policyholders."

3/Herbert E. Goodfriend, "Insurance Issues," in ed. Sumner H. Levine Financial Analysts Handbook, (Homewood, Ill.: Dow Jones-Irwin Inc., 1975), p. 460.

be financed from assets held in reserves and surplus until the policy has been in effect for a sufficient time to pay back its initial cost. Since the rate of policy lapses and surrenders on new policies in force of 2 years or less is considerable, on the order of 20 percent 1/, there is an implied loss to the company and theoretically to the policyholders.

As suggested above the management of a mutual company pursues an objective of growth while conserving corporate assets. The decision to hold surplus funds rather than rebating these excess premiums to policyholders apparently reflects a growth objective. While this may be appropriate for a conventional stock corporation, a growth objective for a mutual life insurance company may not always be in the best interest of the policyholder seeking maximum insurance protection at the lowest possible cost.

Summary

The mutual policyholder's role is primarily that of a customer whose influence is basically limited to his decision to buy or not to buy a particular policy. Both stock and mutual companies' policyholders are practically subject to similar degrees of risk, have a similar lack of rights to the company surplus, and exercise little effective influence over management decision-making. In terms of management, it would appear that both stock and mutual life insurance companies pursue goals of long-term growth and profit.

1/Fact Book 1979, p. 55.

LEGISLATIVE LANGUAGE FOR REPORT RECOMMENDATIONS

TAXABLE INCOME

The importance of the method used by life companies in determining their taxable income is paramount.

GAO found

The provisions of the Act that specify the determination of stock life company taxable income are no longer appropriate. The deferral of one-half of the underwriting gains accruing to stock companies can no longer be justified, and the Code should be revised to reflect current realities. The stated purpose of the tax deferral was to provide a cushion to meet the contingencies of catastrophic losses. However, the industry's operations over the past 20 years have proven quite predictable, and the companies have accumulated a considerable amount of surplus.

GAO concludes

There should be no automatic deferral of one-half the excess of gain from operations over taxable investment income for stock life insurance companies; however, the elimination of this deferral should be gradual and indexed according to the age of the individual company. For new companies, the percentage of the deferral should be 50 percent for the first 15 years and then reduced by 10 percent per year until in the 20th year the percentage falls to zero. For companies already in existence for 15 or more years at the time of enactment of the amendment, the percentage shall be 50 percent and decrease by 10 percent per year thereafter.

GAO recommends

Sections 802(b) and 815(c)(2)(A) be amended as follows. Section 802(b) of the Code currently reads:

[Sec. 802(b)]

(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.--For purposes of this part, the term "life insurance company taxable income" means the sum of--

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

We recommend the following changes:

[Sec. 802(b)]

(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.--For purposes of this part, the term "life insurance company taxable income" means the sum of--

(1) the taxable investment income (as defined in Section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, a percentage of such excess determined as follows:

For the first 15 full taxable years after a company is formed, the percentage shall be 50. For each year in excess of 15 full years, the percentage shall be increased by 10 percent, so that for the 20th and later tax years the percentage shall be 100 percent. For companies already in existence for 15 or more years at the time of enactment of this amendment, the percentage shall be 50 percent for the first tax year following enactment. For each succeeding tax year the percentage shall increase by 10 percent until the full 100 percent is reached in 5 years.

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under Section 815.

As a result of the preceding change, Sec. 815(c)(2)(A) must also be changed. This section currently reads:

[Sec. 815(c)]

(c) POLICYHOLDERS SURPLUS ACCOUNT.--

(1) IN GENERAL.--Each stock life insurance company shall, for purposes of this part, establish and maintain a policyholders surplus account. The amount in such account on January 1, 1959, shall be zero.

(2) ADDITIONS TO ACCOUNT.--The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of--

(A) an amount equal to 50 percent of the amount by which the gain from operations exceeds the taxable investment income,. . .

We recommend that Sec. 815(c)(2)(A) be amended to read as follows:

(A) the amount of gain, if any, not included in taxable income under section 802(b)(2). . .

RESERVE REVALUATION

The method by which life companies revalue reserves is important because it can significantly reduce their tax liability. This results because in calculating the revalued reserves there is a direct effect on the size of the reserve deduction.

GAO found

The current law provides two methods of revaluing reserves--(1) exact revaluation or (2) approximate revaluation. The latter allows an increase of $21 per thousand dollars of the amount at risk for permanent insurance plans. Such an allowance is no longer appropriate as it results in unwarranted reserve deductions.

GAO concludes

The $21 per thousand dollars of amount at risk results in approximate revaluation of reserves at an excessively high level. A more appropriate method of approximating reserves is required today because of changes in product offerings and reserve methods prevalent in the industry.

GAO recommends

Only $15 per thousand dollars of the amount at risk be allowed in revaluing reserves using the approximate method. Specifically, Section 818(c)(2)(A) should be amended as follows.

This section of the Code currently reads:

[Sec. 818(c)]

(c) LIFE INSURANCE RESERVES COMPUTED ON PRELIMINARY TERM BASIS.--For purposes of this part (other than section 801), at the election of the taxpayer the amount taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases;

(1) EXACT REVALUATION.--As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) APPROXIMATE REVALUATION.--The amount computed without regard to this subsection--

(A) increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and. . .

We recommend that Sec. 818(c)(2)(A) be amended as follows:

(A) increased by $15 per $1,000 of insurance in force (other than term insurance) under such contracts, less 1.5 percent of reserves under such contracts, and. . .

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AGENCY AND INDUSTRY COMMENTS AND GAO RESPONSE

We received comments on our draft of this report from the Department of the Treasury, the Internal Revenue Service, and several life insurance industry trade associations. These comments were organized in the following manner: An overview covering broad issues was followed by a more in-depth discussion. Following these comments were page-by-page suggested changes. All but the page-by-page comments have been reprinted in this appendix. The comments dealt with a wide range of topics. Some called attention to minor errors of fact; others, depending on the respondent's perspective and orientation, disagreed with one or more of our conclusions and recommendations but agreed with others. Some changes have been made to the report in response to these comments. Other comments dealt with larger issues that the report simply did not presume to address. Readers are advised to review this appendix as carefully as they do the rest of the report and to regard it as an integral part of this document.

Our purpose in conducting this review was to examine the economic impacts of LICITA 20 years after its passage. Our scope was limited and is presented in chapter 1, pages 3 and 4. The framework of the 1959 Act was accepted for the purposes of this study, though acceptance should not be construed to mean endorsement.

The following comments are no longer appropriate because of deletions and other changes.

July 6, 1981 ACLI comments:

pages 2 and 3	- comparative tax burden
page 6	- first full paragraph

July 15, 1981 ACLI comments:

page 3	- section I.1
pages 4-8	- section A
page 32	- second full paragraph

July 6, 1981 Sutherland, Asbill & Brennan comments:

page 1	- second full paragraph, last sentence
pages 4-5	- last paragraph beginning on page 4

TREASURY AND IRS COMMENTS

The comments from the Department of the Treasury and IRS are a valuable addition to the report. In the following paragraphs we will paraphrase these comments and briefly respond to them.

1. Treasury has suggested that GAO is sponsoring overall tax relief for the industry and questions whether such tax relief is necessary.

Our response

GAO has concluded that the 10 to 1 formula no longer represents a proper way to determine the reserve interest deduction for all companies. GAO's concern is directed at the way the formula operates when there is a widening gap between assumed rates and current earnings rates. However, this should not be considered as an indication that GAO favors tax relief. Actually, two of the alternatives concerning the reserve deduction as well as two specific recommendations GAO presents would result in increased taxation but without the problems inherent in the 10 to 1 formula.

2. Treasury has criticized GAO's "preoccupation" with marginal tax rates as compared to their emphasis on average tax rates.

Our response

GAO does not agree that it is preoccupied with high marginal tax rates of life insurance companies. The report points out (see p. 87 and our exposition of rising marginal tax rates, table 22, p. 88) that in spite of high marginal tax rates, the average tax rates are still below the statutory corporate tax rates. Further, it should be noted that Treasury's discussion of marginal tax rates and calculation of average tax rates (see Treasury's comments, p. 175) are based on assumptions that are not characteristic of the way the industry is currently taxed and are therefore irrelevant. Our concern is with the flaw in the formula that generates such unintended results. Indeed, were we concerned only with high marginal tax rates, other options besides amending the 10 to 1 formula would have been considered.

3. Treasury has questioned GAO's apparent acceptance of and acquiescence with the 1959 congressional action in allowing the use of a reserve interest deduction in excess of that produced by using statutory assumed interest rates.

Our response

A reserve interest deduction has been used for some 50 years. After an extensive study of life insurance taxation in 1958-59, the Congress came up with a formula that produces a reserve interest deduction based, in effect, on earnings rates rather than assumed rates. This was not an accidental result of the formula but was intended by the Congress. As pointed out in the report (see p. 3), the framework of the 1959 Act was accepted for the purpose of our study. We felt that a reopening of this question would, in effect, require the law to be completely overhauled and revised.

4. Treasury agrees with GAO's conclusion that section 818(c)(2) needs revision. However, they feel that GAO's recommendation does not go far enough and that there should have been more emphasis on the need for an exact revaluation only.

Our response

The question of whether or not an exact revaluation is administratively feasible for companies of all sizes is one that we are unable to answer. Certainly it would appear to be easier for a larger company with extensive computer resources than it would be for a very small company. Again, we considered the fact that the Congress, in its concern for the welfare of smaller companies, introduced the idea of an approximate revaluation.

The report points (see pp. 65-66) to the possibility of tightening the use of approximate revaluations for one-year term and similar policies that actually purport to be permanent ordinary life policies. If this situation is corrected and the Congress accepts our recommended change in the adjustment factor for permanent policies, we feel that section 818(c)(2) will no longer be the problem it now is from Treasury's standpoint.

5. Treasury, while accepting our basic recommendation for eliminating the one-half deferral of excess underwriting gains, has questioned the method by which GAO recommends it should be phased in, particularly for new companies.

Our response

In adopting the 1959 law the intention of the Congress to aid new and small companies was clear. We have accepted that intention as a basis for our analysis.

6. IRS has indicated that our report does not give sufficient attention to the tax treatment of deferred annuities, universal life, and the use of modified coinsurance.

Our reponse

For both deferred annuities and modified coinsurance we feel our report does highlight the problems even though it does not specifically define the steps needed to correct the problems. Because the use of modified coinsurance to avoid taxes and the marketing of universal life are recent phenomena, they did not materially affect the tax returns of our sample companies for the years studied (1974-78). These issues as well as deferred annuities merit the attention of the Congress as recommended in the report (pp. 105-6). We do not make specific recommendations because we lack adequate data.

INDUSTRY COMMENTS

The industry representatives' major objections and GAO's response to them are summarized as follows:

1. The report concludes that the performance of the life insurance industry has proven to be predictable. This degree of predictability precludes the need for a cushion to hedge against adverse underwriting results on long-term contracts and catastrophic losses.

Our reponse

As pointed out on pp. 95-100, over time the industry's performance has proven to be predictable. Mortality experience, operating expenses, premium receipts, and investment yields have all been favorable. This conclusion is supported by the industry-wide data provided on pp. 86 and 95-100.

2. Executing the report's recommendations would drastically alter the existing tax balance among competing segments of the industry.

Our reponse

GAO disagrees with this assertion and refers the reader to chapter 6 and appendixes II, III, and V of the report for the analysis and data that support the recommendations.

3. The report fails to address the companies' tax problems in the employee benefit plans market.

Our response

GAO's ability to analyze the pension plan problem was seriously hampered because sufficient data were not available within the required time limits. It would not be appropriate for GAO to conclude and recommend changes in the pension area on the basis of inadequate data analysis.

4. Gain from operations before policyholders' dividend deduction and other special deductions is not a proper tax base for measuring growth in the companies' effective rate of tax.

Our response

As pointed out in the report (see p. 83), gain from operations represents a total income approach that attempts to make taxation of life insurance companies comparable to other corporations. While this income measure may not be precise, it does reflect income after a deduction for the increase in reserves as

well as deductions reflecting the costs of doing business. For purposes of our analysis the special deductions allowed life insurers (i.e., policyholder dividends, group A and H, and nonparticipating deductions) are not subtracted from gain from operations. Also, this income measure does include all policyholder dividends, some of which reflects redundant premiums. Even with these flaws, gain from operations should reflect growth trends in the life insurance industry. Using the gain from operations after these deductions as a tax base is not a precise measure either because of the interest element contained in the policyholders' dividends. Further, it would mean that the interest earned on the investment is distributed to the policyholders without ever being taxed while the earnings on competing investments, such as bank deposits, are taxed at the individual level.

5. The NALC disagrees with our statement that the Act had only a minor effect on the operation of their member companies.

Our response

As pointed out in the report (see p. 141), our statement was based on a summary prepared by the NALC that sought responses from its members concerning the effects of the 1959 Act on their operations. Although the consensus of the member companies responding was that the ". . . 1959 Act is working very well overall, . . ." they also felt that the Act had only a minor effect on their operations.

6. The appropriateness of the sample is questioned. It is asserted that our data base did not reflect the overall composition of the industry.

Our response

As pointed out in the report (pp. 79-83), sample size was limited by the number of companies whose returns were available for 1974-78 from the IRS. While small in number, this sample represents a large portion of the industry's assets, premiums received, new business issued, and insurance in force. In 1978, the sample 42 companies held approximately 72 percent of the industry's assets and wrote about 62 percent of life insurance in force. We also analyzed taxpayer returns for categories of life companies segregated by asset size including a detailed analysis of 1,254 life companies with assets of less than $25 million (see appendix IV). This was done to insure that all life company categories were fairly represented.

DEPARTMENT OF THE TREASURY
WASHINGTON D.C. 20220

ASSISTANT SECRETARY

JUL 13 1981

Dear Mr. Anderson:

This letter, with its attachments, prepared in response to your May 21 letter to Secretary Regan, constitutes the comments of the Department of the Treasury on the draft of a proposed General Accounting Office report entitled "Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendations for Change" (the "Draft Report"), which reviews the Federal income tax treatment of life insurance companies under Part 1 of Subchapter L of the Internal Revenue Code of 1954, as amended.

The GAO's efforts to review Subchapter L come at an especially appropriate juncture. We understand that the life insurance industry has become seriously concerned with what it claims to be inequities in the operation of Subchapter L, said to result primarily from the rise in interest rates since the legislation was enacted in 1959. While the industry has, in the last several years, resorted to questionable "self-help" practices in an effort to minimize its Federal income tax liabilities, we understand that the industry itself is now preparing a package of requests to the Congress in an effort to obtain legislative tax relief.

Whether relief is now appropriate is a question that merits the most careful review. While relief may, in certain respects, prove warranted, the industry's claim that it is now, or soon will be, "overtaxed" should be carefully scrutinized. This is particularly appropriate because the life insurance industry is widely regarded as having had a decisive hand in framing the 1959 legislation, which was fashioned to benefit the industry. Moreover, one should be prepared to reexamine those aspects of Subchapter L claimed to operate to the industry's disadvantage only if one is also prepared to reexamine possibly unjustified features of the law which continue to operate to the industry's benefit.

In this environment, the GAO's effort to analyze the operation of Subchapter L is welcome. At the same time, it is vital that the Report, in its final form, reflect a thorough, even-handed approach to problems that may have arisen in the operation of this statute. While the GAO obviously has devoted significant effort to its examination of Subchapter L, we do feel that the Draft Report, in its current form, falls short of this goal.

We regard several of the Draft Report's recommendations as properly highlighting problems in the operation of Subchapter L. On the other hand, portions of the Draft Report's analysis are incomplete. In some respects it has, without adequate analysis, subscribed to industry positions on controversial and contested issues, and in others it has accepted at face value undocumented industry factual assertions. Moreover, certain passages in the Draft Report are currently worded so that, when read out of context, it appears that the GAO believes that the industry is urgently in need of tax relief.

