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TAXATION OF LIFE INSURANCE COMPANIES

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON

OCTOBER 19, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for October 19, 1989, to consider the Federal income taxation of life insurance companies.

The Subcommittee hearing will review the life insurance company provisions of present law, which were substantially modified by the Deficit Reduction Act of 1984 ("1984 Act"). The hearing will consider the revenue impact of the 1984 Act changes and the different treatment accorded stock life insurance companies and mutual life insurance companies under the 1984 Act. In addition, the hearing will consider the data, analysis, and recommendations contained in the *Final Report to the Congress on Life Insurance Company Taxation*, which was issued by the Treasury Department on August 11, 1989 (the "final Treasury report").

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in connection with the Subcommittee hearing, provides background information on stock and mutual life insurance companies, an overview of the Federal income tax treatment of life insurance companies under present law, and a summary of the revenue effect of the 1984 Act and the analysis of present law contained in the final Treasury report. In addition, this pamphlet discusses criticisms of the different treatment accorded stock and mutual life insurance companies under present law (sec. 809 of the Internal Revenue Code) and provides a description of, and the principal arguments for and against, various proposals that would modify the Federal income tax treatment of life insurance companies.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Taxation of Life Insurance Companies* (JCS-17-89), October 16, 1989.

I. SUMMARY

Background and present law

Stock life insurance companies and mutual life insurance companies are the two principal forms of business organizations that are engaged in the sale of life insurance contracts, annuity contracts, and noncancellable accident and health insurance contracts in the United States. A stock life insurance company is a corporation under State law that is owned by shareholders who are distinct from the policyholders of the company. A mutual life insurance company, on the other hand, is an organization recognized under State law that is owned by the policyholders of the company.

The Deficit Reduction Act of 1984 ("1984 Act") substantially revised the Federal income tax treatment of life insurance companies. One of the more significant and controversial changes contained in the 1984 Act was a provision that imputes income to each mutual life insurance company based on the amount of equity of the company (sec. 809 of the Internal Revenue Code).[2]

The rationale for the enactment of section 809 was based, in part, on the belief that a portion of the policyholder dividends of a mutual life insurance company is a distribution of the earnings of the mutual company to policyholders as owners of the company. Because the amount of earnings of a corporation distributed to its owners (*i.e.*, stockholder dividends) generally is not deductible by the corporation for Federal income tax purposes, Congress determined that the portion of the policyholder dividends of a mutual life insurance company that is a distribution of company earnings to policyholders as owners should not be deductible by the mutual life insurance company.

An additional basis for the enactment of section 809 was the difference in the Federal income tax treatment of mutual company policyholders and stock company shareholders. Under prior and present law, earnings that are distributed by a stock life insurance company to a shareholder generally are includible in the gross income of the shareholder. In contrast, earnings that are distributed by a mutual life insurance company to a policyholder generally are not includible in the gross income of the policyholder.

Finally, section 809 was designed to provide that mutual life insurance companies would pay 55 percent of the total Federal income taxes paid by the life insurance industry for 1984, and at the time of enactment of the 1984 Act, receipts from mutual life insurance companies were estimated by the Treasury Department

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[2] Section 809 imputes income to mutual life insurance companies by reducing the amount of the deduction for policyholder dividends by a differential earnings amount. If the differential earnings amount for any mutual life insurance company exceeds the amount of the policyholder dividends of the company for any taxable year, the excess reduces the closing balance of the life insurance reserves of the company.

to be 55 percent of the total industry receipts for the period 1984–1986.

The total amount of Federal income tax paid by the entire life insurance industry and the relative amount of Federal income tax paid by the stock and mutual segments of the industry were two of the more significant concerns of Congress in 1984 during the process of restructuring the Federal income tax treatment of life insurance companies. Congress determined that these two items should be closely monitored, and, as a result, the 1984 Act required the Treasury Department to provide a series of reports to Congress on the amount of Federal income tax paid by life insurance companies.

On June 15, 1988, the Treasury Department submitted to Congress an interim report that contains data on the amount of Federal income tax paid by the entire life insurance industry and by the stock and mutual segments of the industry for 1984 and 1985.[3] On August 11, 1989, the Treasury Department submitted to Congress a final report that contains data on the amount of Federal income tax paid by the entire life insurance industry and by the stock and mutual segments of the industry for 1984, 1985, and 1986.[4] In addition, the final Treasury report contains an analysis of the different tax treatment accorded stock life insurance companies and mutual life insurance companies under present law and provides various options for improving the taxation of life insurance companies.

Revenue effect of 1984 Act and analysis of present law contained in the final Treasury report

Revenue effect of 1984 Act

The final Treasury report indicates that the amount of Federal income tax paid by the entire life insurance industry for 1984, 1985, and 1986 was substantially less than the amount that was estimated to be paid at the time that the 1984 Act was enacted. The final Treasury report indicates that a total of $9.5 billion of Federal income tax was estimated to be paid by the life insurance industry for 1984, 1985, and 1986. In actuality, a total of $7.2 billion of Federal income tax was paid by the life insurance industry for the 3-year period.[5] The final Treasury report notes that the total amount of tax paid by the life insurance industry would have been significantly less but for the large amount of capital gains recognized by the life insurance industry in 1986 in anticipation of the increased rate of tax imposed on capital gains beginning in 1987.

