United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m. EDT
Thursday
October 19, 1989

Allocation of Taxes Within the Life Insurance Industry

Statement of
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Before the
House Committee on Ways and Means
Subcommittee on Select Revenue Measures

04678

GAO/T-GGD-90-03

GAO Form 160 (12/87)

ALLOCATION OF TAXES WITHIN THE LIFE INSURANCE INDUSTRY

SUMMARY OF STATEMENT BY
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Section 809 of the Internal Revenue Code provides a way of measuring the earnings distributed by mutual life insurance companies through dividends. This amount is included in the taxable income of mutual companies. At the time of section 809's adoption, taxes were expected to split so that mutuals paid 55 percent of the life insurance industry tax bill and stock life insurance companies paid 45 percent.

The actual tax split has not worked out that way, and we do not believe that sound tax policy should require it to. Rather, we believe that taxes should be determined in a way that more closely relates to income. Moreover, a mechanism is needed that steers clear of section 809's problems. These problems include (1) imposing taxes that are higher for mutual companies as a whole in years when their earnings are low and lower when earnings are high and (2) imposing taxes that depend disproportionately on the performance and behavior of large mutual companies.

Our recommendation is to delete section 809 from the tax code and institute a new approach. We believe that the participating policy is the issue that needs to be addressed if neither the stock nor the mutual segment of the life insurance industry is to gain an advantage. Under our approach, policyholders, like shareholders, would be taxed on the earnings part of any dividends they receive, whether from mutual companies or from stock companies. Congress would designate a percentage of policyholder dividends as distributed earnings to be included in taxable income. For administrative reasons, the companies could pay the tax as a proxy rather than have policyholders pay the tax directly.

Mr. Chairman and Members of the Subcommittee:

We are pleased to have the opportunity to help in your hearing on the tax treatment of the life insurance industry and to discuss potential changes in that treatment.

Mr. Chairman, you and the Chairman of the Subcommittee on Health of the House Committee on Ways and Means asked us to analyze how section 809 of the Internal Revenue Code has allocated taxes in the life insurance industry and, if warranted, to suggest improvements. Our final report was issued this morning. It examines alternatives to current law and recommends deleting section 809 from the tax code and replacing it with a new approach.

Before discussing our analysis of section 809 and our suggested changes in the tax treatment of the life insurance industry, I would like to provide some background material to put our recommendation in context.

WHY SECTION 809 WAS DESIGNED

A stock life insurance company is owned by its shareholders, and it distributes earnings to these owners by paying dividends. These dividends are subject to income tax at both the company and individual shareholder levels. Mutual life insurance companies, however, are owned by their policyholders. As a result, the dividends that they pay include a part that is a refund of excess premiums to the policyholder as customer, and a part that is a distribution of company earnings to the policyholder as owner. Deciding what part of the dividend is a refund and what part is income is a source of controversy.

Section 809 was constructed to isolate the earnings component of mutual policyholder dividends so that mutual companies would pay taxes on earnings distributions as stock companies do. In addition, it was designed, at least to some extent, to make up for the fact that the earnings part of dividends is not taxed on a current basis at the individual policyholder level.

Section 809 provided a very complicated mechanism to approximate the earnings distributed by mutual life insurance companies. The purpose was to make the measure of mutual company income correspond to company income for a shareholder-owned corporation. When the revenue estimates were made, in 1984, taxes were expected to split so that mutuals paid 55 percent of the industry tax bill and stocks 45 percent.

TAXES RESULTING FROM SECTION 809

From financial statement data, we calculated that total taxes incurred by the life insurance industry from 1984 through 1987 were $13.4 billion. The Treasury Department, using a survey for

1984 and 1985 and a sample of tax returns for 1986, finds a lower amount of taxes was collected than estimated in 1984. Both our figures and Treasury's show that the split in taxes between stock and mutual companies was not that expected back in 1984. Rather, our calculations show that the split was exactly the opposite: stocks paid 55 percent and mutuals 45 percent. However, the split in taxes that we calculated for the 1984 through 1987 period was consistent with the split in income, as that income was defined under section 809.