We shall attempt to describe fully those aspects of the Draft Report with which we are concerned. Our analysis is principally set out in the two attached documents, one of which contains our General Observations on the Central Recommendation of the Draft Report, the other consisting of a Page-by-Page Commentary on the Draft Report. While these two documents are largely self-explanatory, I would like to make some preliminary observations in this transmittal letter.

The Draft Report proposes three principal recommendations: (1) that the method of computing the reserve interest deduction allowed to life insurance companies in calculating their "taxable investment income" be revised; (2) that the provisions of current law which defer taxation of (and, effectively, exempt) one-half the excess of a life insurance company's "gain from operations" over its "taxable investment income," be phased out; and (3) that the election allowed life insurance companies to revalue life insurance reserves computed on a preliminary term basis using the so-called "approximate revaluation method" be revised.

We welcome the Draft Report's proposal to eliminate deferral on the currently untaxed one-half the excess of gain from operations over taxable investment income, although we feel that the proposed treatment of new companies and transitional periods would continue to allow excessive deferral (or exemption) of income from tax.

We also welcome the Draft Report's recognition that the "approximate method" allowed by section 818(c)(2) of the Code for revaluing preliminary term reserves for tax purposes is unduly generous. Nevertheless, we believe that the Draft Report's proposed revisions to the approximate revaluation formula would continue to allow deductions significantly in excess of those that would result from exact revaluation, thereby preserving some of the undue benefit allowed by current law. We do not understand why the Draft Report refrained from recommending the repeal of approximate revaluation, since no reason is set out in the Draft Report

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why exact revaluation should not be required in most cases. If there is an apprehension that exact revaluation would be costly for the industry to implement, that apprehension should be made more explicit, and your factual basis for it ought to be detailed in the Report. In any event, we feel that the final Report should consider such alternatives as shifting from approximate to exact revaluation prospectively, which would greatly reduce any possible administrative costs to the life insurance industry of the change. Such an approach could be combined with allowing newly-organized life insurance companies to use some form of approximate revaluation for a limited period of time.

More importantly, as set out in greater detail in our General Comments, we believe there are serious deficiencies in the Draft Report's analysis of the need for a change in the "adjusted reserves rate/Menge adjustment" method currently prescribed by the Code for computing a life insurance company's "taxable investment income." The Draft Report focuses almost exclusively on the fact that, in the current environment of high interest rates, the life insurance industry's marginal rate of tax on investment income is approaching the statutory rate of 46 percent and may continue to rise. It is apparently this phenomenon -- rising marginal tax rates on life insurance company portfolio income -- that leads the Draft Report to conclude that legislation is needed.

The Draft Report fails to justify its exclusive focus on marginal tax rates. Even when high interest rates yield high marginal rates on incremental portfolio income realized by a life insurance company, the average rate of tax on a life insurance company's "net investment income" (i.e., gross investment income less investment expenses) or on its so-called "free investment income" (i.e., net investment income minus a policyholder reserve interest deduction based on a company's assumed earnings rates), is substantially less than 46 percent. For example, using the numbers contained in Table 23 at page 6-15 of the Draft Report, where the marginal tax rate experienced by a life insurance company equals the statutory rate of 46 percent, its average rate of tax on net investment income is roughly 23 percent, and its average rate of tax on free investment income is approximately 35 percent. Thus, even those companies that may be experiencing marginal rates near the statutory rate are subject to average rates of tax that are substantially less.

The Report goes on to observe that if portfolio-wide interest rates continue to rise, the industry will begin to experience still higher marginal rates. Even if the industry were to achieve portfolio-wide "adjusted reserve rates" as high as 10 percent, at which point (again according to Table

23) a life insurance company might face a marginal tax rate of 68 percent, its average rate of tax on net investment income would be approximately 34 percent and its average rate of tax on free investment income would equal the statutory rate of 46 percent. In other words, the current procedure for taxing portfolio income of life insurance companies has taxed (and continues to tax) substantial increments of portfolio income at well below the statutory rate.

The fact that the life insurance industry has, for the past 20 years, been taxed on its investment income at substantially below the statutory corporate tax rate is not confronted by the Draft Report. Both the present marginal tax rates and low average tax rates are a function of the method currently used to calculate the reserve interest deduction. It is inappropriate to reexamine one but not the other of the principal consequences of this method. The fact that the Draft Report has done so undermines its conclusion that the method of taxing investment income of life insurance companies "must be" altered to provide relief to the industry.

We therefore believe that the Report should be significantly revised. If legislative relief is to be justified on the basis of rising marginal tax rates, the reliance on marginal rates should be explicitly defended. The Report also must confront the equitability of providing the life insurance industry relief from the high marginal rates it conceivably might face in the future without also correcting for the fact that it has enjoyed in the past, and continues to enjoy, rates of tax on free investment income that are well below the statutory rate. We regard it as essential to the soundness of any report dealing with Subchapter L that these aspects of the tax treatment of life insurance companies be considered.

Indeed, in a larger way we question the Draft Report's conclusion that one of the principal respects in which Subchapter L may need revision is the current method of computing the reserve interest deduction for ordinary and group life insurance reserves. We recognize that, in some respects, the current treatment of pension plan reserves conceivably could be regarded as unsatisfactory, an industry perception that may have encouraged some companies to attempt to secure so-called "interest paid" treatment for such reserves and to resort to modified coinsurance arrangements. Perhaps a case can be made for a revision to the industry's pension reserve deduction, although we are not now convinced that that is so. That issue aside, however, the items that we would consider as more clearly meriting administrative or legislative attention include the following, which we believe have received far too little attention in the Draft Report.

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Modified Coinsurance. While recognizing that modified coinsurance contracts may involve little transfer of risk, the Draft Report's treatment of the subject is superficial and uncritical. Such agreements are widely recognized as lacking economic substance. They are currently under scrutiny at the administrative level, and legislative action to remove any ambiguity would be appropriate.

Deferred Annuity Contracts. The current tax treatment of deferred annuity contracts, which before they are annuitized do not materially differ from other financial investments, requires thorough reexamination. The fact that current tax law treats deferred annuities more favorably than other financial investments has stimulated attempts to market other investment securities through what purport to be deferred annuities in an effort to obtain more favorable tax treatment. While the Draft Report recognizes this trend we believe that more attention should be devoted to this issue.

Standard Life. The Report alludes to, but fails to discuss in any detail, the propriety of the Supreme Court's decision in Standard Life and Accident Ins. Co. v. United States, 443 U.S. 148 (1977), dealing with the tax treatment of due but unpaid and deferred and uncollected premiums. This decision raises serious technical and policy questions that should be more thoroughly considered in the final Report.

Investment Expenses and Premium Income. While the Draft Report identifies problems with the definition of investment expenses, it does not address the subject in any detail. As our Page-by-Page comments note, there are a variety of issues to be examined in this area, including the fact that discounts for premiums paid in advance are treated as interest paid (an investment expense), whereas surcharges imposed for deferred payment of premiums are treated as underwriting income, even though both largely reflect the time value of money (that is, interest).

Finally, we note that, perhaps because of the arcane nature of Subchapter L, in framing this study the GAO consulted with a number of individuals from outside the GAO itself. It appears to us that no Federal governmental official responsible for the administration or oversight of Subchapter L was among those consulted. We can assure you that the Treasury would have been pleased to offer you, from

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that, despite the length of our
usual practice of appending them
final version of the Report. If
relating to this letter or to it
hesitate to contact me.

William J. Anderson
Director, General Government Div
United States General Accounting
Washington, D.C. 20548

Attachments

July 13, 1981

General Comments of the United States
Department of the Treasury
on the Central Recommendation of a Draft GAO Report
on Subchapter L

While the Draft Report is broad in scope, and makes three major recommendations for change and identifies six other areas as warranting further study, the principal focus of the Draft Report is on the method used to compute the deduction, allowed in calculating a life insurance company's "taxable investment income," for amounts considered to be set aside out of investment income to fund reserve liabilities to policyholders (the "reserve interest deduction").

Under existing law life insurance companies are allowed a deduction based on their "adjusted reserves rate," which is usually a five-year rolling average of a company's actual portfolio-wide earnings rate. The rate generally exceeds the so-called "assumed rates" of interest on outstanding policies, which are the rates at which the company assumes that investment earnings will be credited to policyholder reserves. State laws establish ceilings on all life insurance companies' assumed rates. These ceilings operate to require conservative financial management: the lower a company's assumed rates -- that is, the less it assumes will be available from investment activities to fund policyholder reserves -- the more it must set aside out of premium income to meet reserve liabilities. In framing the 1959 legislation, Congress evidently refrained from basing the reserve interest deduction for tax purposes on assumed rates to avoid creating a tax "incentive" to abandonment of conservative financial practices reflected in the use of low assumed rates. Since enactment of the 1959 legislation, the industry-wide "adjusted reserves rate" has at all times exceeded the industry's assumed rates, and its reserve interest deduction has at all times exceeded the deduction it would have been allowed if assumed rates had formed the basis for the deduction.

The use of the adjusted reserves rate, rather than assumed rates, is partially offset by a 10 percent downward adjustment of nominal life insurance reserves (to which the "adjusted reserves rate" is applied in computing the reserve interest deduction) for each one percentage point difference between the company's "adjusted reserves rate" and its assumed rate. This adjustment to nominal reserves is

referred to as the "Menge adjustment." It is the operation of the Menge adjustment that most concerns the industry today, a concern that the Draft Report appears to endorse.

The basic conclusions of the Draft Report on this subject can be summarized simply: 1) life insurance companies "must be" allowed a deduction for amounts set aside out of investment income to meet reserve liabilities; 2) the 1959 Act reflects a Congressional judgment that the deduction may exceed an assumed rate deduction; 3) the Menge adjustment was appropriate when the difference between earned rates and assumed rates was small; 4) the Menge adjustment yields rising marginal rates after a certain level of earnings rates has been achieved; and 5) some large companies are reaching the point at which marginal rates may begin to approach the statutory rate. The Draft Report ultimately concludes that something must be done.

Many of the premises underlying these conclusions are either left unanalyzed or analyzed superficially. In revising the Draft Report, far more attention should be devoted to a systematic analysis of each premise. Specifically, at least some attention should be devoted to whether, in light of the tax exempt nature of life insurance proceeds, any reserve deduction is essential; and to whether, if it is, there is any justification for allowing a deduction in excess of assumed rates. Beyond that, we feel the Draft Report entirely fails to explain why rising marginal rates on investment income justify tax relief when the average rate of tax on a life insurance company's "free" investment income (that is, net investment income less an assumed rate deduction) is, even in today's environment, well below the statutory rate of 46 percent.

Is a reserve deduction essential?

At the most basic level, the Draft Report fails to take adequate account of the difference between life insurance companies and other financial intermediaries. All financial intermediaries function to bring together suppliers and consumers of financial capital. The basic principle underlying the Federal income tax treatment of such institutions is that earnings received by suppliers of capital will be taxed to the financial intermediary or to its customers, but not to both. Thus, interest credited to the depositor in a commercial bank is taxed to the depositor but not to the bank. The same is true of a mutual savings bank or a savings and loan association.

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Life insurance companies represent the principal exception to this rule. Interest credited to reserves on ordinary life insurance contracts generally are not taxed to the policyholder, because of the income tax exclusion (under Section 101) for proceeds of ordinary life insurance. Similarly, earnings credited by a life insurance company to a deferred annuity contract are not taxed currently to the annuity contract holder but are taxed (if it all) only on a deferred basis in accordance with the rules of section 72 of the Code. These aspects of the tax law are referred to as the "inside interest buildup." Additionally, as the Draft Report recognizes, dividends paid to the policyholders of mutual life insurance companies are treated as premium rebates, and are excluded from the recipient's income, even though the dividends may function to distribute investment earnings to the policyholder.

The Draft Report alludes to these differences between earnings credited to life insurance contracts and earnings credited by other financial intermediaries to their customers. At one point (p. 4-14) the Draft Report even suggests that the inside interest buildup may be relevant to an assessment of the manner in which life insurance companies are taxed at the entity level. The Draft Report also indicates that the inside buildup may give life insurance companies an advantage over other financial intermediaries (p. 4-15); and, at another point, that the interest on life insurance reserves perhaps "should be taxed as earned, either at the policyholder level or at the company level." (P. 4-14)

What is lacking in the Draft Report, however, is a systematic analysis of whether the tax-free or tax-deferred "inside interest buildup" should affect the analysis of the proper deduction (if any) to be allowed life insurance companies for investment earnings credited to these contracts in computing their entity-level tax. Obviously, the Congressional judgment to date has been that insurance companies should be allowed a deduction for such amounts credited in computing their taxable income despite the tax favored nature of the "inside buildup." Nevertheless, it seems appropriate, in the context of a major review of the operation of Subchapter L, for this issue to be thoroughly examined.

In the past, some analysts have suggested taxing the inside buildup directly to life insurance policyholders. In the context of its review of Subchapter L the Draft Report ought to examine the soundness of disallowing an entity-level deduction as a surrogate for tax-exemption granted to the policyholder. In this examination, it at least is

appropriate to consider other situations in which a deduction is allowed at an entity level only if the amounts for which a deduction is claimed are included in the income of the recipient. For example, the tax treatment of nonqualified deferred compensation arrangements incorporates just such an approach. While employers are allowed current deductions on contributions to qualified retirement plans, no deduction is allowed to the payor of nonqualified deferred compensation until the amount credited is taken into income by the recipient. This approach is reflected in sections 83(h) and 404(a)(5) of the Code. Thus, in at least some circumstances Congress has considered disallowance of an entity-level deduction to be a suitable surrogate for exemption or deferral in the hands of the recipient. The application of such an analysis to life insurance policies might justify denying an entity-level deduction as a surrogate for the policyholder exclusion. We do not suggest that this conclusion is necessarily appropriate. We do, however, think the issue merits attention.

Should a Deduction be Allowed in Advance of Benefit Payments?

The Draft Report also fails to consider whether, if a deduction is to be allowed life insurance companies for earnings credited to life insurance reserves, the deduction should be allowed in advance of the time that benefits are actually paid. The Draft Report relies on what it perceives to be the "unique" and "long-term" nature of life insurance contracts in concluding that the industry "must be" allowed advance deductions. Yet the Draft Report cites no data in support of the contention that life insurance contracts are in fact long-term, or if they are, that they are unique in that respect. It would be useful to develop information concerning the typical lapse rates on life insurance and deferred annuity contracts in an effort to identify the average life of such contracts. It would also be useful in this respect to examine the implications of the Draft Report's perception that life insurance business has, over the past 20 years, shifted from ordinary life insurance policies (which are nominally of long duration) to term and group insurance contracts (which are not). Such information would enable Congress to determine the extent to which life insurance contracts differ from other financial instruments.

Even if life insurance contracts constitute long-term obligations it is not clear to us that in that respect they are unique. Other activities, for example, manufacturing and electric generating, create liabilities (such as warranty obligations or plant decommissioning expenses) that extend far into the future. Some years ago, in connection with

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proposals to allow tax deductions for anticipated product liability losses, the Treasury concluded that deductions for such losses could be deferred until a future date, provided that appropriate net operating loss carrybacks were allowed. While there has been no opportunity to review such considerations in the specific context of life insurance contracts, it seems appropriate, given the magnitude of the proposed GAO study, to consider whether any reserve interest deduction should be allowed prior to the payment of claims or benefits (assuming, of course, appropriate carryback periods were allowed for underwriting losses). Again, we are not now in a position to say what such an analysis would disclose. It is important, however, that such a question should be posed. Possibly it might lead to the conclusion that a reserve interest deduction for additions to policyholder reserves, in advance of actual payment of benefits, is not an essential part of the tax treatment of life insurance companies. If not, it might shed further light on the central issue of the Draft Report, i.e., whether there should be any modification of the formula for computing the reserve interest deduction under current law.

Is a Deduction in Excess of Assumed Rates Justified?