The final Treasury report also indicates that the distribution of the Federal income tax burden between stock and mutual life insurance companies differed from the distribution that was estimat-

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[3] Department of the Treasury, *Interim Report to the Congress on Life Insurance Company Taxation*, June 1988.

[4] Department of the Treasury, *Final Report to the Congress on Life Insurance Company Taxation*, August 1989.

[5] The $7.2 billion is the amount of Federal income tax paid after taking into account the "true-up" for mutual life insurance companies. As more fully described in Part II of this pamphlet, the amount of income imputed under section 809 is recomputed in later years to take into account information that is from the year with respect to which the income tax return is filed but that is not known at the time that the return is filed. The results of this recomputation (or "true-up") are considered more properly reflected as an adjustment to the income tax paid for the year with respect to which the return was originally filed.

ed at the time that the 1984 Act was enacted. Of the $7.2 billion of Federal income tax paid by the life insurance industry for 1984, 1985, and 1986, mutual life insurance companies paid $2.8 billion (39 percent of the total tax paid by the industry) and stock life insurance companies paid $4.4 billion (61 percent of the total tax paid by the industry).[6]

In addition, the final Treasury report notes that the amount of Federal income tax paid by mutual life insurance companies for 1986 may have been $300 million greater than original Treasury data indicated due to new data provided by the mutual life insurance companies shortly before publication of the final Treasury report. If this additional $300 million of tax is taken into account, the amount of Federal income tax paid by mutual life insurance companies for 1984, 1985, and 1986 would equal $3.1 billion, which is 41 percent of the total Federal income tax paid by the industry for the 3-year period.

The final Treasury report indicates that it was estimated that mutual life insurance companies would pay $5.2 billion of Federal income tax for 1984, 1985, and 1986 (55 percent of the total estimated tax of the industry) and stock life insurance companies would pay $4.3 billion for the same 3-year period (45 percent of the total estimated tax of the industry).

The final Treasury report contains several possible reasons for the shortfall in the amount of Federal income tax that was paid by the entire life insurance industry and by the mutual segment of the industry for the 3-year period. The shortfall is generally attributed to difficulties in accurately estimating future income tax payments at the time that the 1984 Act was enacted.

Analysis of present law

The final Treasury report also contains various conclusions concerning the present-law treatment of stock life insurance companies and mutual life insurance companies. The report indicates that section 809 contains numerous and significant practical shortcomings as well as being subject to criticism on theoretical grounds. In addition, the report states that the focus of Congress in attempting to determine the proper Federal income tax treatment of life insurance companies should include the following goals: (1) equal tax treatment of returns to participating policyholders of both stock and mutual life insurance companies; (2) treatment of stock company shareholders' equity commensurate with the current individual tax treatment of participating policyholders; and (3) more consistent tax treatment of income flowing through life insurance companies and income flowing through other financial institutions.

Criticisms of the different treatment accorded stock and mutual life insurance companies under present law

Both stock life insurance companies and mutual life insurance companies have criticized the different treatment accorded stock and mutual life insurance companies under present law. Some crit-

[6] The amount of tax paid by mutual life insurance companies is determined after application of the "true-up." *See* footnote 5, *supra*.

ics have asserted that the mutual life insurance companies have not paid, and will continue not to pay, their proper share of the total Federal income tax paid by the life insurance industry. It is further maintained that present law provides mutual life insurance companies with a competitive advantage over stock life insurance companies.

On the other hand, other critics believe that present law provides stock life insurance companies with a competitive advantage because under the prepayment analysis, the earnings of mutual life insurance companies are subject to a corporate-level tax, and, consequently, present law improperly imputes income to mutual life insurance companies. In addition, it is contended that it is inappropriate to focus on the total amount of Federal income tax that is paid by each segment of the life insurance industry. It is also argued that the Federal income tax should attempt to accurately measure the economic income of each life insurance company whether stock or mutual. Further, some assert that the reason that the amount of Federal income tax paid by the mutual segment of the industry was less than estimated was due to errors in the estimation process and also the lower profitability of the mutual companies compared to the stock companies.

In addition, some critics believe that the treatment of mutual life insurance companies under section 809 is conceptually flawed if the justification for such treatment is that (1) a portion of the policyholder dividends of a mutual life insurance company is a distribution of earnings to policyholders as owners of the company and (2) mutual life insurance companies should not be entitled to a deduction for the distribution of earnings to owners.

Proponents of the prepayment analysis [7] argue that imputing an equity return to mutual life insurance companies or limiting the deductibility of policyholder dividends of mutual life insurance companies is unwarranted because a portion of the premiums received by a mutual life insurance company is a contribution to the capital of the company. Because all premiums are includible in the gross income of a mutual life insurance company, the prepayment analysis provides that a mutual life insurance company has effectively prepaid income tax on its earnings which justifies a full deduction to the mutual life insurance company when the earnings are paid to policyholders as policyholder dividends.

Others disagree with the conclusions reached through the application of the prepayment analysis on the grounds that the assumptions underlying the prepayment analysis do not reflect the actual operation of mutual life insurance companies or the historical Federal income tax treatment of mutual life insurance companies. For example, the prepayment analysis assumes that a portion of the premiums received by a mutual life insurance company is a contribution to the capital of the mutual company. Some believe, however, that the premiums of mutual companies historically have not, and currently do not, contain a capital contribution.

