COMPARISON OF
PRESENT LAW, A DISCUSSION DRAFT, AND POSSIBLE CLARIFICATIONS
OFFERED BY REPRESENTATIVES STARK AND MOORE,
Relating to the Tax Treatment of Life Insurance Companies
and Their Products

Prepared by the Staff of
the Joint Committee on Taxation
for Use by
the Subcommittee on Select Revenue Measures,
Committee on Ways and Means

September 27, 1983

JCX-25-83

Item	Present Law	Subcommittee Print	Proposed Modifications
1. Structure of the Corporate Level Tax	Life insurance companies are taxed using a 3-phase approach. Phase I taxes investment income currently. Phase II taxes gain from operations--combining both investment income and underwriting gain or loss; if underwriting gain, only one-half is taxed currently. Phase III taxes the untaxed underwriting gain if and when distributed to shareholders.	The 3-phase approach would be eliminated. Life insurance companies would be taxed currently on life insurance company taxable income at the generally applicable corporate tax rates. The alternative tax on capital gains could apply. Special rules would govern-- (1) the deduction for reserves (item 2, below); (2) the deductibility of policyholder dividends (item 3, below); (3) the treatment of small companies (item 5, below); and (4) the aggregate tax burden on the industry generally (item 6, below). Effective date.-- Taxable years beginning after December 31, 1983. Transition rule.--No express rule is provided for the treatment of amounts potentially subject to the Phase III tax.	Current amounts in the policyholder surplus account (Phase III) would retain tax deferral until distributed, subject to the rules for distribution and tax under the 1959 Act.

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2. Policyholder Reserves			
(a) In general	(a) In general.--Taxable income is computed by allowing, in effect, deductions for increases in the prior year-end reserves required under State law. Special rules apply to-- (1) adjust reserves for purposes of the tax on investment income (the Menge formula); (2) allow a revaluation of preliminary term reserves to net level reserves (sec. 818(c)); and (3) provide additional contingency reserves for-- (i) nonparticipating policies, and (ii) accident and health, and group life contracts.	(a) In general.--Companies would be allowed a deduction for reserve increases for certain enumerated items. With respect to life insurance reserves, the amount of the increase would be the higher of (1) the actual cash surrender value, or (2) the reserve calculated using specified methods, interest rate, and mortality assumptions. In any event, the deduction would be reduced by the policyholders' share of tax-exempt interest (see item 7 below).	
(1) cash surrender values		(1) the actual cash surrender value would be computed by reference to the provisions in the contract guaranteeing cash values, without regard to any market value adjustment on surrender.	

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(2) federally computed minimum reserve		(2) for purposes of calculating a reserve under section 807, different methods are provided for life insurance reserves on different types of contracts. The permitted interest rate is the highest permitted in 26 States (in the year of issue or the preceding year). The mortality assumptions required are the most recent adopted by at least 26 States (subject to a 3-year grace period in which a company would be required to give effect to a new table).	In computing the reserves for annuity contract, the obligation to annuitize would be taken into account as future benefits. A technical amendment would recognize as tax reserves the minimum reserve required under foreign law where foreign law dictates the amount of the reserve and under particular State law where State law governs the treatment of products unique to that State.

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(b) Special rules for <u>Variable contracts</u>	(b) <u>Variable contracts</u>.--There are special rules which require separate accounting for asset funds underlying variable annuity contracts, but which do not apply to variable life insurance contracts. Under one specific rule, capital gains recognized by the company on the sale of assets underlying nonqualified annuity contracts are taxed at the company level, although the gains are credited to the policyholder (causing a double tax on such amounts when distributed and taxed again at the policyholder level).	(b) <u>Variable contracts</u>.--Special rules for the company tax treatment of variable contracts, in general, would be provided. A variable contract is defined as either an annuity or life insurance contract under which the policy benefits are adjusted to reflect the current investment return and current market value of a segregated asset fund. The provision would continue the present law tax treatment for variable annuities and would extend the same treatment to variable life insurance.	
(c) Special rule for <u>Group Annuity contracts</u>	(c) <u>Annuity contracts</u>	(c) <u>Annuity contracts</u>.--With respect to group annuities the balance in the policyholder's fund (determined without regard to any market value adjustment) shall be treated as the cash surrender value.	