The preceding analysis suggests that the Draft Report has failed to consider some basic questions relating to the reserve interest deduction. We also have serious doubts about the adequacy of the Draft Report's analysis of the issues it explicitly considers. Specifically, by focusing almost exclusively on the rising marginal rates resulting from the Menge adjustment, the Draft Report fails to accord proper weight to the fact that the average rate of tax on free investment income remains substantially below the statutory rate of 46 percent. For this purpose we define "free investment income" as actual investment earnings less investment expenses ("net investment income"), minus a deduction for amounts credited to policyholder reserves based on the interest rates assumed by a life insurance company in writing its contracts.

As our transmittal letter points out, the Draft Report's preoccupation with rising marginal tax rates on investment income obscures the fact that the industry's average tax on investment income is substantially below the statutory 46 percent rate. For all the industry's concern about high marginal rates, to which the Draft Report's authors have subscribed, the average tax rate on free investment income of life insurance companies remains ten to fifteen points below the statutory rate. (The rate on net investment income would be even lower, on the order of 20-25 percent.)

To make the point concretely, the marginal rate of tax on investment income of the sample of 42 companies used throughout the Draft Report is currently approaching the statutory rate of 46 percent. Assuming, as the Report indicates, that in 1978 the unweighted average adjusted reserves rate for the sample companies was 6.3 percent, that an unweighted average assumed rate for the sample was 2.86 percent, and that the companies' actual portfolio-wide current earnings rate was approximately 6.81 percent (see Appendix III to the Draft Report), a relatively simple calculation discloses that the average rate of tax incurred by these companies on free investment income (that is on income earned at the rate of 6.81 percent less a policyholder reserve deduction based on assumed rates of 2.86 percent) is in the range of 20-30 percent.

This low average tax rate on free investment income merits serious attention, particularly in view of the Draft Report's apparent conclusion that the life insurance industry's rising marginal tax rate justifies tax relief. In reaching such a conclusion, a number of policy questions need to be far more extensively examined than they are in the Draft Report.

For one thing, little analysis is devoted to the soundness of Congress' judgment in 1959 to allow the life insurance industry a deduction in excess of a deduction based on a company's assumed interest rates. Evidently Congress was reluctant to penalize companies that, in the interest of conservative financial practices, employed assumed rates that were below the statutory ceilings. In fact, the current Code formula itself can operate to disadvantage companies that employ assumed rates below the statutory ceilings. This occurs because the magnitude of the Menge adjustment is a function of the difference between earned rates and assumed rates. Consequently, when the adjusted earnings rate materially exceeds assumed rates, as it currently does, a company that employs higher assumed rates in writing its contracts will, all other things being equal, be entitled to a larger reserve interest deduction than a similarly situated company using lower assumed rates. This is dramatically illustrated by the fact that one major mutual life insurance company substantially reduced its Federal income tax bill by modifying all its pre-existing life insurance contracts to increase the assumed interest rates implied in the contracts to the state-law statutory maximum. As an inducement to its policyholders to accept this modification to their contracts, the company offered them increased coverage under pre-existing contracts at no additional premium cost. Since the Menge adjustment itself can operate to disadvantage

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companies using lower assumed rates, the soundness of the Congress' conclusion in 1959 -- that the use of assumed rates in computing the reserve deduction should be avoided for fear of disadvantaging some companies relative to others -- is open to question.

Moreover, the Draft Report itself acknowledges that a reserve deduction in excess of that based on assumed rates might not be justifiable if the benefits of the additional earnings are not passed on to policyholders. However, the Draft Report contains no independent data on the basis of which one may infer that this in fact occurs. Moreover, to the extent that policyholder dividends are used to distribute investment earnings to policyholders, as some mutual companies assert, the Report does not consider whether the treatment of such dividends should now be altered to render them taxable to the recipients.

In short, the Report is deficient in its analysis of whether any deduction in excess of that based on assumed interest rates is warranted.

The Draft Report is equally deficient in assessing whether any revision to the Menge adjustment, favoring the industry, is warranted. The Draft Report asserts that the Menge adjustment worked "reasonably well" at a time of relatively low differentials between portfolio rates and assumed rates. (Pp. 4-11.) It also notes that, during 1958 when assumed rates were approximately 2.78 percent and adjusted reserves rates were approximately 3.56 percent, the Menge adjustment yielded a reserve deduction equal to approximately 3.28 percent of nominal life insurance reserves. Accordingly, the life insurance industry enjoyed a premium of about 18 percent over the deduction that would have been allowed if assumed rates had been used as the basis for the deduction. Apparently, this result is regarded by the authors of the Draft Report as acceptable.

The Draft Report then goes on to point out, however, that under conditions prevailing in 1978, when portfolio-wide assumed rates were approximately 2.86 percent and portfolio-wide adjusted reserves rates were on the order of 6.3 percent, the Menge formula allowed a deduction equal to 4.13 percent of nominal reserves. Thus, the data used in the Report imply a 1978 premium of nearly 45 percent over the deduction that would have been allowed if assumed rates had been used as the basis for the deduction. From 1959 to 1978, therefore, the premium on the deduction allowed by the Menge formula over the deduction that would have been allowed if assumed rates had been used increased by nearly 250 percent.

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which the President has recommended to Congress will, if enacted, moderate interest rates significantly. Moreover, the Draft Report makes no effort to extrapolate on the basis of historical data to see how rapidly average interest rates will rise. A rough calculation based on data contained in the 1980 Life Insurance Fact Book shows that, during the period 1975-79, the industry-wide "adjusted reserves rate"* grew at a compound annual rate of approximately 4.25 percent. If that trend continued the industry as a whole would not reach a portfolio-wide adjusted reserves rate of 9.25 percent -- at which level the industry as a whole would be receiving about the same aggregate reserve deduction as if portfolio rates were 3.5 percent -- until the middle of this decade. Thus, on factual grounds we question the sense of urgency that is conveyed by the report.

Finally, we believe that the Draft Report has failed to canvas thoroughly all the possible changes that might be made to the current formula for computing the reserve interest deduction. For one thing, the Draft Report hastily rejects the notion that the Code formula should be changed to compute the reserve interest deduction on the basis of assumed rates. Apparently this approach is rejected because, at currently prevailing interest rates, it would involve a significant increase in tax to the industry (on the order of $750 million per year), and on the industry's undocumented assertion that they "need" a larger reserve deduction. Any tax increase that would result from employing assumed rates as the basis for the reserve interest deduction merely indicates the current magnitude of the tax benefits that the industry has enjoyed since 1959.

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*Based on an unweighted average of portfolio-wide earnings rates (including life insurance company separate account), 1980 Life Insurance Fact Book, at 61.

APPENDIX VIII

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

JUL 15 1981

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft of a proposed report entitled "Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendations for Change."

The three positive recommendations outlined in pages 7-2 through 7-6 of the proposed report principally involve issues of tax policy that fall under the jurisdiction of the Assistant Secretary (Tax Policy), from whom you will receive separate comments. As to the remainder of the report, we believe that it insufficiently addresses many of the more controversial areas in the taxation of life insurance companies and life insurance products that have been caused by "innovation" within the industry and for which legislative clarification might prove useful.

As a prime example, the report briefly alludes to the tax-free "inside build-up" of earnings on life insurance products, but does not systematically present the significant and controversial tax policy issues resulting from it.

This difficulty is highlighted by the tax treatment of deferred annuities. The deferred annuity with life option that was commonplace in 1959 has been replaced by "variable annuities," "investment annuities," "wraparound annuities," and "flexible premium annuities," to mention but a few. These new investment vehicles are designed to compete with such investments as mutual funds, savings certificates, and money market funds. In many of these so-called annuities, the annuity features are, at most, incidental to the claimed tax-deferred investment features.

One of the most striking recent innovations in this annuity area is the promotion of wraparound annuities. According to a headline in the Wall Street Journal (Monday, July 14, 1980), with these contracts "Creative Brokers Make Annuities a New Means of Using Your Mutual Funds as a Tax Shelter." The shelter aspect referred to is the tax deferral or tax-free build-up associated with annuity contracts under section 72 of the Code. The marketing emphasis on the investment nature of the contract rather than the annuitization benefits raises the policy question whether these contracts are properly to be classified as "annuities" for tax purposes.

Such problems are not confined to the annuity area. The industry is also developing product variations in the whole life insurance area. Recently, there has been a lot of publicity about the universal life insurance policy, which is an attempt to recast whole life insurance and endowment policies in the form of contracts that will attract the investment oriented consumer while retaining the traditional tax consequences under section 101 of the Code for life insurance policies. In addition, the industry has introduced the concept of variable life insurance contracts, which might be viewed as an outgrowth of variable annuity contracts. In referring to such contracts, a recent article in the Wall Street Journal (Monday, May 4, 1981), questioned "Where can you get one of the highest tax-deferred -- or tax-free -- yields on your savings? Try Life Insurance."

By concentrating solely on Subchapter L, the report does not adequately consider the tax deferral from deferred annuities and the tax exemption for proceeds of life insurance contracts granted to the individual taxpayer by sections 72 and 101 of the Internal Revenue Code. Unlike the industry practice in 1959, today the tax deferral benefits of sections 72 and 101 are used as a marketing tactic by insurance companies to compete directly for the investment dollar with other financial institutions. The report obviously devotes a great deal of attention to the adequacy of the reserve deduction allowed to life insurance companies in computing their taxable investment income. It recognizes that, like other institutions such as commercial banks, life insurance companies are financial intermediaries. Under such circumstances we find it difficult to understand why the report's analysis of the deduction allowed to life insurance companies for amounts credited to policyholder reserves was not complemented by an analysis of the propriety of deferral or exemption of that income in policyholders' hands. A comprehensive analysis of the taxation of life insurance companies must consider the tax deferred "inside build-up" granted policyholders.

Another policy issue that needs to be more fully developed is what should be the tax consequences of the use of reinsurance contracts within the insurance industry? The present use of modified coinsurance (to, in effect, change Phase I income to Phase II income) may result in one of the largest single areas of revenue loss to the Government today. Many, if not all, of these contracts involve minimal risk-sharing, and are negotiated for the predominant purpose of producing tax savings. According to an article in the Wall Street Journal (Wednesday, May 20, 1981), financial statements filed by big mutual life insurance companies with the New York State Insurance Agency show in some cases major reductions in Federal tax bills in the past year due to reinsurance transactions. For instance, it was reported in the Wall Street Journal that from 1979 to 1980, Prudential's Federal tax bill declined by $260,000,000 and Metropolitan Life's dropped approximately $265,000,000. The report seems to proceed on the casual assumption that modified coinsurance is simply a means of correcting a problem with the pension reserve deduction when, in reality, it may represent a major area of tax avoidance.

Mr. William J. Anderson

In general, the draft report, as a proposal for the revision of the 1959 Act, does not sufficiently deal with the most important tax policy questions concerning the taxation of life insurance companies. By referring to, but not fully presenting issues that are currently under consideration by the Service (modified co-insurance) and new products for which tax consequences have not been fully resolved (the universal life insurance policy and deferred annuities), we are concerned that the draft report may put the Government at an unfair disadvantage in attempting, legislatively or administratively, to resolve these problems.

Because this report may have a considerable impact on policymakers, we believe a special effort should be made to fully present both sides of each issue. Because the report's information was gathered almost exclusively from the industry directly, or from industry associates, a concerted effort should be made to review the report to ensure that its focus and its language are as neutral as possible. The draft report does not achieve this desired neutrality. Rather, it focuses on the principal concerns of industry while failing to adequately consider the principal concerns or the Government.

One final but important point relates to some of the language used in making the six recommendations for study. At page 7-8, the draft report discusses the definition of life insurance reserves "required by law." The report suggests that these interpretive problems can possibly be resolved by uniform administration by agents. The implication is that the Service is deciding like cases in an unlike manner. This discussion and the supporting discussion starting at page 4-37 does not provide specific examples that support this statement. If you have knowledge of such cases, it is vitally important to our administration of the tax laws that we be provided with such cases so that prompt remedial relief can be provided to the affected taxpayer(s). We have a similar problem with the language used on page 7-9.

In addition to the above general comments, we have enclosed a number of specific and technical comments that we hope will be helpful to you in the preparation of your final report.

With kind regards,

Sincerely,

Enclosure
As Stated

APPENDIX VIII

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006
(202) 862-4307

Richard V. Mrick
Executive Vice President

July 6, 1981

United States General Accounting Office
Attention: Mr. Natwar Gandhi
Program Analysis Division
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Gandhi:

As Executive Vice President of the American Council of Life Insurance, I thank you for the opportunity to comment on the draft GAO Report, "The Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendation for Change." Over 500 life insurance companies are members of the Council and these companies account for 95 percent of the life insurance written in the United States, 99 percent of the reserves for insured pension plans, and 97 percent of the assets of all life insurance companies in the United States.

Since May 22, when we received the draft, it has been the subject of review not only by our own staff but also by our member companies. A small task force has been created to assemble and organize detailed comments on the Report, as well as a page-by-page listing of minor technical inaccuracies. We plan to present them during the week of July 13. In the meantime, however, your staff has asked for a brief and initial summary of the Council's views. This letter is in response to that request.

We are impressed by the scope of the Report as well as its analyses of both the life insurance business and the complex law under which our members pay their federal income taxes. Further, we welcome your recognition of the indispensable roles of the life insurance industry in meeting the nation's long-term capital needs and providing security, through life insurance, to individual policyholders and their families; and the threat to both of these roles of continuing high levels of inflation.

As you may know, the American Council of Life Insurance is nearing the end of its own intensive, two-year study of the Life Insurance Company Income Tax Act of 1959. On the basis of that study, we too are convinced that the Act is outdated and badly in

need of revision. Moreover present law in many instanc We are, for example, acutel have made the so-called "10 too identify that as a prob a solution that exacerbates Additionally, we believe th tax disincentive to life co and municipal bonds. (We w to you as soon as it is com two major conclusions of yo to your recommendations, ur clusions are:

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We also believe that y consideration to:

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--the significance of as a mechanism for re passing investment ir along to them; and

--the industry's compet and insured welfare p

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1. Comparative Tax Bur recommendations on the assu compared to all U. S. corpor insurance industry does not nificant pattern over the ti from Table 17 which, on a be crease in the life insurance 2.55% in 1976, a 5% increase parison used in this table i

To cite tax figures on a before tax credit basis produces serious distortions, for this ignores the dramatic effect that foreign and investment tax credits have had since 1962 on the profits tax figures of most U. S. firms. As these credits have, by contrast, had a minimal effect on the taxes of the life insurance industry, we believe the only fair way to compare relative U. S. tax burdens is on an after tax credit basis. On such a basis, the life insurance company share of all corporations' income tax collections is shown to be 2.51% in 1960 and 4.49% in 1975--a 79% increase.

Other economic measures of growth demonstrate this increase in life insurance company taxes dramatically. Over the period 1960 to 1978, life insurance company taxes increased six times, while life insurance company gain from operations after taxes increased only four times. By contrast, during the same period, the federal income taxes of all corporations grew only three times as compared with a growth factor of 4-1/2 times for all corporations' income after taxes.

We believe that these figures clearly illustrate that the life insurance business has carried an ever-increasing share of the general corporate tax burden--and that the taxes on the life insurance business have grown faster than the insurance company gain from operations. An understanding of this increasing tax burden on the life insurance business is, we believe, essential to any attempted revision of the 1959 Act.

We agree with you that one of the principal standards by which any tax law should be judged is its equity and that equity is determined by comparing the relative tax burdens of firms engaged in similar businesses. The appropriate comparison in the case of the life insurance industry is with other financial intermediaries and particularly with banks. Your Report demonstrates that since 1960, while life companies' share of total tax payments of all financial intermediaries increased by some 72%, the banks' share declined by nearly 44%. At the same time, the life companies' taxes, stated as percentages of their assets, rose 50% and the banks' taxes went down 71%. You brush this disparity aside by noting the difference between the federal income tax treatment of bank depositors and life insurance policyholders. This seems to us to ignore the fundamental difference between the products offered by the respective institutions as well as the complexities of the policyholders' tax position. We should also like to point out that banks are allowed full deductions for that part of their investment income paid to depositors while life insurance companies' deductions for such payments are severely limited.