[7] *See* Graetz, "Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential," in M. Graetz (ed.), *Life Insurance Company Taxation: The Mutual vs. Stock Differential* (1986).

The prepayment analysis also assumes that all the premiums received (including the amount that is a capital contribution) have been subject to Federal income tax at the time of receipt by the mutual life insurance company. It is contended by some that the premiums of mutual life insurance companies have historically not been subject to tax as received.

Further, the operation of section 809 has also been criticized. Some contend that section 809 is subject to manipulation by mutual life insurance companies. For example, It is asserted that a mutual life insurance company is able to reduce the amount of its equity in order to decrease the amount of Federal income tax payable for any year.

In addition, section 809 is criticized by some for its so-called "socialization" effect, that is, that the amount of Federal income tax paid for any year by any mutual life insurance company is dependent on the earnings of the 50 largest stock life insurance companies as well as the earnings of all other mutual life insurance companies. Furthermore, some contend that section 809 acts as a disincentive to maintain adequate surplus for the protection of policyholders.

Finally, some would say that section 809 is excessively complex thereby resulting in significant compliance costs to taxpayers and significant administrative costs to the Internal Revenue Service.

Proposals to modify the Federal income tax treatment of life insurance companies

A number of proposals have been developed to modify the Federal income tax treatment of life insurance companies. Many of these proposals would repeal section 809 and enact in its place an alternative income imputation mechanism or an additional tax that would apply to mutual life insurance companies, to both mutual and stock life insurance companies, or to all insurance companies. Other proposals would repeal section 809 and deny a deduction for a percentage of the policyholder dividends of mutual life insurance companies. Finally, certain proposals would modify section 809.

The final Treasury report recommends the repeal of section 809 and the enactment of a tax that would be imposed on the net investment income of both stock and mutual life insurance companies. Under the Treasury proposal, stock life insurance companies would be allowed a 15-percent credit against the investment income tax for dividends paid to shareholders.

II. BACKGROUND AND PRESENT-LAW RULES RELATING TO THE TAXATION OF LIFE INSURANCE COMPANIES

A. Background

Stock life insurance companies and mutual life insurance companies are the two principal forms of business organizations that are engaged in the sale of life insurance contracts, annuity contracts, and noncancellable accident and health insurance contracts in the United States. A stock life insurance company is a corporation under State law that is owned by shareholders who are distinct from the policyholders of the company. A mutual life insurance company, on the other hand, is an organization recognized under State law that is owned by the policyholders of the company.

The Deficit Reduction Act of 1984 ("1984 Act") restructured the Federal income tax treatment of life insurance companies by replacing a three-phase tax structure with a single-phase structure. The single-phase tax structure was based on a stock life insurance company model in order to provide a relatively simple tax structure that bore a close resemblance to the general tax treatment of corporations. In addition, the choice of the stock company model reflected the view that all life insurance companies should be subject to tax as separate entities at corporate rates.

The 1984 Act also contained a provision that imputes income to each mutual life insurance company based on the amount of equity of the company (sec. 809 of the Internal Revenue Code).[8] The rationale for the enactment of section 809 was based, in part, on the belief that a portion of the policyholder dividends of a mutual life insurance company is a distribution of the earnings of the mutual company to policyholders as owners of the company. Because the amount of earnings of a corporation distributed to its owners (*i.e.*, stockholder dividends) generally is not deductible by the corporation for Federal income tax purposes, Congress determined that the portion of the policyholder dividends of a mutual life insurance company that is a distribution of company earnings to policyholders as owners should not be deductible by the mutual life insurance company.

In addition, section 809 was justified, in part, by the more favorable Federal income tax treatment accorded the policyholders of a mutual life insurance company with respect to ownership distributions made by the mutual company as compared to the treatment accorded shareholders of a stock life insurance company with respect to ownership distributions made by the stock company.

[8] Section 809 imputes income to mutual life insurance companies by reducing the amount of the deduction for policyholder dividends by a differential earnings amount. If the differential earnings amount for any mutual life insurance company exceeds the amount of the policyholder dividends of the company for any taxable year, the excess reduces the closing balance of the life insurance reserves of the company.

Under present law, earnings that are distributed by a stock life insurance company to its shareholders generally are includible in the gross income of the shareholder. In contrast, earnings that are distributed by a mutual life insurance company to policyholders as owners of the company generally are not includible in the gross income of the policyholders.

Finally, section 809 was designed to provide that mutual life insurance companies would pay 55 percent of the total Federal income taxes paid by the life insurance industry for 1984, and at the time of enactment of the 1984 Act, receipts from mutual life insurance companies were estimated by the Treasury Department to be 55 percent of the total industry receipts for the period 1984–1986.