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(d) Accident & health insurance contracts	(d) Accident & health insurance contracts.--Unearned premium and unpaid loss reserves are established in connection with these contracts. For purposes of the unearned premium reserve, gross premiums are earned pro rata over the life of the contract. Unpaid losses are estimated and reserved for on a non-discounted basis.	(d) Accident & health insurance contracts.--Present law tax treatment would be retained for unearned premiums and unpaid losses for A&H contracts.	
		Effective date.--Taxable years beginning after December 31, 1983.	
		Transition rule.--Reserves would be recomputed under the new rules as of the close of 1983. Any income or loss arising from the recomputation would be taken into account ratably over 10 years.	Transition rule.--Any income or deduction arising from the recomputation should not be taken into account at all.

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3. Limitation on Deduction for Policyholder Dividends Paid by Mutual Companies ("Ownership Differential")			
(a) <u>In general</u>	(a) <u>In general</u>.--In computing taxable income, companies are allowed certain special deductions including the deductions for policyholder dividends, nonparticipating contracts, and A&H and group life contracts, subject to limitations. (1) Under the permanent provisions of the 1959 Act, these special deductions cannot reduce taxable income below an amount equal to taxable investment income less a statutory amount of $250,000 (Phase 1). (2) Under the temporary provisions applicable to 1982 and 1983, a company can use (1) the 1959 Act rule with the $250,000 statutory amount increased to $1,000,000, targeted to smaller companies, or (2) a limitation equal to the statutory amount, plus 100 percent of dividends on pension business, plus 77-1/2 percent of nonpension policyholder dividends for mutual companies (85 percent for stocks).	(a) <u>In general</u>.--No limitation would be placed on the deduction of policyholder dividends or similar amounts by stock life insurance companies. No special deductions for nonparticipating, A&H and group life contracts would be allowed. The deduction for policyholder dividends paid by mutual companies would be limited to the excess of--(i) adjusted statutory gains from operations, over (ii) the imputed return on equity. In no event would the deduction be more than a maximum percentage nor less than a minimum percentage of policyholdr dividends. Policyholder dividends would be defined to include excess interest, and experience-rated refunds (on other than group pension contracts) and would be deductible when paid or accrued rather than on the basis of reserves.	

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(b) Equity base	(b) Equity base.--Under the 1959 Act, assets held for policyholders in their capacity as owners of the company are not identified in any way. The Act does, however, distinguish between investment assets held with respect to liabilities to policyholders and other investment assets. Investment income earned on assets not held for liabilities to policyholders is taxed at the company level through the limitation in policyholder dividends.	(b) Equity base.--The equity base of a mutual would be measured and would equal its surplus and capital as shown for State regulatory purposes, with the following adjustments: (1) nonadmitted financial assets would be included; (2) reserves would be computed under the Federal tax rules; (3) any mandatory securities valuation reserve, deficiency reserve, or voluntary reserve would be included; and (4) 50 percent of any provision for policyholder dividends payable in the following year would be included.	

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(c) Imputed earnings		(c) Imputed earnings.--Mutual companies would be treated as earning a specified pre-tax rate of return on their equity. For taxable years beginning after 1984, the rate of return would be adjusted annually to reflect changes in the average rate of return earned by comparable stock companies over a three-year period ending with the calendar year prior to the calendar year in which the taxable year begins. Effective date.--Taxable years beginning after December 31, 1983.	(c) Imputed earnings.--The rate of return imputed for mutual companies, for 1984, would be that which results in the mutual companies paying 55 percent and the stock companies paying 45 percent of the aggregate tax burden. For subsequent years, rate used for adjustment of the initial rate should be a numerical average of the 50 largest stock companies.

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4. Stock Subsidiaries of Mutual Companies	Present law does not directly distinguish between stock subsidiaries of stock and mutual life insurance companies.	Stock life insurance subsidiaries that are at least 80 percent owned by mutual life insurance companies [mutual entities] would be treated as mutual companies. In the case of an affiliated group that includes a mutual common parent and a stock life insurance subsidiary, the limitation on the deduction for policyholder dividends would be determined on an aggregate basis and allocated in proportion to policyholder dividends paid. This rule would apply whether separate returns or consolidated returns are filed. Regulations would provide rules for stock life insurance subsidiaries of mutuals, not included in an affiliated group. <u>Effective date</u>.--Taxable years beginning after December 31, 1983.	The rule for stock subsidiaries of mutuals would apply to any company becoming a subsidiary of any mutual entity after December 31, 1983; the rule should also apply to existing life insurance companies that are subsidiaries of mutual life insurance companies. Dividends received from a stock subsidiary that is at least 80 percent owned would be deductible by the parent under rules generally applicable to other corporations. (Such dividends would not be subject to proration.)