We believe that sound tax policy requires less concern with a predetermined split in taxes between two segments of the industry and more concern with basing taxes on income. We understand that these segments are competing with one another very closely and that any sizable, long-standing tax difference could favor one segment at the expense of the other. We think it would be best to focus on income and examine taxes in relation to that income.

Regardless of the split in taxes between the segments, there are still problems with section 809. When we testified last year, we raised certain questions about this section of the tax code. The analysis contained in our report shows that our concerns were justified. The most significant problems relating to the taxes imposed by section 809 are the following:

--The taxes are higher for the mutual companies as a whole in years when their earnings are low, and lower in years when their earnings are high.

--They are more burdensome for low-earnings companies than for high-earnings companies. This problem results from using segmentwide averages to arrive at each company's taxes.

--These taxes also depend disproportionately on the behavior and performance of the larger mutual companies.

MUTUAL COMPANIES NEED NO EXTRA TAX AT THE COMPANY LEVEL

The problem of taxing the distribution of earnings by mutual life insurance companies has been analyzed very carefully from a number of perspectives. One perspective that has generated much discussion is the prepayment approach associated with Professor Michael Graetz, who appeared before your subcommittee last year. According to this approach, there is no need to tax the earnings part of policyholder dividends at the company level because mutuals pay taxes when they receive new capital. They receive new capital from participating life insurance policies--the primary product mutual companies sell. The participating policy differs from the nonparticipating policy in that the premiums charged are larger for the same insurance coverage. The premiums include one part that pays for insurance and a second part (called the excess premium) that can be looked upon as a contribution of capital to the company. The extra amount generated by this higher premium is refunded over time to the policyholders along with a return that is the distribution of earnings that section 809 is meant to tax. The prepayment approach holds that because the excess premium was included in taxable income, there is no need to tax the return on the excess premium. The tax has been "prepaid." The same analysis can be applied to stock companies that sell participating policies.

There are a number of assumptions that underlie this approach. Among the most important are that:

- excess premiums are a source of new capital for the mutuals;
- most equity in the mutual segment has been subject to a company-level tax; and
- actual returns on equity for mutuals are, on average, the same as the returns that were anticipated when the excess premiums were paid.

Although these assertions have not been conclusively demonstrated, all seem consistent with our observations of the industry. In particular:

--If there is a return on equity paid by mutuals, it must be based on some contribution to capital by the policyholder. No business could long survive if it provided equity returns without having received an equity contribution.

--While some premium income escaped full taxation before 1984, we have no indication that a substantial amount of mutual equity remains untaxed.

--Taxing companies prospectively (when the capital is received through excess premiums) rather than on the basis of actual performance (as income is earned) is not in keeping with a standard income tax. However, in the case of a mutual company, the present value of taxes generated by the returns on a capital contribution should, on average, approximate a tax on the contribution itself.

Thus, our conclusion is that the prepayment approach is substantially correct and, as a result, there is no need for section 809 to impute a company's distributed earnings.

OUR RECOMMENDATION FOR TAXING LIFE INSURANCE AT THE POLICYHOLDER LEVEL

While the prepayment approach appears to solve the problem of distinguishing policyholder earnings from premium refunds at the company level, a problem remains. Dividends paid to shareholders are taxable at the individual level, but dividends paid to policyholders are taxable only when the sum of those dividends exceeds the sum of premiums paid into the policy or when the policy is surrendered. This can give a market advantage to policies that pay these tax-deferred dividends.

We recommend taxing policyholders on the earnings part of any dividends, whether received from mutual companies or stock companies. While it is clear that mutual policyholders as owners receive equity returns, the policyholders of stock companies receive performance-based payments that have many of the earmarks of equity returns. We believe that the participating policy is the issue that needs to be addressed if neither segment is to gain a tax advantage. Whether the policy is sold by a stock or mutual company is of less importance.