B. Present Law

Definition of a life insurance company

Under present law, a life insurance company is defined as an insurance company that is engaged in the business of issuing life insurance contracts, annuity contracts, or noncancellable accident and health insurance contracts if more than 50 percent of the total reserves of the company are (1) life insurance reserves and (2) unearned premiums and unpaid losses on noncancellable life, accident, or health contracts that are not included in life insurance reserves. For purposes of this definition, a company qualifies as an insurance company only if more than 50 percent of the business activity of the company during the year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

The determination of whether more than 50 percent of the business activity of a company is the issuing of insurance or annuity contracts is dependent on the facts and circumstances. Factors to be considered include the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities. The character of the business actually carried on during the taxable year determines whether a company is taxed as an insurance company.[9]

Life insurance company taxable income

A life insurance company is taxed at corporate rates on its life insurance company taxable income. Life insurance company taxable income is life insurance gross income reduced by life insurance deductions. A stock life insurance company is also taxed, at corporate rates, on any distributions from a pre-1984 policyholders' surplus account.

Life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income. For this purpose, premiums consist of the gross amount of premiums and other consideration received on insurance and annuity contracts reduced by return premiums paid to policyholders, such as on the cancellation of a

[9] *See, e.g., Service Life Insurance Co. v. United States*, 189 F. Supp. 288, *aff'd. on other grounds*, 293 F.2d 78 (9th Cir. 1961).

policy, and premiums and other consideration paid to another insurer on indemnity reinsurance.

General deductions

Life insurance companies are allowed deductions for (1) claims and benefits accrued and losses incurred (whether or not ascertained) during the taxable year on insurance and annuity contracts, (2) net increases in reserves, (3) policyholder dividends, (4) dividends received by the company (limited to the company's share), (5) operation losses, (6) consideration paid for assumption reinsurance, and (7) policyholder dividend reimbursements paid to another insurance company under a reinsurance agreement. In addition, life insurance companies are allowed other deductions generally allowable to corporate taxpayers in computing taxable income, subject to certain modifications.

Small life insurance company deduction

Small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. The amount of the deduction is 60 percent of so much of tentative life insurance company taxable income for a taxable year as does not exceed $3 million, reduced by 15 percent of the excess of tentative life insurance company taxable income over $3 million. The small life insurance company deduction is only available to life insurance companies with gross assets of less than $500 million.

Deductions with respect to reserves

In general

Life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. In general, the net increase or net decrease in reserves is computed by comparing the closing balance of the reserves with the opening balance of the reserves. The closing balance of the reserves for any year generally is the opening balance for the following year.

In computing the net increase or net decrease in reserves, the following six items are taken into account: (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group-term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both.

For purposes of determining life insurance company taxable income, the life insurance reserve for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. In no event may the amount of the tax reserves for any contract at any time exceed the amount of the statutory reserves, which include any deficiency reserves relating to the liabilities. The net surrender value is the cash surrender value reduced by any surrender penalty, except that any market value adjustment required on surrender is not taken into account.

In computing the Federally prescribed reserve for any contract, the tax reserve method applicable to that contract must be used, along with the prescribed interest rate and the prevailing commissioners' standard tables for mortality or morbidity. Thus, in computing the Federally prescribed reserve, a company begins with its statutory or annual statement reserve, and modifies that reserve to take into account the prescribed method, the prescribed interest rate, the prevailing mortality or morbidity table, as well as the elimination of any reserve for net deferred and uncollected premiums and the elimination of any reserve in respect of "excess interest" guaranteed beyond the end of the taxable year. Except for the Federally prescribed items, the methods and assumptions employed in computing the Federally prescribed reserve are to be consistent with those employed in computing a company's statutory reserve.

Tax reserve method

In general, the Federally prescribed reserve method for any contract is the method recommended by the National Association of Insurance Commissioners (NAIC) for that type of contract. There is no requirement that the method also be consistent with the prevailing view of the States. Thus, as a general rule, in computing any life insurance reserve, a company is required to take into account any factors specifically recommended by the NAIC. If specific factors are not recommended by the NAIC, the prevailing State interpretation of such method is considered for purposes of determining what factors are to be taken into account in applying the computation method for tax purposes.

Interest rates

The interest rate to be used in determining the amount of the life insurance reserves for any contract is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate for the calendar year in which the contract is issued. The applicable Federal interest rate is the rate determined under the discounting rules for property and casualty reserves for the calendar year in which the contract is issued. The prevailing State assumed interest rate for any contract is to be determined as of the beginning of the calendar year in which the contract is issued and is to equal the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type.

In the case of reserves for contracts that do not involve life, accident, or health contingencies, the interest rate to be applied is the greatest of (1) the applicable Federal interest rate, (2) the prevailing State assumed interest rate, or (3) the rate assumed by the company in determining the guaranteed benefit.

Mortality tables

The prevailing commissioners' standard tables for mortality or morbidity to be used for computing the Federally prescribed reserves are, with respect to any contract, the most recent tables prescribed by the NAIC and permitted to be used for that type of contract in computing reserves under the laws of at least 26 States when the contract is issued. If a table becomes a prevailing commissioners' standard table during a calendar year, then the new table may be used as the prevailing table from the beginning of the calendar year. Generally, when mortality and morbidity tables are being updated and adopted by the States, companies will have 3 full years after a particular set of tables becomes the prevailing view of the States before such table becomes mandatory for computing reserves for tax purposes.

Deduction for policyholder dividends

Under present law, a deduction is allowed for dividends or similar distributions to policyholders. The amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year.

In general, policyholder dividends are dividends and similar distributions to policyholders, but not return premiums. The term "policyholder dividends" generally refers to amounts returned to policyholders that are not fixed in the contract, but depend on the experience of the company or the discretion of management.