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5. Treatment of Small Companies	There is a small company deduction of $25,000 that is available to all companies. Also, although not limited to small companies, the deferral of tax on one-half of underwriting income, the revaluation of reserves under section 818(c), and the special deductions for nonparticipating and group life and A&H contracts significantly reduce the tax burden of many small companies. For purposes of computing the limitation on the deduction for policyholder dividends and other special deductions under temporary provisions applicable for 1982 and 1983, the $1 million statutory amount phases out as policyholder dividends and special deductions increase from $4 million to $8 million.	Small companies would be permitted a deduction equal to 60 percent of the first $1 million of otherwise taxable income. This percentage figure would be reduced to zero as taxable income increases from $1 million to $4 million. Thus, the maximum benefit that could be enjoyed by a small company would be $600,000, and a company with $4 million or more in taxable income would not be entitled to any small company deduction. Companies with more than $500 million in assets would not qualify for the deduction. Eligibility would be determined on the basis of affiliated groups. Effective date.--Taxable years beginning after December 31, 1983.	The small company deduction percentage would apply to the first $3 million of income of a company and be phased down to zero as income increases from $3 million to $15 million.

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6. Taxable Income Adjustment (Special Life Insurance Company Deduction)		All life companies would be allowed a deduction in an amount equal to a specified percentage of their taxable income. The deduction would apply after the deduction for policy-holder dividends and small companies. <u>Effective date</u>.--Taxable years beginning after December 31, 1983.	The amount of the special life insurance company deduction would be 25 percent.

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7. Tax-Exempt Income	Annual additions of interest to policyholders' reserves are treated as funded proportionately out of taxable and tax-exempt income.	A proration rule would be retained. However, the policyholders' share would be determined by reference to both investment and underwriting income. Effective date.--Taxable years beginning after December 31, 1983.	Tax-exempt interest and intercorporate dividends received deduction (not including dividends received from 80% owned subsidiaries) would be allocated to policyholders in the same proportion statutory required interest on policyholder funds and all other amounts paid or credited to policyholders as customers (i.e., the amount of deductible policyholder dividends) bears to gross investment income less specified investment expenses.

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8. Reinsurance	Present law prevents the avoidance of Federal income tax through reinsurance transactions by (1) denying a deduction for interest on reinsurance-related debt, (2) permitting Treasury to reallocate income and deductions in coinsurance transactions between related parties, and (3) treating policyholder dividends as paid by the primary insurer rather than the reinsurers.	Present law rules would be retained except that a broader definition of related parties would be adopted. Also, in a reinsurance agreement where one party is an agent of or conduit for the other, Treasury would have the same reallocation authority. Effective date.--Taxable years beginning after December 31, 1983.	

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9. Foreign Tax Credit	Present law may distinguish between foreign and U.S. source income on a phase-by-phase basis. Thus, for example, a company taxed in Phase I may be able to claim a foreign tax credit only if it has a foreign source taxable investment income.	No provision is included. <u>Effective date</u>.--Taxable years beginning after December 31, 1983.	Deductions for policyholder dividends, reserve increases, and claims paid would reduce foreign and U.S. income (whether from investments or underwriting) pro rata.
10. Contiguous Country Branches of U.S. Life Companies	Income of Canadian and Mexican branches of U.S. life companies that benefits only policyholders is not subject to U.S. tax unless repatriated to the United States.	Generally, the same as present law.	The equity of a mutual company would be reduced by the amount which is allocable to business conducted in non-contiguous countries in the Western Hemisphere (South American countries). The reduction would be equal to the percentage of reserves allocable to such foreign business.