2. Life Insurance Industry Stability. On page 6-32, GAO concludes that "since overall industry performance has been

quite predictable, Congress may wish to consider phasing out the 50% deferral provision." Giving effect to this GAO recommendation would deprive stock companies of their present ability to continue accumulating tax-deferred funds for the long term protection of their policyholders. At a time when the need for such long term protection has never been greater, the suggestion seems singularly inappropriate. It is also without factual support.

Most of the policies written by stock life insurance companies are nonparticipating. Under such policies, premiums are guaranteed for future years. There is no redundant portion of any such premium that can, as is the case for each participating contract, "cushion" unfavorable experience during the period of coverage. Since competition dictates that new policies be priced to reflect current yields and mortality experience, there is a very real risk that premiums will prove inadequate. Congress designed the Phase III deferral as the principal means of giving stock companies the cushion they do not otherwise have to assure their solvency.

The draft Report's recommendation that this cushion be eliminated is premised on the findings of overall favorable industry experience during the past twenty years. Such an approach ignores the fact that maintaining solvency and the consequent capacity to meet obligations as they mature is an individual company, not an industry-wide, problem. Further, although the Report hedges its findings of predictability with the phrases "barring some unforeseen catastrophe," and "if present trends continue," it assumes--as no prudent company management could--that there will be no unforeseen catastrophes, and that the "discerned" trends will continue.

As to catastrophes, they are always occurring: they are "unforeseen" only in the sense that we cannot anticipate their nature, their frequency, or their magnitude. We at least know that our technology has produced new opportunities for catastrophe by giving us, for example, jumbo jets that can crash and nuclear power plants that can explode.

With respect to trends, there is already some evidence of reversal. Interest rates may have peaked. Mortality experience for 1980 and 1981 has shown higher death rates and operating expenses cannot yet be regarded as under control.

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Further, Congress recognized in 1959 that ascertaining the income of a life insurance company for any one year is a difficult, if not impossible, task. This is because one of the principal charges against revenue is each year's increase in reserves, an amount that depends on actuarial estimates the accuracy of which will be established only over many years.

Finally, a potentially serious surplus strain could arise in the near future because of the increased demand on life insurance companies for low interest policy loans. A dramatic rise in such loans could force individual companies to borrow funds or sell assets at a loss to satisfy current obligations. If the deferred fund in the policyholders' surplus account were eliminated, companies would be stripped of a major protection against these kinds of contingencies.

In view of the current increasingly unstable economic conditions, we believe the GAO should carefully review its conclusion of predictability and its recommendation to eliminate the deferral of one-half of the excess of gain from operation over taxable investment income.

3. Stock/Mutual Balance. At numerous points the draft Report notes, with apparent approval, that Congress took great care in writing the 1959 Act to maintain the existing competitive balance between stock and mutual companies. In view of the GAO's obvious sensitivity to this issue, it is especially puzzling that the draft Report proposes revisions that would drastically disrupt this balance.

For example, the GAO's first recommended proposals seek to change the computation of the policyholder's share of investment income. Although one of these proposals--the geometric "10 for 1" rule--would provide some tax relief for companies in a Phase I tax position, it provides no benefit for Phase II companies. For the most part, Phase II companies are stock companies.

The GAO's second proposal would eliminate the deferral of one-half of the excess of gain from operation over taxable investment income. This would have a very detrimental effect on companies in a Phase II tax situation--the overwhelming number of which are stock companies.

The third GAO proposal would effect the §818(c) election. In its inception, this election was intended to afford relief for small companies. Since such companies are almost all stock companies, your proposal to change this provision would bear most heavily against them.

Finally, the recommendation that what you refer to as "the $250,000 statutory deduction" be repealed would, if adopted, bear most heavily upon small companies, most of which are stock companies.

In this connection, we have been led to believe that the 42-company sample used by the GAO in developing the draft Report may have been a major factor in creating the imbalance in the draft's proposed recommendations. It has been reported that, of the 42 companies studied, only 18 were stock companies and of the 18 only three were in a Phase II positive tax situation. We question whether it is appropriate to base suggested industry-wide tax revisions on a data base that does not reflect the overall composition of that industry.

4. Treatment of Policyholder Dividends. At several points in the draft Report, the GAO notes the decline of life insurance as a savings vehicle, and perceptively discerns the link between this decline and the availability of increasingly higher yields in other investment options. Yet the draft Report fails to identify the major reason for today's relative unattractiveness of permanent life insurance as a savings vehicle--the inability of life insurance companies more fully to deduct the amounts of investment income paid out to policyholders in the form of dividends. For this reason, although dividends represent price reductions, they have come increasingly to be paid out of after-tax income and have necessarily been reduced by the tax they have borne.

If life insurance companies are to remain competitive, they must pass most of their investment income through to consumers in the form of price reductions or policyholder dividends. However, because of unforeseen distortions brought about by inflation and resulting soaring interest rates, the dividend deduction limitation provisions of the 1959 Act have operated to create an ever shrinking policyholder dividend deduction. Our figures indicate that effective deductions for policyholder dividends have fallen from 90% in 1959 to about 60% in 1978.

To our member companies that sell participating insurance, the major inadequacy of the present law is its increasingly detrimental effect on policyholder dividends. A report on the 1959 Act that does not deal with this problem is itself inadequate.

5. Pension and Welfare Benefit Plan Funds. The draft Report at several points asserts that life insurance companies pay no federal income tax on investment income attributable to pension funds. This

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is not the fact. At least part of this income often bears a significant tax, although the extent of such tax varies not only from company to company but also from one type of contract to another.

Even the income credited to the relatively small portion of pension funds (16.24% of the 1978 total) held in "segregated asset" accounts (within the meaning of Code section 801(g)) may bear some tax. This occurs whenever the investments of an account are supported by debt capital, or the account realizes net short-term capital gains.

In the case of pension funds held in life insurance companies' general accounts or in separate accounts supporting contracts containing principal and interest guarantees, the investment income that is free from tax is frequently less than the income applied to fund benefits. This is because, when the contracts involve permanent insurance guarantees, the policyholder's share exclusion derives from the average rate earned on each company's entire portfolio, including such nonearning and low-earning assets as furniture and fixtures, policy loans, and stock of subsidiaries that are rarely allocated to the pension line of business. This problem is exacerbated when pension plan reserves are increasing faster than life insurance reserves. The exclusion also fails to reflect realized long-term capital gains allocated to pension funds. The differential between the amounts credited and the tax exclusion has been made even greater as all the major companies in the business, and more and more of the smaller companies, have adopted investment year methods for determining the interest to be credited to pension contracts.

To the extent investment income is allocated to pension accounts through policyholder dividends, substantial taxes arise by reason of the limitation on dividend deductions impqsed by section 809(f) of the Internal Revenue Code.

These effects are contrary to Congress' intent to put insured pension plans on a parity with those funded through trusts.

Equally significant competitive disadvantages inhere in the existing tax treatment of insured employee welfare benefit plan funds. Problems in this area will be outlined in greater detail in our fuller submission.

Finally, we should like to say a word concerning our industry's role in capital formation. Your draft notes its importance. Except indirectly, however, you have failed to define the special character of life company investments. Because the companies' obligations

are long-term, the preponderance of their assets have, historically, also been long-term and chiefly in various forms of debt instruments. To the extent these instruments were issued to obtain industrial capital the life insurance companies were their principal buyers. Long-term debt instruments constituted relatively small portions of the commitments of commercial banks and the savings and loans, the two larger groups serving as financial intermediaries. Because of the interplay of inflation and their detrimental tax position, the life insurance companies are being forced to de-emphasize their long-term investments. The higher yields available for alternatives to permanent life insurance have not only depressed sales of this product but have also, in effect, converted amounts almost equal to the industry's reserves into demand obligations. To maintain the liquidity required by this situation the companies have been forced to shorten maturities. If present conditions--including the tax law--persist, there will soon be no major source of long-term capital.

* * * * *

We thank you again for letting us see your proposed Report and hope these brief comments will be of some assistance to you. I wish to stress again, however, that this letter provides only a very general and incomplete summary of our views. The American Council believes, as I'm sure you will agree, that the draft Report merits a much more thorough analysis than is possible in a short letter.

Very truly yours,

Richard V. Minck

Richard V. Minck

RVM:dec

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American Council of Life Insurance

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(202) 862-4307

Richard V. Minck
Executive Vice President

July 14, 1981

Mr. Natwar Gandhi
Program Analysis Division
United States General
Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

R

Dear Mr. Gandhi:

Re: Draft of Proposed Report, 4-9-81
"Life Insurance Company Income Tax Act
of 1959: An Analysis and Recommendation
for Change"

My letter of July 6, 1981, written in behalf of the Council's membership of over 500 life insurance companies, provided our preliminary comments with respect to the above-entitled draft. The letter noted that a Task Force of industry officers was preparing a more detailed discussion of your draft and that this would be forwarded to you as soon as it had been completed.

THE AMER

I have now received the Task Force Study and am pleased to transmit it herewith. Still to be delivered is an appendix that will list (with specific page references) a number of technical inaccuracies in your work and make suggestions for their correction. We are sure you will find this useful as you move to put your report in final form.

Sincerely,

Richard V. Minck

Richard V. Minck

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Enclosure

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OVERVIEW

This memorandum sets forth the comments of the American Council of Life Insurance on the draft GAO Report, "The Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendation for Change".

The Draft's analyses of both the life insurance business and the complex law under which our members pay their federal income taxes are extremely perceptive. We are in full agreement with the Report's conclusion that the Life Insurance Company Income Tax Act of 1959 is outdated and badly in need of reform. But the reforms suggested would be neither appropriate nor adequate.

We are persuaded that your recommendations stem from two major misconceptions--as to the extent of the life companies' tax burden, and the stability of their business. We find the Draft further deficient in failing to consider certain major inequities of our tax structure. We believe that upon reexamination of these matters your conclusions will be considerably altered. In brief, our areas of greatest concern are as follows:

1. The Draft fails to recognize that the life insurance industry is overtaxed.

Contrary to the conclusions reached in the Report, in the years since the adoption of the 1959 Act the tax burdens of life insurance companies have grown disproportionately relative to those of both U.S. corporations generally and other financial intermediaries. This result is apparent on every proper measure of comparison.

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2. The Draft erroneously concludes that the performance of the life insurance industry has been and will continue to be "highly predictable".

Focusing upon aggregate figures for the entire industry, the Report draws a picture of permanent and foreordained prosperity. Such a picture ignores both vast differences among companies and the fundamental uncertainties of the entire business.

3. Giving effect to the Draft's recommendations would drastically alter the existing tax balance among competing segments of the industry.

Many of the changes that GAO suggests would bear more heavily upon stock life insurance companies than upon their mutual counterparts. The present tax structure was designed to balance the respective tax burdens of these two groups on the theory that without such balance they could not effectively compete. There is no reason to believe that this position should be abandoned.

4. The Draft fails to address the companies' tax problems in the employee benefit plans market.

Life insurance companies compete for pension business with the banks and for employee welfare plans with various forms of uninsured arrangements. The noninsurance alternatives bear little or no tax. Insurance companies on the other hand incur significant federal income tax liabilities with respect to this business. This inequity is contrary to Congressional intent and should be eliminated.

DETAILED DISCUSSION

I. The Draft Fails To Recognize That The Life Insurance Industry Is Overtaxed.

Chapter 6 of the Draft Report asserts that the concerns of the life insurance industry

> relate primarily to certain specific provisions in the Act which increase tax liabilities above what the companies feel appropriate. The major industry concern appears to center on changing the controversial 10 to 1 rule for determining the policyholder reserve deduction . . . .

The implication of this statement is that the industry views its federal income tax statute as essentially fair and suffering only a technical defect in the policyholder reserve deduction formula. This is simply incorrect. The life insurance industry tax burden has been far higher than it should be. The tax base created by the 1959 Act is seriously defective. The present form of the 10 to 1 rule contributes to, but is only part of, the problem.

GAO's misconception of the magnitude of industry concerns and of the inequities of life insurance company tax burdens derives from premises that are basically flawed. It is not true:

> 1. that, when compared to all U.S. corporations, the tax burden of the life insurance industry under the Act has not changed in any significant pattern (page 6-1);
>
> 2. that, when the tax burden of the life insurance industry is viewed as a percentage of tax collections from financial intermediaries, or when the combined tax on life insurance companies and their policyholders is compared to that on banks and their depositors, there is no long-term trend evincing discrimination against life insurance (pages 6-1 & 2); or
>
> 3. that life company taxes as a percentage of gain from operations before policyholder dividends and other special deductions is a proper means of measuring growth in the companies' effective rate of tax (page 6-9).

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For the reasons set forth below, GAO's conclusions are not justified. In the period since 1960 (the first full effective year of the 1959 Act) there have been significant inequities. The result of these inequities has been to place our industry at an intolerable competitive disadvantage.

A. The Draft's comparisons of the growth of life insurance company tax levels to the growth of U.S. corporate taxes is basically flawed.

The Draft Report concludes that "when compared to all U.S. corporations, the tax burden of the life insurance industry does not appear to have changed in any significant pattern over the time period studied." This conclusion is drawn from Table 17 which, on a before tax credit basis, shows an increase of 5 percent in the life insurance company share of corporate taxes--from 2.42 percent in 1960 to 2.55 percent in 1976. This table is very misleading.

A comparison of the tax burdens borne by corporations generally with those imposed on any particular class of corporations should be made on the basis of taxes after tax credits. Had this been done in the instant case, the life insurance companies' tax share would have been seen to have increased substantially. The two significant tax credits for corporations that must be considered in this context are the investment credit and the foreign tax credit.

Since 1962, the investment tax credit has reduced the effective tax rate on domestic businesses that make substantial capital expenditures. It has had little effect on the tax liabilities of

financial institutions such as life insurance companies. It is thus wrong to support the assertion that life insurance taxes have gone up no more than those of other corporations with figures that ignore the special relief given other corporations.*/

Taxes on a before credit basis also include U.S. taxes on foreign source income. This involved no distortion as long as credited foreign income taxes were--as was the case until 1973--essentially similar to the U.S. levy and the foreign income share was relatively constant. As the GAO statistics indicate, in the period between 1959 and 1973 when there was little distortion caused by foreign tax credits, the life insurance companies' share of total corporate taxes, whether measured before foreign tax credits or after foreign tax credits, rose sharply.

After 1973, however, the foreign profits and foreign tax credit statistics became grossly distorted with the change in oil pricing arrangements imposed in that year by the members of the Organization of Oil Exporting Countries (OPEC). By increasing world oil prices, OPEC also increased company profits. At the same time, however, OPEC nations increased their taxes on those profits. In real terms, therefore, the U.S. companies producing oil in OPEC countries had about the same margin of profit after tax.

*/ It is not relevant to say the purpose of the investment tax credit is to encourage more investment. Even strong advocates of the incentive effect do not go beyond asserting that a 10 percent credit should increase investment about 10 percent, i.e., that 90 percent is tax reduction for investment that would have occurred anyway. See G. Fromm, Tax Incentives and Capital Spending (Brookings 1971).