The term policyholder dividends includes any distribution to a policyholder that is the economic equivalent of a dividend. In addition to any amount paid or credited to policyholders (including an increase in benefits) that is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds.

The term "excess interest" means any amount in the nature of interest that is paid or credited to a policyholder and determined at a rate in excess of the prevailing State assumed interest rate for the contract. Amounts in the nature of interest include all amounts paid for the use of money regardless of the particular designation adopted by the payor or payee. Thus, amounts in the nature of interest include interest payments with respect to amounts left on deposit and amounts paid in lieu of interest, such as in the case of origination or service fees. Similarly, amounts in the nature of interest include amounts calculated as interest (*e.g.*, the increase in reserves or cash surrender values attributable to assumed or guaranteed interest rates rather than premium contributions). Thus, for example, any increase in the cash surrender value of a contract above that which would result if the prevailing State assumed interest rate were used to compute the increase is treated as excess interest.

The term "premium adjustment" means any reduction in the premium under an insurance or annuity contract which, but for such reduction, would have been required to be paid under the contract. If no premium amount is fixed in the contract, variations in premiums paid during the course of the contract are not considered premium adjustments. Further, a change in the amount of a premium that is attributable to the insurability of the insured is not considered a premium adjustment.

Finally, the term "experience-rated refund" means any refund or credit based on the experience of the contract or group involved. Thus, for example, if a company sells a group policy to an employer covering the lives of its employees and the premiums received exceed the sum of the claims paid and other expenses, any refund of such excess is an experience-rated refund. Any policyholder dividend that increases any of the benefits payable under the contract (including the cash surrender value), or reduces the premium otherwise required, is treated as paid to the policyholder and returned by the policyholder to the company as a premium.

Special treatment of mutual life insurance companies

In general

Although the general rules and definitions relating to the determination of life insurance company taxable income apply to stock and mutual life insurance companies alike, for mutual companies, the amount of the deduction for policyholder dividends is reduced under section 809 of the Internal Revenue Code by a "differential earnings amount." If the differential earnings amount exceeds the allowable deduction for policyholder dividends, then the excess reduces the closing balance of the company's reserves.

The rationale for the enactment of section 809 was based, in part, on the belief that a portion of the policyholder dividends of a mutual life insurance company is a distribution of the earnings of the mutual company to policyholders as owners of the company. Because the amount of earnings of a corporation distributed to its owners (*i.e.*, stockholder dividends) generally is not deductible by the corporation for Federal income tax purposes, Congress determined that the portion of the policyholder dividends of a mutual life insurance company that is a distribution of company earnings to policyholders as owners should not be deductible by the mutual life insurance company.

The portion of the policyholder dividends of a mutual life insurance company that is considered a distribution of company earnings to policyholders as owners is based on the amount of the equity of the company because Congress believed that profit-oriented enterprises tend to distribute earnings to their owners in amounts that are proportional to the equity in the business. Congress also believed that the appropriate percentage of the equity that is considered a distribution of company earnings should be determined by comparing the post-dividend rates of return on equity for both stock and mutual companies. Historically, the average post-dividend, pre-tax return on equity of mutual companies was less than the average post-dividend, pre-tax return on equity for a comparable group of stock companies. Congress concluded that this difference was attributable to the distribution of mutual companies' earnings to their owners through policyholder dividends.

This approach to identifying the ownership distributions of a mutual life insurance company is implemented by reducing the deduction for policyholder dividends of a mutual life insurance company by a "differential earnings amount." The differential earnings amount is computed by multiplying the average equity base of a mutual life insurance company for a taxable year by the "differential earnings rate" in effect for such year. The differential earnings rate is the excess of the "imputed earnings rate" for a taxable year over the "average mutual earnings rate" for the second calendar year preceding the calendar year in which the taxable year begins.

Imputed earnings rate

For taxable years beginning in 1984, the imputed earnings rate was 16.5 percent. For taxable years beginning after 1984, the imputed earnings rate equals the amount that bears the same ratio to 16.5 percent as the current stock earnings rate (*i.e.*, the numerical average of the rates of return for the 50 largest stock companies for the 3 years preceding the current taxable year) bears to the base period stock earnings rate (*i.e.*, the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983).

Congress anticipated that the 16.5-percent rate would result in the mutual segment of the life insurance industry bearing 55 percent of the aggregate industry tax burden for 1984. The legislative history of the 1984 Act indicates that Congress believed that this percentage allocation was appropriate based on a number of factors including the historic allocation of the industry's tax burden, the relative percentage of assets held by the stock and mutual segments of the industry, and the difference in the Federal income tax treatment of mutual company policyholders and stock company shareholders.[10]

Because Congress determined that the 16.5-percent rate resulted in an appropriate allocation of the industry's tax burden for 1984 given these various factors, this rate is adjusted in proportion to changes in the rate of return for large stock companies. Specifically, the imputed earnings rate is indexed to reflect changes in the relationship between (1) the current stock earnings rate and (2) the average of the stock earnings rates for a base period of calendar years 1981, 1982, and 1983.