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11. Foreign Life Companies --Minimum Surplus Adjustment	Foreign life companies that do not maintain U.S. surplus (U.S. assets less U.S. liabilities) comparable to U.S. companies' average surplus must reduce certain deductions.	Generally the same as present law.	
12. Definition of Life Insurance Companies	To qualify as a life insurance company, a company must hold more than 50 percent of its reserves as life insurance reserves. It is unclear how pension funds without permanent life annuity purchase rate guarantees should be treated. Under the temporary provisions for 1982 and 1983, no company is allowed to change its life company status because of its treatment of such pension funds.	Generally, the present law definition would be retained. Reserves on pension funds without permanent life annuity purchase rate guarantees would not be treated as insurance reserves for purposes of the 50% qualification test. Effective date.--Taxable years beginning after December 31, 1983.	

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13. Consolidation with Other Companies	Generally, life insurance companies are permitted to join with other companies in the filing of a consolidated return. Special rules apply, however, to limit the extent to which nonlife insurance losses can be used to offset life insurance income.	The present law rules would be retained. In addition, the following special rules would apply.-- (1) If life and nonlife companies consolidate. (a) the special life insurance company and small life insurance company deductions would offset life insurance company taxable income; and (b) consolidated nonlife losses would offset life insurance company taxable income before the special deductions. (2) Related life insurance companies would be treated as one company for purposes of: (a) computing the special deductions; (b) computing the limitation on the deduction for policyholder dividends in the case of stock subsidiaries of mutuals.	Under the general rule for computing the amount of the special deductions, the taxable income base for the specials would be computed without regard to noninsurance items. Thus, noninsurance losses would not reduce the deductions and noninsurance gains would not increase them. With respect to consolidated returns, consistent treatment would be provided for by applying the general rule on a combined basis only to the life insurance members of the group (and nonlife insurance companies' gains or losses would not increase or decrease the amount of the special deductions).

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14. Accounting Rules		Federal tax accrual accounting rules would have primacy over State statutory accounting rules. State rules would apply to the extent consistent with, or required by, Federal tax rules. The holding of the Supreme Court in Comm'r. v. Standard Life and Accident Ins. Co., 433 U.S. 148 (1977), would, in effect, be reversed.	

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15. Definition of Life Insurance			
(a) <u>In general</u>	(a) <u>In general</u>.--There is no statutory definition of "insurance" or "life insurance." Death proceeds paid under a life insurance contract to a beneficiary are exempt from income tax. Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, and is taxed upon termination of the contract prior to death to the extent the cash surrender value exceeds the policyholders' investment in the contract (the aggregate premiums paid).	(a) <u>In general</u>.--There would be a statutory definition of life insurance for tax purposes.	
	<u>Temporary guidelines</u> For 1983 and 1984, death proceeds from flexible premium policies (e.g., universal life) are treated as life insurance if either of two tests are met.	Using the pattern of the temporary guidelines, contracts would qualify as life insurance contracts under either of two tests:	
	<u>Alternative 1</u> (a) Premiums paid for the benefit cannot exceed the net single premium (at 6 percent) or the sum of the net level premiums (at 4 percent), assuming the policy matures no earlier than 20 years or age 95, if earlier, and	<u>Alternative 1</u> (a) Premiums paid could not exceed the premiums that would be paid for a level death benefit, level premium, 10-pay life contract maturing no earlier than at age 95, and	The 10-pay requirement would be deleted. <u>Corridor modification</u>.--See separate handout.

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	(b) the death benefit must be at least 140 percent of cash value at age 40, phasing down each year to 105 percent (corridor limitation). <u>Alternative 2</u> The cash value cannot exceed the net single premium (at 4 percent) for the amount payable at death, assuming the policy matures no earlier than 20 years or age 95, if earlier.	(b) the death benefit must be at least 250 percent of cash value at age 40, phasing down each year to 100 percent. <u>Alternative 2</u> The cash value could not exceed the cash value of a 10-pay level death benefit life contract maturing at age 95. Special rules would be provided in regulations to provide for reasonable paid-up additions.	

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(b) Consequences of failure	(b) Consequences of failure.--Under an IRS ruling, contracts that fail to meet such guidelines are treated as a combination of term life insurance and an annuity.	(b) Consequences of failure.--Contracts that fail would be treated as a combination of term life insurance and a currently taxable deposit fund. Effective date.--Taxable years beginning after December 31, 1983 (December 31, 1984 for certain debit insurance).	Transition rule.--Contracts issued prior to January 1, 1985, would be treated as qualifying if they would meet the present-law cash value test.