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TABLE 1

Data on Alternative Measures of the Life Insurance Company Share of the Corporate Tax Burden

Year	Tax Before Credits			Foreign Tax Credit			Tax After Foreign Tax Credit			Tax After All Credits	
	All Corps.	Life Insur. Cos.	Oil[1] Cos.	All Corps.	Life Insur. Cos.	Oil Cos.	All Corps.	Life Insur. Cos.	Oil Cos.	All Corps.	Life Insur. Cos.
	Dollar Figures in Billions										
	Life Insurance Company Percentages in ()										
1960	$21.87	$0.53 (2.42%)	$ 0.90	$ 1.22	$0.01	$ 0.59	$20.65	$0.52 (2.52%)	$0.31	$20.65	$0.52 (2.52%)
1972	42.89	1.55 (3.61%)	3.76	6.32	0.08	2.94	36.57	1.47 (4.02%)	0.82	33.57	1.46 (4.34%)
1975	66.14	1.92 (2.90%)	18.24	19.99	0.11	14.96	46.15	1.81 (3.92%)	3.28	39.69	1.78 (4.48%)

[1] Includes corporations classified as primarily crude oil producers and firms classified primarily as petroleum refiners.

Source: Department of Treasury, Internal Revenue Service, Statistics of Income Corporations, various issues.

Nevertheless, the statistics on a before tax credit basis show an enormous increase in "profits", in "tax before credits", and in foreign tax credits.

Table 1 highlights the defects in the GAO selection of tax burden statistics. Figures are shown for 1960, 1972 and 1975. (We do not have the 1976 Statistics of Income that was available to GAO, but the 1975 and 1976 figures are comparable.)

The first three columns show the tax before credits figure used by GAO. It will be seen that these numbers correspond exactly to the life insurance shares cited in the GAO Report at page 6-4. Between 1960 and 1972, the life insurance share shows a great increase no matter which tax series is used. The increase is 50 percent before credits and 72 percent after credits.

Between 1972 and 1975, there is a massive $14 billion increase in the "before credit" tax liability of the oil companies, but simultaneously a $12 billion increase in the foreign tax credit. This is responsible for the decline in the life insurance share of "before credit" taxes between 1972 and 1975, and, we assume, for the larger decline to 1976. A better measure of the increase in U.S. tax on companies is shown in the columns "Tax After Foreign Tax Credit", which indicate that the life insurance share in 1975 was about 4 percent, nearly 56% over the 1960 level. After all tax credits, the 1960-75 increase in the life companies' share of total corporate taxes was about 78%.

These figures clearly illustrate that the life insurance industry has carried an ever-increasing share of the general corporate tax burden. An appreciation of this increase, and

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of its effect on the life insurance business, is essential to any thought on how the Act should be revised.

B. The Draft's comparison of life insurance industry taxes to taxes imposed on other financial intermediaries, including most particularly banks, is incomplete and misleading.

With respect to the comparison between the tax burden of life insurance companies and other financial intermediaries, we agree that tax equity is determined by comparing the relative tax burdens of firms engaged in similar businesses. The appropriate comparison in the case of the life insurance industry is with other financial intermediaries and particularly with banks.

The Draft Report demonstrates that over the period since 1960, life insurance companies' share of the total tax payments of all financial intermediaries increased by some 72 percent, while the banks' share declined by nearly 44 percent. At the same time, taxes stated as a percentage of assets increased 50 percent for life insurance companies, but decreased 71 percent for banks. This result is not surprising, for a bank is allowed a full deduction for the portion of its investment income paid to depositors, while a life insurance company's deductions for such payments are severely limited. The Draft Report brushes the disparity between life company and bank taxes aside by noting the difference between the federal income tax treatment of bank depositors and life insurance policyholders. It fails, however, to make any rigorous analysis of the effects of this difference. It is immaterial whether the financial intermediaries or their customers bear the tax on passed-through income if the aggregate amount of such tax is identical. As between the banks and their customers on the one hand and the

life companies and theirs on the other, the aggregates are not identical. Savings through life insurance are much more heavily taxed than bank savings.*/

Recent studies by the ACLI indicate that the effective rate of tax on the nonpension investment income of life insurance companies was about 19 percent in 1978. In contrast, in 1959, the effective tax on total investment yield, without any deduction for amounts credited or paid to policyholders, was about 12.5 percent. If all of this income were being paid or credited to policyholders,**/ and they were currently taxed, what would result?

In recent testimony on the President's Economic Recovery Program, the Secretary of the Treasury indicated that during 1980 the average effective tax rate on individuals had reached the unusually high level of 11.4 percent. Stark as is the contrast between this and the level of the life companies' tax, reflection suggests even greater disparity. The average effective rate for all taxpayers is probably higher than that which policyholders would pay:

--life insurance policyholders are typically middle and lower income taxpayers whose tax rates are lower than the averages;

--because many forms of investment income are now tax favored (interest and dividends qualify for a $400 exclusion on joint returns; only 40 percent of capital gains is taxed;

*/This matter is treated more thoroughly in the Appendix to this memorandum entitled "Comparison of Integrated Tax On Savings Income Derived Through A Life Insurance Company And Through A Bank".

**/See the footnote on page 21 for a discussion of the amount of investment income likely to be retained.

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savings through tax-exempt bonds and owner-occupied housing are free of tax; and qualified pension savings and similar arrangements benefit from long-term tax deferral), average tax rates on investment income are lower than average rates on all forms of income; and

--current tax cut proposals being considered by the Congress--not only those of the Administration, but others with even more sweeping impact--are certain to effect a substantial reduction in the average effective rate on individuals.

Without attempting precisely to quantify the adjustments needed to reflect the make-up of life insurance policyholders, the favorable provisions applicable to some forms of investment income, and likely legislative enactments, an average effective tax rate of 10 percent of investment income earned by life insurance policyholders would probably be overly conservative. Comparing this figure with a 19 percent effective tax rate imposed upon investment income derived through a life insurance company*/, it is clear that, on an integrated basis, the life insurance industry is overtaxed. The proposals of the GAO Draft would further increase this already excessive figure. The Draft's position is particularly troublesome in view of GAO's finding that the savings function of the life insurance industry has declined.

*/ The Administration's current corporate tax reduction proposals would have no effect on the effective rate of tax paid on life insurance company taxable income, although alternative proposals being considered by Congress to reduce the general corporate tax rate would provide some relief.

According to the GAO Draft Report, saving through life insurance companies, and in particular through life insurance as opposed to life company-administered pension plans, has declined from a high of 13.5 percent of total net individual acquisitions of financial assets in 1954 to 4.2 percent in 1978. The Report comments further that this decline is even more striking if policyholder loans are also considered. This striking decline is due in part to the excessive taxation of life insurance compared to the taxation of other financial intermediaries. The result has necessarily been to lessen the industry's ability to carry out its traditional role as supplier of long-term capital to American industry.

C. Mutual companies strongly disagree with the assumption that gain from operations before dividends is a proper measure for comparing growth in effective tax rates.

The GAO Draft Report compares growth in effective tax rates of life insurance companies by comparing taxes to gain from operations before dividends. Mutual companies strongly believe that the correct measure is gain from operations after dividends.

Policyholder dividends are primarily retrospective price reductions that must be made in order to provide maximum values to policyholders and in order for life insurance products to remain competitive. As such, mutual companies are strongly of the view that most or all policyholder dividends should be deductible in determining the economic net income of a life insurance company.

In fact, full deductibility of policyholder dividends was proposed by the Treasury Department in 1958. Later in the

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legislative process, the limited deduction in today's law was inserted in large measure as a compromise to maintain competitive balance between mutual companies and stock companies and to achieve a targeted amount of revenue. At that time the limitation on policyholder dividends only precluded deduction of about 10 percent of such dividends. The pragmatic compromise that was made in 1959 does not change the fact that in the view of mutual companies, conceptually, most policyholder dividends should be deductible in computing the economic net income of a life insurance company. This, indeed, was the case in 1959 when 90 percent of policyholder dividends were deductible.

Thus, the GAO should also use a base that allows such a deduction to determine trends in the effective rate of tax of the life insurance industry. Industry statistics indicate that by this standard, federal income tax on the income of mutual life insurance companies was a staggering 61.6 percent in 1960-62 and has been as high as 103.5 percent in 1974-76. If stock companies are included, the respective percentages are 61.8 in 1960-62 and 88.7 in 1974-76.

In the next section of these comments, we explain more fully how the life insurance industry is overtaxed, why these dramatic increases in the industry's tax burden have occurred, and why the 1959 Act needs to be revised in light of today's changed economic conditions.

D. Life insurance companies currently receive an inadequate deduction for investment income that they pay or credit to policyholders as prospective price reductions or policyholder dividends.

In the 1959 Act, Congress recognized the need for an exclusion from taxable income for investment income set aside to meet life insurance company reserve requirements computed under the interest rate assumed by state law. Congress also recognized that there are other uses to which investment income may be put that should also reduce taxable income. One of these uses is for the company to respond to competitive pressures by crediting investment income in excess of state law reserve requirements in its pricing structure.

This crediting may be done prospectively either by reducing premiums or by providing greater benefits for the same premium. Prospective crediting of investment results is possible to the extent that it does not cause an undue strain on surplus, and it will result in a reduction in the company's taxable income.

The second method of crediting the additional investment income to the policyholder is to reduce prices retrospectively by paying policyholder dividends on participating policies. Under the 1959 Act, a portion of this investment income is deductible and a portion is not. The portion that is deductible results from the fact that, in computing taxable investment income, the reserve deduction formula excludes from taxable income a greater amount of investment income than is necessary to meet state law reserve requirements.

The system described above worked reasonably well in 1959. At that time average portfolio earnings rates were approximately

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3.8 percent and the rate of inflation was only about .8 percent. This meant that, either through prospective pricing procedures or through the distribution of policyholder dividends, companies were able to pay or credit to the life insurance consumer investment income at rates close to their portfolio rates, that such payments or credits could be made on a deductible basis, and that the consumer enjoyed a real economic return. The fact that almost all investment income credited through the dividend process was deductible is reflected by the fact that, when the 1959 Act was adopted, 90 percent of policyholder dividends were deductible.

Economic conditions have changed dramatically since the adoption of the 1959 Act. As a result of inflation, interest rates have reached unprecedented highs without any increase in real economic growth. In order to remain competitive with other financial intermediaries and to continue to provide the consumer with real economic values, life insurance companies must be able to continue to reduce their taxable income by nearly the full amount of investment income they credit to policyholders. But the method of crediting investment income via the payment of policyholder dividends no longer achieves this result under the 1959 Act.

With respect to participating policies, inadequacies in the 1959 Act prevent a life insurance company from receiving an appropriate tax deduction if it attempts to pass through high

current interest rate[illegible] d
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sell more of its product by reducing prices through the policyholder dividend process, it used all its investment income for additional promotional activities.

The problems caused by the current limitation on the deductibility of policyholder dividends may be illustrated by a simple example. The adjusted earnings and assumed interest rates of life insurance companies today are about 8 percent and 3 percent, respectively. If such a company had mean life insurance reserves of $1,000, it would earn $80 on the assets set aside for such reserves and its reserve deduction, based on the assumed rate, would be $30. Because, as explained above, the reserve deduction formula permits an additional deduction, the company could distribute $10 as a deductible policyholder dividend.*/ However, the company would receive no deduction for any portion of the remaining $40 of investment income, which would be subject to full corporate taxation, that is distributed as policyholder dividends. This obviously places a severe limit on the amount of investment income that can be passed through to policyholders. In fact, to remain competitive and to provide the maximum possible value to consumers, life insurance companies are paying policyholder dividends far in excess of the amount that is deductible. The deductible portion of policyholder dividends has fallen from 90 percent in 1959, to 60 percent in

*/ The total reserve deduction is $40 [$1,000 x (100% + 30% - 80%) x 8%]. The deductible policyholder dividend is $10 ($40 - $30).

. 78, and continue to [illegible]. Projections made by some companies indicate that in 1984 only 45 percent of policyholder dividends will be deductible.

The life insurance industry cannot continue operating under a system of taxation that does not allow an adequate deduction for investment income credited to policyholders. Therefore, the industry has concluded that a legislative solution is the most appropriate means of dealing with its current excessive tax burden.

The inadequate deduction for policyholder dividends is the result of two basic problems. The first is that the reserve adjustment formula is mathematically inaccurate. The second is that even a "corrected" formula does not allow enough of a deduction from investment income for dividends paid to policyholders to enable the company to provide maximum possible value to policyholders and to remain competitive with other financial intermediaries. Both of these problems must be solved to enable life insurance companies to receive the appropriate deduction for policyholder dividends.

The formula used to revalue life insurance reserves in computing the reserve deduction from taxable investment income is mathematically inaccurate. To compute this deduction, a life insurance company uses its adjusted earnings rate.*/ This rate is multiplied by the amount of its life insurance reserves

*/ This rate is the lower of the current earnings rate or the average earnings rate over the past 5 years.

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adjusted under the Menge formula. Under this 10 to 1 arithmetic formula, reserves are reduced 10 percent for every one percent by which the adjusted earnings rate exceeds the assumed rate. This formula is intended to revalue the reserves established using the state law assumed rate as they would have been if, instead, they had been established using the company's adjusted earnings rate.

This method worked reasonably well at the time of the adoption of the 1959 Act when adjusted earnings rates were only slightly greater than assumed rates. However, this approximation is very inaccurate under current economic conditions because the 10 to 1 Menge formula produces distortions from an exact revaluation of reserves. These distortions increase at an accelerated rate as the excess of adjusted interest rates over assumed rates increases. As a result, with a 3 percent assumed rate, the marginal tax rate on additional investment income is 46 percent when the adjusted earnings rate is 6.5 percent, 73 percent when the adjusted earnings rate is 10 percent, and 100 percent when the adjusted earnings rate is 13 percent.

The GAO recognizes that the 10 to 1 approximation formula is defective, and suggests three basic proposals for correcting the problem.*/ The three proposals are (1) substituting the actual required interest based upon assumed rates of interest for the 10 to 1 adjustment, (2) replacing the 10 to 1 formula with a reserve deduction based upon a geometric approximation,

*/The Report actually describes four proposals; however, two of the proposals are variations of the basic 4.5 percent described below.

and (3) substituting a 4.5 percent cap on the average earnings rate under the 10 to 1 or geometric reserve adjustment. As the Report indicates, the substitution of assumed rates for the 10 to 1 adjustment "hardly appears to be a practical solution to the problems the industry is encountering." The Report might also have noted that this method had been rejected repeatedly even prior to the 1959 Act by Congress as an appropriate method for determining the amount of investment income companies must set aside for policyholders.

With respect to the geometric and 4.5 percent cap proposals, the Report suggests that both methods are "arbitrary" and that in effect the choice should be made on some nonspecific analysis of what the proper level of tax on the industry should be. The Report seems to favor the 4.5 percent cap, but gives no reason other than it would produce tax revenues in between the other two proposals suggested. We strongly disagree with the Draft Report's suggestion that the problems with the current 10 to 1 formula can be "solved" by substantially increasing the tax imposed on life insurance company income. The fact is that only one of the Draft Report's proposals -- the geometric formula -- corrects the mathematical defect in the 10 to 1 formula without substantially departing from the rationale underlying the policyholder reserve deduction in the 1959 Act. The Report gives no reason for departing from this rationale to adopt a "4.5 percent cap" or any other approach, and in our view there is simply no justification for such a departure. Under the geometric formula, the company in

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our example could distribute $17[*] as a deductible policyholder dividend, as opposed to $10 under current law.

Even a geometric reserve adjustment formula does not allow enough of a deduction from investment income for dividends paid to policyholders, however. For most mutual companies this formula, and the entire separate computation of taxable investment income, serves no function other than as a limitation on the deductibility of policyholder dividends. This limitation produces a deduction that bears no rational relationship to the amount of investment income that should be taxed to the company. Thus, although correction of the Menge formula partially restores the ability of a life insurance company to deduct investment income credited through the payment of policyholder dividends, even after this correction an excessive amount of the investment income credited to policyholders would not be deductible. This amount would be inappropriately taxed to the company because of the arbitrary limitation that prevents policyholder dividends from reducing life insurance company taxable income below taxable investment income.