Stock earnings rate

The stock earnings rate for any particular year is the numerical average of the earnings rates of the 50 largest stock life insurance companies. The numerical average of stock earnings rates is used in order to reduce the potential impact on the rate by a few large stock companies. The 3-year period used in determining the current stock earnings rate is designed to reduce the possibility of a significant increase or decrease in the rate of return for the stock segment of the industry, thereby providing mutual companies with some ability to predict tax costs for purposes of pricing their products.

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[10] Earnings that are distributed by a stock life insurance company to a shareholder generally are includible in the gross income of the shareholder. In contrast, earnings that are distributed by a mutual life insurance company to a policyholder generally are not includible in the gross income of the policyholder.

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Average mutual earnings rate

The average mutual earnings rate for any year is the weighted average of the rates of return for all mutual companies. The General Explanation to the 1984 Act states that the use of a weighted average reflects the treatment of the entire mutual segment of the life insurance industry as a taxpaying "entity" required to bear a specified percentage of the industry tax burden; and that the use of a weighted average mutual earnings rate to determine the differential earnings rate ensures that the regular tax (computed without the ownership differential provision and assuming no tax preference items), plus any increase in tax owed due to the application of the ownership differential provision, will meet the prescribed aggregate mutual company tax burden.

Computation of earnings rates

The earnings rate for any life insurance company is to be determined by the Secretary of the Treasury by reference to the statement gain or loss from operations of the company as a percentage of the average equity base of the company.

The statement gain or loss from operations is the net gain or loss from operations set forth in the annual statement, determined without regard to Federal income taxes and with further adjustments for certain tax items. First, the statement gain or loss from operations must be adjusted by substituting the amount of the deduction for policyholder dividends (unreduced by the differential earnings amount) for the amount shown on the annual statement for policyholder dividends. In addition, the statement gain or loss from operations is determined on the basis of tax reserves rather than statutory reserves.

In calculating the stock earnings rate or the average mutual earnings rate, the Secretary is to take into account companies that may be operating at a loss and, in effect, have a negative rate of return, as well as companies that are operating on a profitable basis. However, in order to eliminate distortions in the computation of the average earnings rate of the 50 largest stock companies, the Secretary has the authority to omit certain companies that, because of a small equity base (for example, because the company is close to being, or is, insolvent), would seriously distort the stock earnings rate.

Average equity base

The average equity base of a stock or mutual life insurance company is the average of (1) the equity base determined as of the close of the taxable year, and (2) the equity base determined as of the close of the preceding taxable year. The equity base equals the statutory surplus and capital of the company plus any nonadmitted financial assets, the excess of statutory reserves over tax reserves, the amount of any mandatory securities valuation reserve, the amount of any deficiency reserve or voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

The term "nonadmitted financial asset" does not include due and accrued investment income reported as a nonadmitted asset, investments in office furnishings or fixtures, or agents' balances owed to the company. Thus, for example, an amount of due and accrued interest on defaulted bonds is not a nonadmitted financial asset even though the underlying defaulted bond may be a nonadmitted financial asset. In determining the excess of statutory reserves over tax reserves, the amount of statutory reserves should not include any amount attributable to deferred and uncollected premiums that have not yet been included in life insurance gross income.

Policyholder dividends payable in the following taxable year refers generally to the total amount set aside on the annual statement for apportioned and unapportioned dividends. Only 50 percent of this amount is added to the average equity base because it was believed that, on average, only 50 percent of the total annual statement provision for policyholder dividends to be paid in the following year (whether accrued or unaccrued for tax purposes at the end of the taxable year) is fairly allocable as a liability for the current year. Although a policyholder dividend may be paid at the end of a policy year, and not accrue for tax purposes until payment, recognition of part of that dividend as a current liability to determine the equity of the company recognizes that a dividend, in theory, accrues to the policyholder in a financial sense over the entire policy year.

Amounts included in equity generally refer to, and are valued as, amounts shown on the annual statement of the company. However, a classification or characterization of an item on a company's annual statement in an attempt to avoid these requirements is disregarded.

Differential earnings rate

The differential earnings rate for any taxable year is the excess of (1) the imputed earnings rate for the taxable year over (2) the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins. The use of the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins is considered necessary because the Secretary will not have the required data to determine the average mutual earnings rate prior to the date that mutual companies are required to file Federal income tax returns. However, when actual data becomes available, any difference between the differential earnings amount for the second preceding taxable year is to be taken into account as an addition to, or deduction from, income for the taxable year during which the Secretary determines the average mutual earnings rate for the prior taxable year (an adjustment known as the true-up).

Because any additions to, or deduction from, income will be taken into account in the first year during which the actual differential earnings rate is recomputed, no interest payments are required. If a company ceases to be a mutual insurance company during any year, then any adjustment will have to be taken into account for the taxable year giving rise to the adjustment.

In order to simplify the administration of the ownership differential provision during the first two years that the provision was in effect, the 1984 Act provided a fixed differential earnings rate of 7.8 percent to be used for purposes of filing returns for taxable years beginning in 1984 and for purposes of determining estimated taxes for taxable years beginning in 1985.

Table 1 contains the various rates necessary to determine the deduction for policyholder dividends of mutual life insurance companies for all years prior to 1989.