A tax on the earnings paid to policyholders takes us back to the problem that section 809 set out to resolve. How do you separate the earnings part of policyholder dividends from the price rebate part? Rather than use the complicated mechanism of section 809, we suggest a simpler alternative. Congress should designate a proportion of policyholder dividends as earnings to be included in taxable income. Our approach would not entail all of the difficulties described earlier.

Under our approach, Congress would use the dividend distribution behavior of shareholder-owned corporations as a benchmark for calculating the earnings distributed through policyholder dividends. Participating life insurance policies compete in a market with other assets that pay an equity return. As a result, they should be expected to distribute earnings that are comparable to the distributions paid on corporate stock. This comparison need not be limited to the dividends distributed by stock life insurance companies. Our calculations show that, in the 1980s, corporations distributed about 6 percent of equity annually to their shareholders. Therefore, we would designate a percentage of each year's policyholder dividends that is equivalent to about 6 percent of mutual equity. This comes out to about 25 percent of financial statement dividends or 20 percent of the broader measure of dividends defined under section 808 of the tax code for both stock and mutual companies. The rate could also be adjusted upward to reflect, in addition to distributed earnings, a measure of capital gains. If the payout behavior of corporations or mutuals changes, the taxable portion of dividends should be altered to maintain consistency.

This tax on a proportion of policyholder dividends would be less regressive company-by-company and year-to-year than section 809 or any tax on equity. In addition, it would eliminate the weighted average issue and the corresponding influence of the larger companies.

The approach can be put into place as an individual level tax or as a proxy tax paid at the company level. If the individual approach is used, policyholders would receive notice of the earnings imputed to them through an information form, and they would be expected to include that amount in their adjusted gross income when filing their income tax returns. The advantage of this approach is that all policyholders would be taxed at the rate that correctly applies to their income level. The disadvantages are: (1) that the amount imputed to a particular policyholder is an average over all types of policies and need not reflect the return paid on the type of policy owned by that individual, and (2) there would be substantial administrative and compliance costs involved, with millions of taxpayers making calculations.

The alternative that we favor is a proxy tax paid by the company, after adjusting the tax base for the difference in company and individual tax rates. The proxy tax would be paid by the company for the average policyholder, so there would be less concern that the amount attributed to each policyholder was correct. It would only have to be right for the average policyholder. Compliance and administration costs would be lower if each company calculated and paid the tax than if all of the company's policyholders did the same.

The measure of dividends that should form the base for this tax is policyholder dividends broadly defined. As long as the payment of a dividend is at the discretion of the company and the policyholder has the option of taking the payment in cash without surrendering the policy, there is an equity component that can be reached without incurring tax and this component should be taxed.

Policyholder dividends that are paid on group life insurance or group annuities should not be included in the tax base. Generally, companies or organizations that pay for the policies or annuities should include the dividends in their income. Thus, either the earnings are already subject to a corporate-level tax or are paid to tax-exempt entities like pension funds.

Since policyholder dividends are taxed when the cumulative total exceeds premiums paid into the policy or upon surrender, some offset is necessary to reflect this current tax on a portion of policyholder dividends. Our suggested approach would be to calculate income using the current method but allow a tax credit for taxes the company has already paid on policyholder dividends.

The company would have to inform policyholders of the taxes that have been paid on the dividends attributable to them.

CONCLUSION

In conclusion, because our analysis shows that mutuals prepay taxes when their premium income is taxed, we recommend that section 809 be deleted. We believe that part of the dividends paid to policyholders of mutual and stock companies represents a distribution of earnings and should be taxed. The method that we recommend is to designate a proportion of the policyholder dividends paid by stock and mutual companies as taxable income. Our recommended approach involves the use of industry averages and a proxy tax. As such, it will not be exact for each individual. One of the things we have discovered in our analysis of section 809 is that simplicity is an important virtue. We believe our approach provides the proper balance between simplicity and precision.

This concludes my prepared statement. We would be pleased to respond to any questions.