Under the facts assumed in the example above, the corrected formula allows a life insurance company a maximum $47 deduction against net investment income of $80. However, to compete effectively with other financial intermediaries, a life insurance company would have to be able to pay (through the dividend process) or credit (by accumulating reserves) a total of about $75 to its

[*] The reserve deduction is $47 ($1000 x $.9^{8-3}$ x 8%). The deductible policyholder dividend is $17 ($47 - $30).

policyholders.[*] Such a company would have a profit of $5 but under current law its taxable investment income and, therefore, its life insurance company taxable income, would be $33 ($80 - $47). In fact, the tax imposed on this income ($33 x 46% = $15.18) would prevent the company from returning the full $75 to its policyholders unless it reduced accumulated surplus or capital. Clearly, the result of the limitation on the deductibility of policyholder dividends is excessive taxation of the life insurance company.

In a footnote on page 3-19, the Draft Report raises a question about whether the "interest element" in policyholder dividends should be taxed. The Draft Report seems to imply that the limitation on deductibility of policyholder dividends, and the resulting excessive corporate level tax, can be justified as a means of having the life insurance company pay tax on the investment element of the dividend as proxy for the policyholder. This theory is not tenable, however, if the facts are carefully examined. In our example, the difference between the company's taxable investment income and reasonable profit retention is $28 ($33 - $5). Thus, under the GAO's theory, the company may be viewed as paying a tax of $12.88 ($28 x 46%) as proxy for the policyholder. This amount is, of course, 46 percent of the $28 of investment income that would otherwise be paid or credited to the policyholder in the form of a policyholder dividend. By any

[*] A reasonable profit retention for pure financial intermediaries generally is approximately .5 percent of their assets. In the example, the life insurance company has $1000 of assets, and .5 percent of $1000 is a $5 profit margin. Since investment yield is $80, $75 ($80 - $5) must be paid or credited to policyholders to compete effectively with other financial intermediaries. A life insurance company provides other services beyond investment of funds for which it earns profits out of underwriting income.

measure, a proxy tax at a 46 percent rate is excessive. As we discuss in the previous section of these comments, the average effective tax rate on the personal income of individuals is currently 11.4 percent, and the average effective tax rate on the investment income of life insurance company policyholders is, under reasonable assumptions, no greater than 10 percent. Consequently, the limitation on the deductibility of policyholder dividends, even with a geometric Menge formula, cannot be justified by the lack of policyholder taxation under current law.

To deal with the inadequacies of current law, even with a corrected Menge formula, the limitation on the deductibility of policyholder dividends should be changed so that it is no longer arbitrarily tied to the amount of taxable investment income. This approach recognizes, as the GAO Draft Report does not, that the deduction for policyholder dividends, as limited under current law, is insufficient in view of present economic conditions and the need of life insurance companies to compete with other financial intermediaries that receive a full deduction for investment income paid or credited to customers. While it may be appropriate to tax this investment return at the company level as a proxy for policyholders, the amount so taxed should be substantially reduced to reflect the difference between the corporate tax rate and the appropriate tax rate for savings income of individuals.

The limitation on deductible policyholder dividends is often explained as a means of maintaining a competitive balance between participating and nonparticipating policies. If possible, however,

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E. Section 820 is a remed
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We agree that the need for preserving reinsurance is indisputable; for reinsurance is the way by which one insurance company, the reinsured, transfers all or a portion of its risk under an insurance or annuity contract or a group of contracts to another company, the reinsurer. Reinsurance agreements are not filed forms; but rather, actual and substantive transactions, and modified coinsurance (which was initially developed in 1936) is just one form of reinsurance.

But, it is also indisputable that reinsurance may affect the federal income tax liability of either or both companies involved in a reinsurance transaction. This effect on taxes leads to two questions--one specific and one general. The first question is what standard should be used in evaluating whether a reinsurance contract is a valid contract whose tax effects must be recognized for federal income tax purposes; the second question is whether the changes in tax liability produced by a reinsurance contract fit in with the statutory scheme and produce a desirable result. In Chapter 4, the Draft Report discusses the pension reserve interest deduction and concludes the following:

> Recently companies have been reinsuring business other than pensions, thereby reducing taxes considerably. In some cases there is a question of whether or not there is any real shifting of the insurance risk, which is usually considered a requisite for a bonafide reinsurance transaction. This use of section 820 could lead to a call for its repeal, in which case companies issuing pensions with annuity guarantees would no longer be able to use this method of securing what they feel is an adequate pension reserve deduction.

The quoted statement confuses the tax reduction that may arise under a reinsurance contract with the standards for determining whether a reinsurance transaction is bonafide. Whether or not a transfer of risk has occurred under a specific contract is a question of "facts and circumstances". The courts have always recognized the fact that a taxpayer is entitled to cast a transaction in the form that produces the best tax consequences. The problem has been how to separate transactions with real economic substance from sham transactions whose only purpose is tax induced without economic motivation. (See William H. Edwards v. The Chile Copper Company, 270 U.S. 452 (1962); Higgins v. Smith, 308 U.S. 473 (1940); Helvering v. LeGierse, 312 U.S. 531 (1941).

The Supreme Court in U.S. v. Consumer Life Insurance Company, 430 U.S. 725 (1977) and Frank Lyon Company v. U.S., 435 U.S. 561 (1978) has now provided a succinct guideline for separating real transactions from sham transactions. The transaction must have a business motive, even if that business motive is remote when compared to the tax savings. More importantly, however, after the transaction is completed and the "dust has settled", there must have taken place a real, rather than chimerical, shifting of burden and benefit, and economic relationships. Therefore, a true shifting of risk can occur within the meaning of LeGierse even though substantial tax benefits may be derived by the reinsurer or the reinsured.

We believe that most of the modified coinsurance contracts entered into by the insurance industry under section 820 will

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satisfy the standards set forth by the Supreme Court when these contracts are examined on a facts and circumstances basis. But the analysis of the technical requirements under the law for these modified coinsurance transactions to be upheld does not answer the second question posed above: whether modified coinsurance fits in with the statutory scheme of the 1959 Act and produces a desirable result.

The Draft Report's discussion of the pensions reserve interest deduction in Chapter 4 is a very accurate summary of the problem many companies are facing--the inability to deduct the full amount that is being credited to the pension client. It points out that this limit on deductability is contrary to Congressional intent. In such circumstances, modified coinsurance allows the law to work as Congress initially intended it to work. Indeed, in the long run, no changes in tax would occur from these "pension" modified coinsurance contracts if the law were working properly. The statutory scheme, therefore, presents the taxpayer with a problem (not intended in 1959), but at the same time provides a remedy.

There is no reason, however, that this approach to modified coinsurance should be limited to the pension area. In the current inflationary environment, financial intermediaries must return a larger and larger percentage of their increasing investment income back to the public. But, as explained fully above, the 1959 Act's formulae for determining taxable investment income discourage the natural forces of the market from working because they impose a heavy tax burden where no tax burden was originally

intended. In 1959, life insurance companies were able to deduct approximately 90 percent of their dividends to policyholders. Without modified coinsurance, that percentage would be less than 50 percent in 1981. The law, however, presents the problem and the remedy--modified coinsurance, in effect, allows a greater percentage of dividends to be deducted, despite the inability of the limitation on dividend deductions under section 809(f) to work properly in our inflationary environment.

On page 4-24, the Draft Report comments that "apparently there is a feeling in the life insurance industry itself that section 820 will probably not continue in its present form." While this "feeling" may exist in some parts of the life insurance industry, it exists at all only because section 820 is an imperfect remedy to the problems of current law and not because there is anything inherently "wrong" with modified coinsurance. Section 820 is a remedy, albeit a somewhat imperfect remedy, that is absolutely necessary until a better solution to the problems of the 1959 Act is adopted.

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II. The Draft Erroneously Concludes That The Performance Of The Life Insurance Industry Has Been And Will Continue To Be "Highly Predictable".

The Draft asserts, on page 6-31, that "over time the industry's performance has proven highly predictable", and that, in light of favorable

> mortality experience, operating expenses, premium receipts, and investment yields . . . no significant deviation in the future income streams of life companies should be expected . . . .

Although this conclusion is hedged with the phrases "barring some unforeseen catastrophe," and "if present trends continue," it assumes--as no prudent company management could--that there will be no unforeseen catastrophes, and that the "discerned" trends will continue.

Moreover, the assertion is based on an examination of a record of industry performance and not on that of component companies. Among the risks that individual companies must consider and provide adequately for are the following:

--Mortality rates may be higher than expected. The very low level of mortality rates assumed today creates an increased risk of future mortality losses. To illustrate: a fluctuation of one death per thousand lives produces a much higher relative loss when the assumed rate is two deaths per thousand rather than, as in the past, five deaths per thousand. There is already some evidence that mortality rates may have peaked; mortality experience in 1980 and 1981, for example, has already shown higher death rates than those prevailing in the immediately preceding years.

--Interest rates may be lower than expected. Although new policies are priced to reflect today's high interest yields, it is quite possible that, over the life of these policies, interest rates will go down, perhaps to a level lower than the interest rates assumed in pricing the policies. This has happened before. In the 1920's, for example, when new investment yields were in the 6 to 7 percent range, premiums and reserves assumed up to 3-1/2 percent interest. During the 1940's, however, new money rates plunged below 3 percent and the average portfolio rate of the industry reached 3.1 percent. In this situation it was necessary for companies to establish additional reserves out of surplus.

--Interest rates may be higher than expected. Because of money market effects, higher interest rates may also cause surplus losses. For example, today's soaring interest rates have created an increased and unanticipated demand on life insurance companies for low interest policy loans. A dramatic increase in such loans could force individual companies to borrow funds or to sell low-yielding fixed dollar investments at a loss to satisfy current obligations.

--Expenses may be higher than expected. Prediction of the rate of inflation for fifty years into the future is a virtually impossible task. Yet it must be done in pricing policies.

--Accident and health benefits continue to rise. The increase in medical claims has been far more rapid than

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the rise in medical premiums. As a result, many of the life companies providing such coverage have suffered severe losses in this line of business.

The GAO's finding of industry predictability is adduced in direct support of its recommendation to eliminate the deferral of tax on 50 percent of the excess of gain from operations over taxable investment income. Any such action would impair the ability of stock companies to safeguard their policyholders against the contingencies noted above.

Most of the policies written by stock life insurance companies are nonparticipating. Under such policies, premiums are guaranteed for future years and no redundant portion of the premium exists to "cushion" unfavorable experience during the period of coverage. Since competition dictates that new policies be priced to reflect current yields and mortality experience, there is a very real risk that premiums may, over the long range, prove inadequate. Congress designed the Phase III deferral as the principal means of giving stock companies the cushion they do not otherwise have to assure that they can meet their long range commitments.

We recognize that little Phase III tax has been paid. This, however, does not establish a lack of need. In general, the continued deferral means only that the business of stock life insurance companies has expanded since 1959, and that this expansion has been accompanied by a parallel increase in the amount of underwriting gain. In this situation a company does not reach the statutory limits on the policyholders surplus account. Congress wa: if any, Phase III tax would b companies. Hearings on H.R. 86th Cong. 1st Sess. 29 (test: to the Secretary of the Treas 1st Sess. 131 (Supplemental v: (1959).

The Draft's focus on ove past results is inappropriate. conclusion of predictability that rests upon it.

III. Giving Effect To The Dra Alter The Existing Tax Ba The Industry.

At numerous points the D that Congress took great care the existing competitive bala In view of the GAO's obvious especially puzzling that the would drastically disrupt thi

For example, the GAO's f computation of the policyhold one of the methods of effecti rule--would provide some tax tax position, its benefit for For the most part, Phase II c

A second GAO proposal would eliminate the deferral of one-half of the excess of gain from operations over taxable investment income. As discussed previously, we seriously question this proposal's substantive validity. Moreover, the proposal would have its detrimental effect only on companies in a Phase II tax situation--the overwhelming number of which are stock companies.

Similarly, the recommendation to repeal what is referred to as "the $250,000 statutory deduction" would, if adopted, bear most heavily upon small companies, most of which are stock companies. We note that this provision is not in fact a "statutory deduction"; it becomes available in large part only when a company has actually paid policyholder dividends in excess of those needed to reduce gain from operations to the level of taxable investment income.

A final proposal that would dramatically affect the current stock/mutual company balance is the GAO's recommendation with respect to the Internal Revenue Code section 818(c) election. In its inception, this election was intended to afford relief for small companies. Since such companies are almost all stock companies, the GAO's proposed change to this provision would bear most heavily against them. Moreover, we believe, as discussed below, that the GAO's section 818(c) proposal is ill-advised.

The Draft recommends changing the approximate revaluation election under section 818(c) to provide for a factor of $15 for insurance in force (other than term insurance). The GAO's recommended factor is calculated on the basis of a theoretical, industry average distribution of business. But in practice, the

distribution of business within individual companies by age, sex and plan of insurance varies widely.

Examples of distributions of business where $15 per thousand at risk is inadequate include the following:

--The GAO's revised Table 37 shows that for permanent plans issued at age 55, the average factor needed is $25.73 and at age 65, the average factor needed is $33.67--amounts far greater than the $21 provided under current law. Some companies do sell to the higher age market with average issue ages exceeding age 50 and do require a revaluation factor in excess of $21 in order to approximate net level premium reserves.

--The $15 per thousand of insurance in force assumes that all policies are whole life. Endowment or limited payment life insurance policies, however, generate a higher factor. For example, at age 45, the first policy year difference is $18.60 for whole life and $25.43 for a 20 year limited payment life insurance policy. Some companies, such as home service companies and individual qualified pension companies, sell primarily these higher factor plans.

The current $21 factor is needed so that the great majority of companies can revalue their reserves to a net level premium basis without incurring the severe administrative burdens that would be caused by exact revaluation. Permitting a simplified method of reserve revaluation was Congress' goal in 1959; the Reagan Administration's strong advocacy of regulatory simplification indicates that this goal is equally valid today.

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As the points noted above demonstrate, the GAO recommendations would create a dramatic imbalance in the current stock/mutual company competitive positions. We assume that this result was not intended by the GAO. Clearly, a basic premise of any proposed tax law revision must be--as it was in 1959--to maintain the existing balance of taxation between stock and mutual companies. We are puzzled by the GAO's failure to recognize this fundamental tax policy principle.

The 42 company sample used by the GAO in developing the Draft Report may have been a major factor in creating the imbalance in the Report's proposed recommendations. Of the 42 companies studied, only 18 were stock companies. It has been reported that of the latter, only three were in a Phase II positive tax situation. We question whether it is appropriate to base industry-wide tax revisions on a data base that does not reflect the overall composition of that industry.

IV. The Draft Fails To Address The Companies' Tax Problems In The Employee Benefit Plans Market.

The current tax treatment of insured pension and employee welfare benefit plan funds has severely hampered the life insurance industry's ability to compete in the pension and group insurance areas. Yet the Report virtually ignores the significant problems discussed below.

A. Pension funds taxation.

The Draft Report at several points asserts that life insurance companies pay no federal income tax on investment income

attributable to pension funds. This is not the fact. At least part of this income often bears a significant tax, although the extent of such tax varies not only from company to company but also from one type of contract to another. Indeed, even the income credited to the relatively small portion of pension funds (16.24 percent of the 1978 total) held in "segregated asset" accounts (within the meaning of Code section 801(d)) may bear some tax.

In the case of pension funds held in life insurance companies' general accounts or in separate accounts supporting contracts containing principal and interest guarantees, the investment income that is free from tax is frequently less than the income applied to fund benefits. This occurs when the contracts involve permanent insurance guarantees, for in such instances the policyholder's share exclusion derives from the average rate earned on each company's entire portfolio--including nonearning and low-earning assets (e.g., policy loans, stock of subsidiaries) that are rarely allocated to the pension line of business.

In addition, the exclusion fails to reflect realized long-term capital gains allocated to pension funds. The differential between the amounts credited and the tax exclusion has been made even greater as all the major companies in the business, and more and more of the smaller companies, have adopted investment year methods for determining the interest to be credited to pension contracts.

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Finally, to the extent investment income is allocated to pension accounts through policyholder dividends, substantial taxes arise by reason of the limitation on dividend deductions imposed by section 809(f) of the Code.