Table 1.—Data for Calculation of Section 809 Differential Earnings Rate

[Percent]

Year	Stock earnings rate [1]	Current stock earnings rate [2]	Imputed earnings rate [3]	Average mutual earnings rate	Differential earnings rate [4]	Recomputed differential earnings rate [5]	"True-up" rate on subsequent year returns
1988	NA	16.067	14.549	NA	[6] 0	NA	NA
1987	9.239	18.564	16.811	8.735	3.676	8.076	4.401
1986	20.279	17.983	16.285	17.980	10.539	[6] 0	[6] −10.539
1985	18.683	18.026	16.323	13.135	6.157	3.188	−2.696
1984	16.731		[7] 16.5	5.746	[7] 7.8	10.754	2.954
1983	18.535			10.166			
1982	18.812						
1981	17.316						

[1] Unweighted earnings rate of the top 50 stock life companies in the current year.
[2] Preceding three-year average of the stock earnings rate.
[3] Equal to 0.9055 of the current stock earnings rate (CSER), since the imputed earnings rate is .165 times the ratio of the CSER divided by the base period stock earnings rate (18.221).
[4] Equal to the imputed earnings rate minus the average mutual earnings rate from two years earlier.
[5] Equal to the imputed earnings rate minus the average mutual earnings rate from the same year.
[6] In Notice 88-106, 1988-2 C.B.444, the IRS stated that Treasury regulations will provide that the differential earnings rate and the recomputed differential earnings rate may not be negative.
[7] Set by statute.

Source: Rev. Rul. 89-106, 1989-37 I.R.B. 14. Department of the Treasury, Office of Tax Analysis, June 1988.

Treatment of stock life insurance subsidiaries

Certain modifications to the equity base of a mutual life insurance company are required if a mutual life insurance company owns one or more subsidiaries that are life insurance companies. Such subsidiaries are generally treated as stock life insurance companies in computing such subsidiaries' entity level income tax liability. However, for purposes of computing the differential earnings amount, a mutual parent of a subsidiary life insurance company is required to include the equity of such company in its own equity base (in lieu of the value of the stock of the subsidiary).

For purposes of determining the statement gain or loss from operations of the mutual parent, the mutual parent does not take into account any dividends it receives from the subsidiary. Also, for purposes of computing the average mutual earnings rate and the imputed earnings rate, life insurance subsidiaries of a mutual life insurance company are treated as mutual companies. If a subsidiary life insurance company is owned by more than one mutual entity and is not a member of an affiliated group, the Secretary is to provide adjustments that are to be made in the equity bases of mutual life insurance companies owning stock therein to carry out the general rules described above.

This treatment is in contrast to the treatment of nonlife insurance subsidiaries, the stock of which is included in the parent mutual company's equity and the earnings of which are only taken into account in computing the average mutual earnings rate when and as dividends are received by the parent mutual company.

Studies required by the 1984 Act

The total amount of Federal income tax paid by the entire life insurance industry and the relative Federal income tax paid by the stock and mutual segments of the industry were two of the more significant concerns of Congress in 1984 during the process of restructuring the Federal income tax treatment of life insurance companies. Congress determined that these two items should be closely monitored, and, as a result, the 1984 Act required the Treasury Department to provide a series of reports to Congress on the amount of Federal income tax paid by life insurance companies.

Beginning in 1985, the Secretary of the Treasury was required to submit an annual report to the House Committee on Ways and Means and the Senate Committee on Finance on the revenues received under the life insurance provisions for the most recent taxable year. Each report was to present the aggregate amount of revenue received for the most recent taxable year for which data were available. The revenue received was to be compared with the revenue anticipated as a result of the changes made by Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984. In addition, the report was to provide the reasons for any difference between the actual revenue received and the revenue anticipated when the Acts were adopted. An analysis of revenue collected from life insurance companies was included in the interim report submitted by the Treasury Department to Congress on June 15, 1988.[11]

The Secretary of the Treasury, in consultation with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation, was also instructed to conduct a study of the effects of the provisions of the 1984 Act on the different segments and products of the life insurance industry during 1984, 1985, and 1986.

This study was to include an analysis of the relative shares of life insurance company taxes paid by mutual life insurance companies and stock life insurance companies. The study also was to consider any other data considered to be relevant by either stock or mutual life insurance companies in determining appropriate segment balance. Among the relevant variables for consideration were the amounts of the following items for each segment of the industry: equity, life insurance reserves, other types of reserves, dividends paid to policyholders and shareholders, pension business, total assets, and gross receipts. The study was to include an analysis of to what extent taxes paid by stockholders of life insurance companies affect proper evaluation of segment balance. Finally, the study was to include an analysis of life insurance products and their taxation and an analysis of whether the tax provisions in Part I of Subchapter L of the Code operate as a disincentive to growing companies.

The final Treasury report on the study was submitted to Congress on August 11, 1989.[12]

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[11] Department of the Treasury, *Interim Report to the Congress on Life Insurance Company Taxation*, June 1988.

[12] Department of Treasury, *Final Report to the Congress on Life Insurance Company Taxation*, August 1989.