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16. Annuity Contracts			
(a) In general	(a) In general.--After the annuity starting date (the payout phase) each payment is treated as part a payment of income out of the contract and part a return of capital (the policyholder's investment in the contract). Distributions prior to the annuity starting date are treated as being made first out of income and then as out of the policyholder's investment in the contract.	(a) In general.--Present law would be retained with respect to the taxation of income from an annuity contract.	

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(b) <u>Penalty on premature distributions</u>	(b) <u>Penalty on premature distributions</u>.--Premature distributions from annuity contracts are subject to a penalty tax equal to 5 percent of the amount includible in income.	(b) <u>Penalty on premature distributions</u>.--Same as present law.	

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(c) Definition of premature distributions	(c) Definition of premature distributions.--A distribution (including a loan or partial surrender) is treated as premature if made before the annuitant reaches age 59-1/2 and if the income portion of the distribution is attributable to an investment made within 10 years of the distribution. Exceptions are provided for: (1) distributions at death; (2) distributions on account of disability; (3) distributions under an annuity for life or at least 5 years; (4) distributions under a qualified pension plan; and (5) distributions allocable to pre-August 14, 1982, investments.	(c) Definition of premature distributions.--The exception from the penalty for income on investments held more than 10-years would be eliminated. Annuitization would be required by age 70-1/2. Exception for annuitization would be modified to require payment over life or at least 10 years. Effective date.--Date of enactment.	In lieu of the requirement to distribute funds in an annuity contract by age 70-1/2, a rule would be adopted that, if the annuity has not been annuitized upon the death of the contractholder, the income in the contract will be taxable upon such death and includible in the final return of the contractholder.

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17. Policyholder Loans	No deduction is allowed for: (1) interest paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan which contemplates the systematic direct or indirect borrowing of part of all of the increases in the cash value of such a contract; (2) interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract; and (3) premiums paid on any policy covering the life of any officer, employee or financially interested person, when the taxpayer is a beneficiary. An exception is provided to the rule disallowing amounts paid or accrued on indebtedness incurred or continued as part of a plan if: (1) no part of four of the first seven annual premiums is paid by means of indebtedness; or	Generally, present law would continue to apply. However, no deduction would be allowed for interest paid on aggregate loans in excess of $50,000. <u>Effective date</u> - August 2, 1983. <u>Transition rule</u> - The new rule would apply to all indebtedness incurred after August 2, 1983, without regard to the date of the policy.	Policies issued as of September 27, 1983, would be grandfathered. The limitation for corporations would be $50,000 per insured. The limitation would be converted into an interest limitation based on the deficiency rate existing as of January 1 of the tax year.

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	(2) the total of the amounts paid or accrued during the taxable year and for which no deduction would be available do not exceed $100; or (3) the indebtedness was incurred because of an unforeseen substantial loss of income or increases in financial obligations; or (4) the indebtedness was incurred in connection with the taxpayer's trade or business.		
18. Policyholders Investmemt in a Contract	On the withdrawal of cash from, or surrender of, a life insurance policy, a taxpayer has income to the extent of the excess, if any, of the cash surrender value of the policy over the policyholders investment in the contract (i.e.), aggregate premiums paid less réturn premiums.	The policyholders investment in the contract would be reduced by the cost of the term insurance protection provided. Effective date - Taxable years beginning after December 31, 1983. Transition rule - The provision would apply to all new contracts purchased after the effective date.	

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19. Group-Term Insurance			
(a) In general	(a) In general.--Under present law, an employee can exclude from income the cost of $50,000 of group-term life insurance under a policy (or policies) carried by the taxpayer's employer (or employers). Retired employees do not have to include the cost of group-term insurance at all. Cost of group-term life insurance is determined on the basis of uniform cost table prescribed by regulations.	(a) In general.--Retired employees would be subject to the $50,000 cap on exclusion from income or group-term insurance.	
(b) Nondiscrimination requirements	(b) Nondiscrimination requirements.--The exclusion is not available to key employees covered under discriminatory group-term life insurance plans.	(b) Nondiscrimination requirements.--The nondiscrimination rules will be extended to retired employees. Employees or retired employees under discriminatory plans would not be able to use the uniform cost table.	