These significant problems frustrate Congress' intent to put insured pension plans on a parity with those funded through trusts.

B. Employee welfare benefit plan funds taxation.

Equally significant competitive disadvantages inhere in the existing tax treatment of employee welfare benefit plan funds. These problems have a dual cause--a 1969 amendment to the Internal Revenue Code provision regarding tax exempt trusts, and the enactment of the Employee Retirement Income Security Act of 1974 (ERISA). The result of these legislative provisions is that noninsured employee health plans receive more favorable tax treatment (at both the federal and state levels) than insured health plans.

This more favorable treatment for self-insured health plans has two basic effects. First, while investment income earned on health insurance reserves held by insurance companies is subject to federal income tax, employers who fund employee benefits through tax-exempt trusts may accumulate investment income in the trust on a tax-free basis. This dispartiy also exists in the case of some types of reserves for life insurance plans for employees.

Second, although premiums received by insurance companies are subject to state premium taxes, by contrast, amounts paid by employers to fund employee health benefits on a noninsured basis apparently cannot be taxed by the states because of the ERISA preemption provision.

The favorable treatment afforded tax-exempt trusts and the protection from state taxation afforded by ERISA has created a strong incentive for employers to self-insure employee health and life plans.

If life insurance companies are to remain able to compete in the insured pension and employee welfare benefit plan areas, the current tax inequities in these areas must be removed. Any report on the 1959 Act that fails to address these inequities is itself inadequate.

APPENDIX VIII

WORLD SERVICE LIFE INSURANCE COMPANY
COVERAGE AROUND THE WORLD
ADMINISTRATIVE OFFICES • 307 WEST SEVENTH STREET • P O BOX 1876 • FORT WORTH • TEXAS 76101 • TEL 817-390-1011

July 1, 1981

U.S. General Accounting Office
Attn: Mr. Natwar Gandhi
Program Analysis Division
441 G. Steet N.W.
Washington, D.C. 20548

Dear Mr. Gandhi:

I am a member of the Legislative Affairs Committee of the National Association of Life Insurance Companies (NALC). Mr. S. Roy Woodall, Jr., the Executive Vice President of the NALC, informed me that you needed a response by Monday, July 5, 1981 from the NALC regarding the draft of a proposed report of the General Accounting Office (GAO) titled "Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendations for Change" (GAO Report). You had previously indicated that the NALC's comments should be received by July 13, 1981. In order to comply with your request, this letter expresses our interest in commenting on the GAO Report. A subsequent letter will be sent to you by July 13, 1981 which presents our comments in greater detail.

The NALC was formed in 1955 to provide services to progressive life insurance companies and to provide a forum where their voices could be heard in the life insurance industry, before Congress and before the state insurance departments. Today, as indicated in the GAO Report, the NALC consists of approximately 300 small and medium size life insurance companies representing 170,000 home office and field employees, 400,000 shareholders and 60,000,000 policyholders. The association has a full-time staff to coordinate its endeavors which include monitoring Federal and state legislative actions affecting the life insurance industry and disseminating such information to the members. The association is assisted in these efforts by its Washington Counsel, Edward J. Schmuck and William B. Harmon, Jr. of Sutherland, Asbill & Brennan and the Legislative Affairs Committee. In summary, the NALC is an aggressive association which has the mechanism to serve the needs of its members and, accordingly, must be considered in formulating any change in taxation affecting the life insurance industry.

Appendix V, page 8, of the GAO Report states with reference to the NALC ". . . They also felt that the Act had only a minor impact on their operations."

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and that the current law should not b

The GAO Report discusses six other ar
by Congress and we agree that some of
quent letter to be sent to you by Jul
to the material contained in the GAO

If you have any questions, please con

Yours very truly,

Ransom B. Jones
Vice President

RBJ/dh

cc: Mr. S. Roy Woodall, Jr.
Mr. Gerald F. Beavan

National Association of Life Companies
3340 Peachtree Road, N.E. • Tower Place • Atlanta, Georgia 30026 • Phone 404/262-3737

July 14, 1981

U.S. General Accounting Office
Attn: Mr. Natwar Gandhi
Program Analysis Division
Room 5015
441 G. Street N.W.
Washington, D.C. 20548

Dear Mr. Gandhi:

This response to a draft of a proposed report of the General Accounting Office (GAO) titled "Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendations for Change" (Report) is made on behalf of the National Association of Life Insurance Companies (NALC).

We believe that the Report does not fully consider the adverse impact of its proposed changes on the small and medium size life insurance companies which comprise our membership. Accordingly, we will address the effect on our membership of various provisions contained in the Report. Among these provisions are certain recommendations for what we believe are far-reaching and adverse changes to the Life Insurance Company Income Tax Act of 1959 (Act), to wit:

1. Change the definition of life insurance company taxable income by eliminating deferral of one-half the excess of gain from operations (GFO) over taxable investment income (TII).

2. Reduce the benefit available through the use of the approximate method of revaluing preliminary term reserves to net level premium reserves as provided by Section 818(c) of the Internal Revenue Code of 1954, as amended (hereinafter all code sections refer to this source unless otherwise stated).

Further, we believe that the six provisions of the Act which the Report cites as needing further Congressional consideration are designed primarily to assist the large life insurance companies in defining TII. However, the provisions affecting small and medium size life insurance companies would adversely impact their tax

burdens. Finally, the Report states that the Act contains eight features especially designed to benefit small and new companies. We do not believe that all of these features benefit the small and medium size life insurance companies and that other features which truly do benefit such companies must be maintained in order to encourage entrepreneurship, free enterprise, individual opportunity and competition. The end result of retaining these benefits is to provide the public with better insurance products at better prices.

Currently, inflation is increasing the cost of doing business in all sectors of the economy and has had a tremendous adverse impact on the operating results of small and medium size life insurance companies. General operating expenses have skyrocketed, creating an extremely critical situation for some companies because of the long-term nature of insurance contracts. Premiums on long-term life insurance contracts are developed by considering two factors:

1. Net valuation premium - The mortality charge which is developed through actuarial tables.

2. Loading - The charge provided for the expenses of acquiring and servicing policies and for company profit.

Because inflation has greatly increased the costs of acquiring and servicing policies and because premiums on long-term contracts cannot be increased, small and medium size life companies are having difficulty generating adequate returns to shareholders. This dilemma is not as difficult for the large life insurance companies because their asset bases are larger and investment earnings can more easily offset the impact of reduced underwriting profits. Further, the small and medium size life insurance companies have difficulty competing with large life insurance companies due to the ability of large companies to effect cost savings through realizing economies of scale. For example, most life insurance companies must utilize computers to effectively service customers, however, the same computer can service a company with 10,000 policyholders or a company with 100,000 policyholders. Further, the life insurance industry is extremely technical, and to be successful, an insurance company must have expertise in the following areas:

1. General Management
2. Investments
3. Data Processing
4. Actuarial
5. Legal
6. Accounting
7. Marketing
8. Policyholders' Service

In each of these areas, economy of scale can have a tremendous impact on profitability. This makes it more difficult for the small and medium size companies to provide good returns to their shareholders, thereby making these companies more susceptible to takeover bids by larger companies. We believe, however, that small and medium size life insurance companies are valuable to the American public and should not be hindered by altering the current system of taxation. As noted in the Report, current Federal income taxation of life insurance companies has encouraged investors to form life insurance companies which we believe is desireable. We further believe that the benefits contained in the Act to provide incentives for investors to form life insurance companies should be maintained.

Having discussed the general economic conditions existing in the life insurance industry, we will now focus on the impact of the specific Report proposals on the small and medium size life insurance companies.

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However, we will first comment on the proposed change in the Menge formula. As noted in our previous correspondence, the Menge formula is of little consequence to our membership, although it does affect the taxable income of our members in which TII is less than GFO. We believe that the Report focuses too sharply on the interest of the large life insurance companies in defining TII and does not properly consider the needs of the small and medium size life insurance companies. For example, on page 6-1 (hereinafter all page references are to the Report unless otherwise stated), the Report states:

> The major industry concern appears to be on changing the controversial 10 to 1 rule for determining the policyholder reserve interest deduction.

Based on the large number of life insurance companies comprising the small and medium size sector compared to the number of large life insurance companies, how can it be concluded that this is the major industry concern? Does the Report only consider financial resources in determining major industry concern? This philosophy seems to embody the entire report.

The NALC is extremely concerned that any revenue balancing measures between the large insurance companies and the small and medium size insurance companies will operate to the detriment of the latter. Accordingly, the impact of the suggested changes is discussed from this perspective.

Definition of Life Insurance Company Taxable Income

The Report recommends that the provision allowing life insurance companies to defer one-half the excess of GFO over TII be changed. This recommendation is based on the following observations:

(1) The industry's operations over the past twenty years reflect a high degree of predictability which precludes the need for a "cushion" in the event of catastrophic losses.

(2) The larger companies with moderately large shareholders surplus accounts do not need the extra cushion provided by the deferral of the policyholders surplus account.

(3) Most large stock life insurance companies do not benefit from the provision.

(4) The companies have large surpluses in the tax deferred accounts.

(5) Since the Act, the stock company sector has grown at a more rapid pace than the mutual sector.

(6) This feature was designed to benefit small and new companies and has had a minor impact on such companies.

(7) Most small, stock, noncredit life insurance companies do not utilize the benefit of the deferral provision.

(8) The provision essentially provides a permanent tax-free deferral.

We do not believe that these observations indicate that the current law should be changed because the provision was designed to primarily benefit small and new companies for the following reasons:

1. The long-term nature of insurance contracts makes a determination of annual income extremely difficult.

2. A "cushion" is necessary in the event of catastrophic losses.

The Report states that the industry's operations over the past twenty years reflect a high degree of predictability which precludes the need for a cushion to hedge against adverse underwriting results on long-term contracts and catastrophic losses. While the results of operations of the industry as a whole may have experienced a high degree of predictability, no statistics are provided in the Report for the companies which will be affected by changing this provision. The large life insurance companies generally have accumulated sufficient surplus to absorb adverse underwriting results on long-term contracts and/or catastrophic losses. However, such companies generally avoid catastrophic losses because their risks are more widely spread in terms of both the number of insureds and the geographic distribution of the insureds. The small and medium size companies must use reinsurers to properly distribute their mortality risks which reduces their profitability and generally increases the profitability of the large life insurance companies which can assume such business. Further, the small and medium size life insurance companies sometimes have difficulty arranging reinsurance.

Page 7-4 indicates that stock life companies have accumulated a considerable amount of surplus as a result of the deferral and because of large surpluses in the tax deferred accounts, the Code should be revised to reflect current realities. It must be remembered that this provision was not intended to benefit the large stock life insurance companies and Appendix III indicates that the provision would have little effect on the large stock companies. The Report included a sample of 18 stock companies of which only 3 availed themselves of this provision in 1978. Accordingly, the sample is not representative of the affected companies. The statement that large surpluses have been accumulated in tax-deferred accounts is meaningless in light of the intent of the provision and the fact that much of the amounts accumulated by the companies in the sample are not as a result of deferring GFO. Most additions result from the deductions for certain nonparticipating contracts and for certain accident and health insurance and group life insurance.

The Report states that the stock company sector has grown at a more rapid pace than the mutual sector. This should not be a factor which would indicate a need to eliminate this provision. The relative growth of stock companies compared to the mutual companies since the passage of the Act can be explained. The number of mutual insurance companies has decreased by eleven since the Act because of the reasons indicated on page 3-26. The stock sector of the industry has grown for various reasons including the following:

1. The ease of forming stock as opposed to mutual life insurance companies.

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2. The desire of investors to enter into a business venture which can provide a return on investment.

3. The recognition by various industries of the economic opportunity existing in the insurance business.

However, we believe that the stock sector's growth provides no justification for changing the Act. Your study addresses growth in terms of number of companies, total assets and insurance in force. The average size and financial strength of the small companies and their ability to absorb adverse underwriting results on long-term contracts and catastrophic losses are not addressed.

The Report states that most small stock, noncredit insurance companies do not utilize this benefit. On Page V-10, however, in 1977 34.1 percent of the 1,254 stock companies in the sample benefitted from this provision. Further, 21.7 percent of the small companies other than credit reinsurers utilized this provision. We believe that this is a significant number of small companies and that the provision is providing the benefit to the small and medium size insurance companies as intended by the Act.

The Report indicates that the deferral is essentially a permanent deferral. However, Table 45 reflects that 16.3 percent and 7.7 percent of credit reinsurers and all small companies, respectively, paid Phase III tax in 1977. We believe this percentage and the related tax was significant compared to the GFO of all small companies. Further, credit life insurance companies and small companies in general are bearing their share of the tax burden as supported by the information contained in Tables 27 and 28. For credit insurance companies, Table 28 indicates that credit reinsurers in the small size categories have experienced higher taxes per company, larger taxes as a percentage of assets and larger taxes as a percentage of statutory gains. This is probably in large part due to the inclusion of Phase III tax. The accumulations in the policyholders' surplus account were intended to be deferred and certain events were stipulated which would trigger such income. The mere fact that some companies arrange their affairs to defer recognition of Phase III income does not eliminate the needs which were perceived by those drafting the Act.

We believe that this provision of the Act provides the benefits which were intended by Congress and must be preserved to provide incentives for the growth of small companies and to provide a safeguard for their financial stability.

Section 818(c)

The Section 818(c) election as currently written is also vital to the small and medium size life insurance companies. All the reasons which were contemplated in the Act are even more pertinent in today's economic environment. The small and medium size insurance companies are currently experiencing extreme difficulty in maintaining adequate surplus and the tax deduction provided by the approximate Section 818(c) revaluation is of extreme importance. The Report on page 4-41 states:

> This is of primary importance only to smaller companies since they are predominant users of preliminary term.

On page V-9, the Report states that the conversion from preliminary term to net level for tax purposes has actually aided large companies more than small companies. Your sample included only the 42 largest life insurance companies. Accordingly, how can you support this statement? We believe that the relative effect of the provision on income taxes benefits the small life insurance companies as intended by the Act.

Six Additional Portions of The Act Which Merit the Consideration of Congress

Before concluding our response, we would like to very briefly address the Report's suggestion regarding the need for further Congressional consideration of certain specified portions of the Act. We believe that the six areas so specified are intended primarily to assist the large life insurance companies in defining TII. On the other hand, the provisions of primary importance to the small life insurance companies would be extremely adverse to their operations. We believe that the current definition of a life insurance company as espoused judicially in Consumer Life and the use of modified coinsurance are critical to small and medium size insurance companies.

In summary, we believe that neither the definition of taxable income nor Section 818(c) should be changed. The recommended changes would be devastating to small and medium size insurance companies and would jeopardize their future existence. The changes would discourage investment in new companies and would force small and medium size life insurance companies to be acquisition candidates. The end result would be to diminish competition and ultimately cost consumers. We would welcome the opportunity to meet with the GAO to discuss this response.

Legislative Affairs Committee

Ransom B. Jones

APPENDIX VIII

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July 6, 1981

Mr. Natwar Ghandi
General Accounting Office
441 G Street, N.W.
Room 5107A
Washington, D.C. 20548

Dear Mr. Ghandi:

In response to your request, the Consumer Credit Insurance Association ("CCIA"), hereby transmits comments on the draft of a proposed report, entitled "Life Insurance Company Income Tax Act of 1959: An Analysis and Recommendations for Change," dated April 9, 1981, prepared by your staff. CCIA is a national organization which represents more than 160 credit insurance companies which write and reinsure life and accident and health insurance written in connection with credit transactions. The comments relate specifically to the portions of the draft report concerning credit life reinsurance (merely one of a number of lines of reinsurance) which CCIA believes has been unfairly singled out for discussion in the report.

As explained in the attached comments, many of the assumptions and conclusions in the report concerning credit life reinsurance are inaccurate. The ultimate recommendation concerning credit life reinsurance -- that the Congress consider "tightening" the definition of a life insurance company for federal income tax purposes -- is based upon these inaccurate assumptions and conclus
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COMMENTS ON DRAFT OF A PROPOSED REPORT --
"LIFE INSURANCE COMPANY INCOME TAX ACT OF 1959:
AN ANALYSIS AND RECOMMENDATIONS FOR CHANGE"

Submitted to the U.S. General Accounting Office by the
Consumer Credit Insurance Association

July 6, 1981

The following comments relate specifically to the portions of the draft report concerning credit life insurance (merely one of a number of lines of reinsurance) which we believe has been unfairly singled out for discussion in the report. The portions of the draft report concerning credit life reinsurance contain a number of inaccurate assumptions and conclusions which, in turn, form the basis for a proposed recommendation to the Congress that the definition of a life insurance company for federal income tax purposes be tightened "to prohibit a company doing mostly nonlife insurance business from qualifying as a life insurance company for tax purposes."

There is nothing unique or sinister about credit life reinsurance or those who own credit life reinsurance companies as CHAPTER 5, "Credit Life Reinsurance: A Special Case" seems to imply. To single out such companies and their owners from all other types of insurance companies and their owners for special comment in the draft report is unwarranted and discriminatory. Even the title of Chapter 5 is inaccurate and misleading.

As discussed below, the qualification of a life insurance company for federal income tax purposes is determined by the insurance reserve ratio test, found in section 801 of the Internal Revenue Code. That test has been used to distinguish life insurance companies from nonlife insurance companies for federal income tax purposes since before 1921. The insurance reserve ratio test applies to all companies qualifying as insurance companies within the meaning of Section 1.801-3(e) of the Treasury Regulations. It provides a workable, administrable test for distinguishing the federal income tax treatment to be accorded various types of insurance companies.

Any attempt to alter the definition of a life insurance company for federal income tax purposes or to alter the insurance reserve ratio test -- particularly for the purpose of singling out one class of reinsurer -- could lead to confusion and controversy which does not exist under the current test. Any controversy involving the application of the insurance reserve ratio test to insurance companies writing or reinsuring credit life and credit accident and health insurance has been resolved by the Supreme Court. In addition, the conclusion, without qualification, that the federal income tax treatment accorded life insurance companies is "preferential," especially in today's economic climate, is inaccurate. The tax benefits from qualification as a life insurance company for federal income tax purposes may be more illusory than real, as is recognized in a number of other places in the draft report.

Discussion of these points and our specific comments on CHAPTER 5 of the draft report follow:

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I. INTRODUCTION (Pages 5-1 through 5-4 of the Draft Report)

Reinsurance serves many important functions in the insurance industry. One author has summarized the functions of reinsurance as:

1) protection of insurers from underwriting losses which may imperil their solvency;

2) stabilization of underwriting results;

3) increasing the flexibility of an insurer in the size and types of risk and the volume of business he can underwrite;

4) further spreading the risk of loss; and

5) assistance in the financing of insurance operations, and assistance by major reinsurance companies and brokers of a range of secondary insurance underwriting, claims handling, administrative and technical services. */

The emphasis in the draft report that one of the "major objectives" of reinsurance agreements is to enable a company to qualify as a life insurance company overshadows the fact that reinsurance serves these important functions.

By focusing on the use of reinsurance to qualify credit insurance companies as life insurance companies for federal income tax purposes, the draft report ignores the fact that reserves held under reinsurance agreements, since they are included in the insurance reserve ratio test, may result in either qualifying or disqualifying any type of insurance company as a life

*/ Carter, Reinsurance (Alden Press, Oxford 1979).

insurance company. To single out the reinsurance of credit insurance and reinsurance for special comment in the draft report is unwarranted and discriminatory. The focus in the draft report on only one result of reinsurance and then only on its relation to credit life reinsurance is misplaced.

Several points raised in the "Introduction" section of CHAPTER 5 merit specific mention. First, the portion of the premium paid as a sales commission */ on any insurance contract is not relevant to the question of the qualification of an insurance company as a life insurance company for federal income tax purposes. In addition, the comments in the report relative to types of investors who establish insurance companies specializing in credit insurance or reinsurance are also not relevant to the question of the qualification of an insurance company as a life insurance company for federal income tax purposes. Surely the references on pages 5-2 and 5-3 were not intended to suggest that the federal income tax treatment of an insurance company should depend upon the amount of premiums charged or commissions paid or upon who or what the status of the investors or owners of a company are.

Furthermore, on page 5-3 of the draft report there is a statement that after a credit reinsurance company reimburses

*/ All states regulate the maximum premium rate that can be charged on credit insurance contracts. The commission rate is also regulated in a number of states.

APPENDIX VIII

the original writer for the claims reinsured (the way all reinsurance agreements typically operate) "its owners get the money that is left over." We submit that there is nothing improper or untoward about owners of a business -- any business -- getting "the money that is left over", that is, any profit from the business. This is true for owners of any type of business; they bear the risks of losses, if any, in the business, and they share the profits, if any, upon which they will be taxed.

The report then continues that the profit from credit life reinsurance transactions is "partially shielded from Federal income tax because of the special deductions available under the 1959 Act." While this statement may be correct, at least for companies in certain tax positions, it is equally true for all types of insurance companies in the same tax positions which are taxed as life insurance companies under the 1959 Act. Credit reinsurers are not taking any more, or less, advantage of "special deductions" than any other insurer or reinsurer.

The issues concerning the proper way to tax the underwriting gain or profit of a life insurance company were thoroughly considered prior to the adoption of the 1959 Act. */ These issues were resolved, and a decision was made to tax the

*/ See, "A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies", Prepared by the Committee on Ways and Means of the U.S. House of Representatives (November, 1954).

underwriting profit of any insurance company qualifying as a life insurance company for federal income tax purposes -- a decision that was reflected in the "total income" approach of the 1959 Act.

Under the 1959 Act, the underwriting profits of a credit insurance or reinsurance company qualifying for federal income tax purposes as a life insurance company are taxed exactly like those of any other life insurance company. To single out companies conducting only credit reinsurance business for comment or criticism is unfair and unwarranted, since, to the extent any tax on underwriting gain is deferred for such companies, it would be deferred for any other life insurance company taxed on the same base under the 1959 Act.

Finally, the draft report inaccurately concludes that "while doing mostly nonlife business" credit reinsurance companies have qualified for "major tax advantages meant for companies doing mostly life insurance business."

First, we submit that the conclusion that credit life reinsurance companies are doing "mostly nonlife business" is in error. Simply because such companies do not directly write life insurance contracts, does not mean they are doing "mostly nonlife business." There are a number of companies which are engaged primarily in the reinsurance of business directly written by other insurance companies which qualify as life insurance companies for federal income tax purposes. These companies were

APPENDIX VIII

not singled out as companies doing "mostly nonlife business." As discussed in detail below, section 801 of the Internal Revenue Code provides an insurance reserve ratio test whereby an insurance company which qualifies under the test will be treated for federal income tax purposes as a life insurance company. A company that qualifies under that test cannot, by definition, be doing "mostly nonlife business", at least for federal income tax purposes.

Second, the statement that "major tax advantages" are available under the 1959 Act is misleading. While, as noted throughout the draft report, there may be some advantages to being taxed as a life insurance company, the draft report also notes that in the current economic climate there are substantial disadvantages to a company which is taxed as a life insurance company.

Although there is no focus in the draft report on this point, an insurance company that is taxed under Parts II or III of Subchapter L (i.e., as a mutual or stock casualty company), instead of Part I, enjoys a full deduction for any dividend paid to its policyholders. In addition, because the proration formula is not applicable to insurance companies taxed under Parts II or III, those companies obtain full advantage from the receipt of intercorporate dividends and investments in tax exempt bonds. Since there is no question but that a credit insurance or reinsurance company would qualify as an insurance company for federal income tax purposes, such a company, if taxed under Parts II or III,

would not suffer any of the de
under Part I. Thus, we submit
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may be more illusory than real

II. DEFINITION OF A LIFE INSUI
5-6 of the Draft Report)

The draft report cor
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insurance companies.

Separate provisions
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the cancellable accident and health, fire or automobile liability business.

An insurance reserve ratio test for determining the qualification of an insurance company as a life insurance company was adopted as part of the Revenue Act of 1921. That test incorporated a test that had been used by the Treasury Department prior to 1921 and provided that a company qualified as a life insurance company if it:

> "engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds." Section 242. Revenue Act of 1921. (Emphasis added.)

The reason the Treasury Department had applied this test was explained as follows:

> "Some companies mix with their life business, accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that if this accident and health business was more than 50 percent of their business, as measured by their reserves, it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 percent of their business we treated them as a life insurance company." Hearings on H.R. 8245 Before the Senate Comm. on Finance, 67th Cong., 1st Sess. 85. (1921) (Statement of T.S. Adams, Tax Advisor to the Treasury Department.) (Emphasis added.)

Thus, the purpose of the test was to distinguish life insurance companies engaged primarily in the life insurance and annuity business, which involves long-term risks, from insurance companies which wrote large amounts of cancellable accident and health insurance business, which involves short-term risks, based upon the size of the insurance reserves held for each type of business, not based upon the number of insurance contracts written or reinsured.

The primary and predominant business activity of a company is the test for determining whether it qualifies as an insurance company for federal income tax purposes. Section 1.801-3(a)(1) of the Treasury Regulations. That test is not, nor ever has been, the test for determining whether an insurance company qualifies as a life insurance company for federal income tax purposes. Where a company assumes both life and nonlife risks, it is the size of the reserves held for each of those types of business that determines whether the company qualifies for federal income tax purposes as a life insurance company or not. The sheer volume of policies issued or reinsured is not determinative of whether an insurance company qualifies as a life insurance company. It is the nature of the liabilities or risks assumed -- as measured by the reserves held -- that is determinative. Any insurance company with reserves on its life insurance contracts that exceed 50 percent of its total insurance reserves is not, by definition, a "nonlife insurance company" for federal income tax purposes.

APPENDIX VIII

It is difficult to understand why the draft report concludes that the reserve ratio test creates a "problem" in determining the federal income tax status of credit reinsurance companies but does not reach that conclusion about determining the federal income tax status of any other insurance or reinsurance company. Clearly, only those companies with life insurance reserves plus unearned premiums and unpaid losses on noncancellable accident and health policies in excess of fifty percent of total insurance reserves qualify as a life insurance companies for federal income tax purposes. */ Companies that so qualify are not doing "mostly nonlife business" for federal income tax purposes.

If every other type of insurance company that in terms of volume writes more cancellable accident and health policies than life insurance policies but carries higher reserves on those life insurance policies qualifies as a life insurance company for federal income tax purposes, why should a company that reinsures credit insurance with life insurance reserves in excess of fifty percent of total reserves be treated differently? If there is a problem or an abuse based on the insurance reserve ratio test, it is not confined to credit reinsurers.

*/ The draft report states that the unearned premium reserves for nonlife policies are included only in total insurance reserves (the denominator) and not life insurance reserves (the numerator) for purposes of the insurance reserve ratio test in section 801. This is not entirely correct since unearned premiums and unpaid losses on noncancellable accident and health policies are also included in the numerator of the insurance reserve ratio test.

Absent some compelling reason not stated in the draft report, a legislative change in the definition of a life insurance company for federal income tax purposes is not warranted. Some suggestions for change in the definition of life insurance companies to cover specialty insurance companies were considered and rejected at the time the 1959 Act was adopted. In its consideration of the 1959 Act, Congress was aware that some credit insurance companies could qualify as life insurance companies under the insurance reserve ratio test, but Congress chose not to alter a test that had proved workable and administrable since before 1921. */ A source of income test (alluded to on page 7-7 of the draft report) would be virtually impossible to implement in way that would properly differentiate between life and nonlife insurance companies for federal income tax purposes without more confusion and controversy than ever exists today.

As the Supreme Court noted in United States v. Consumer Life Insurance Co., 430 U.S. 725, 742-43:

> "The 1921 Act was thus built upon the assumption that important differences between life and nonlife insurance called for markedly different tax treatment. Strict adherence to this policy

*/ See, H.R. Rep. No. 1098, 84th Cong., 1st Sess., 3-7 (1955); S. Rep. No. 1571, 84th Cong., 2d Sess., 3-8 (1956); Hearings before the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, 85th Cong., 2d Sess., 78, 242-44, 330, 422-34 (1958); and Hearings on H.R. 4245 before the Senate Committee on Finance, 86th Cong., 1st Sess., 84-85 (1959).

> rationale would dictate that any company insuring both types of risks be required to segregate its life and nonlife business so that appropriate tax rules could be applied to each. Congress considered this possibility but chose instead a more convenient rule of thumb, the 50% reserve ratio test." (Emphasis added.)

The draft report does not offer any reason for altering a test that has proved workable and administrable for over 60 years, nor does it suggest any sound tax policy basis for recommending a legislative change which would lead to discrimination against reinsurers of one type of business in the application of the federal income tax laws.

Finally, the suggestion in the draft report that there is some impropriety in credit reinsurance transactions because a primary insurer may maintain the unearned premium reserve on credit accident and health insurance policies reinsured stems from an apparent misunderstanding of how reinsurance agreements typically are structured. The statement is made on page 5-5 of the draft report that the reinsurer "usually" assumes full liability on insurance policies for which the unearned premiums have been paid, while the direct writer keeps the unearned premium reserve and only pays over the reserves when the premiums are earned -- apparently implying that the reinsurer is somehow inadequately compensated for the insurance liabilities it assumes.

The economic terms of any reinsurance agreement, such as the premiums to be paid or portion of claims reimbursed, are subject to negotiation between the parties to the agreement.

Credit reinsurance agreements, including those described in the draft report, are not devoid of economic substance -- a point specifically recognized by the Court in Consumer Life, 430 U.S. 725, at 737. Credit reinsurance companies are subject to state regulation just like other insurance and reinsurance companies, and they are required to carry insurance reserves which accurately reflect their insurance liabilities. Therefore, it is erroneous to suggest that somehow credit reinsurance transactions are improper or that the reinsurer of such business is "usually" not adequately compensated for the risks undertaken.

III. THE CONSUMER LIFE CASE (Pages 5-6 through 5-11 of the Draft Report)

While it is true, as stated in the draft report, that the issue of life insurance company status for credit reinsurers has been the subject of controversy and litigation, the controversy was resolved by the Supreme Court with its decision in United States v. Consumer Life Insurance Co., supra. or so it was assumed. Although apparently the government was not entirely satisfied with that decision, at least the Court of Claims when presented with a similar question appeared to be satisfied that the Consumer Life decision had resolved the controversy. See, Western Diversified Life Insurance Co. v. United States, ___ F.2d ___ (Ct. Cl. 1/30/81). This appears to be the only reported case on this issue since Consumer Life, and there are no cases currently pending in litigation on this issue.

Thus, just as other issues under the 1959 Act have been resolved by litigation, e.g., United States v. Atlas Life Insurance Co., 318 U.S. 233 (1965) and Standard Life and Accident Ins. Co. v. United States, 433 U.S. 1488 (1977), the issue of the qualification of a credit reinsurance company for federal income tax purposes also appears to have been resolved by litigation. The insurance reserve ratio test of section 801 was found by the Supreme Court in the Consumer Life decision to be the proper test for determining a credit life reinsurance company's status for federal income taxation -- exactly like it would be for any other insurance company.

IV. SUMMARY

Credit life and accident and health insurance and reinsurance companies are subjected to state regulation just like all other insurance companies and their reserves are subject to the same standards as those of any other life insurance company. Such companies should not be singled out for any federal income tax treatment which is different from that of other insurance companies.

Any attempt to alter the qualification ratio test for purposes of altering the definition of a life insurance company -- particularly for the purpose of singling out one class of reinsurer would lead to confusion and controversy which does not exist today. Furthermore, to alter a test which has proved workable and administrable for over 60 years would be a mistake. We

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