III. FINAL TREASURY REPORT: SUMMARY OF REVENUE EFFECT OF 1984 ACT AND ANALYSIS OF PRESENT LAW

A. Federal Income Tax Paid by Mutual and Stock Life Insurance Companies for 1984, 1985, and 1986

The Deficit Reduction Act of 1984 required the Treasury Department to submit reports to Congress on the total amount of Federal income tax paid by the entire life insurance industry and the relative amount of Federal income tax paid by the mutual and stock segments of the industry. In order to comply with this requirement, the Treasury Department conducted a special survey of life insurance companies during 1987. A report issued by the Treasury Department in 1988, *Interim Report to the Congress on Life Insurance Company Taxation* (the "interim Treasury report"), utilized data gathered from this survey to compute the total amount of Federal income tax paid by the entire life insurance industry and the amount of Federal income tax paid by the mutual and stock segments of the industry for 1984 and 1985.

On August 11, 1989, the Treasury Department issued a final report, *Final Report to the Congress on Life Insurance Company Taxation* (the "final Treasury report"), on the taxation of life insurance companies. The final Treasury report extends the revenue analysis of the interim report through 1986 by including data from a sample of tax returns filed by life insurance companies for 1986.

Total Federal income tax paid by the life insurance industry for 1984, 1985, and 1986

The final Treasury report confirms the findings of the interim Treasury report that the total amount of Federal income tax paid by the entire life insurance industry under the 1984 Act was less than the amount that was anticipated to be paid at the time that the 1984 Act was enacted. The Treasury Department data on the amount of Federal income tax paid by the life insurance industry are summarized in Table 2.

The table indicates that while the Treasury Department estimate of the total Federal income tax to be paid by the life insurance industry for 1984, 1985, and 1986 was $9.5 billion, the actual Federal income tax paid by the life insurance industry for the 3-year period was $7.2 billion (including tax liabilities attributable to the mutual sector's true-up). In addition, the final Treasury report notes that this $2.3 billion shortfall would have been substantially greater but for unexpectedly large capital gains recognized by life insurance companies in 1986 in anticipation of the increased rate of tax imposed on capital gains beginning in 1987.[13]

[13] The amount of capital gains recognized by life insurance companies in 1986 totaled $7.3 billion as compared to $3.7 billion for the entire six-year period from 1980 through 1985. *See* final Treasury report, Table 3.3, p. 16.

Table 2.—Federal Income Tax Paid By Mutual and Stock Life Insurance Companies, 1984–86

	1984	1985	1986	Total
A. Dollar amounts (billions)				
All life insurance companies:				
1984 estimate	3.0	3.1	3.4	9.5
Actual payments	2.4	2.9	3.3	8.5
Actual payments with "true-up"	2.7	2.2	2.3	7.2
Mutual life insurance companies:				
1984 estimate	1.6	1.7	1.9	5.2
Actual payments	1.0	1.3	[1] 1.9	4.1
Actual payments with "true-up"	1.3	0.6	[1] 0.9	2.8
Stock life insurance companies:				
1984 estimate	1.4	1.4	1.5	4.3
Actual payments	1.4	1.6	1.4	4.4
B. Percentages of industry total				
Mutual life insurance companies:				
1984 estimate	53	55	56	55
Actual payments	42	45	58	48
Actual payments with "true-up"	48	27	39	39
Stock life insurance companies:				
1984 estimate	47	45	44	45
Actual payments	58	55	42	52
Actual payments with "true-up"	52	73	61	61

[1] The final Treasury report notes that Federal income tax paid by mutual life insurance companies for 1986 may be $300 million larger based on data provided by representatives of the mutual life insurance companies to the Treasury Department shortly before publication of the final Treasury report.

Source: Final Treasury report, Table 3.1, p. 13.

As described in Part II above, the Federal income tax paid by a mutual life insurance company is adjusted in later years to reflect a recomputation or "true-up" of the amount of income that is imputed to mutual life insurance companies under section 809 of the Internal Revenue Code. Table 2 indicates that the amount of Federal income tax paid by the entire life insurance industry for 1984, 1985, and 1986 was $8.5 billion if the true-up is disregarded. This amount exceeds the $7.2 billion of Federal income tax paid by the entire life insurance industry after taking into account the true-up because approximately $1.4 billion less tax was paid by mutual life insurance companies in 1987 due to the true-up adjustment attributable to returns filed for 1986.

Relative amount of Federal income tax paid by the mutual and stock segments of the life insurance industry, 1984-1986

The final Treasury report also indicates that the distribution of the Federal income tax burden between the mutual and stock segments of the life insurance industry differed from the distribution that was assumed in the revenue estimates that were made at the time that the 1984 Act was enacted. Table 2 illustrates the percentage of the total life insurance industry tax burden that was paid by the mutual and the stock segments of the industry for 1984, 1985, and 1986.

Of the $7.2 billion in Federal income tax paid by the life insurance industry for 1984, 1985, and 1986 (after taking into account the true-up for mutual life insurance companies), the mutual life insurance companies paid $2.8 billion (39 percent of the total tax paid by the industry) and the stock life insurance companies paid $4.4 billion (61 percent of total tax paid by the industry). The final Treasury report, however, notes that the amount of Federal income tax paid by the mutual sector for 1986 may be $300 million larger based on data provided by representatives of the mutual life insurance companies to the Treasury Department shortly before publication of the final Treasury report. If this additional $300 million is taken into account, the amount of Federal income tax paid by mutual life insurance companies for 1984, 1985, and 1986 would equal $3.1 billion, which is 41 percent of the total Federal income tax paid by the industry for the 3-year period.

The final Treasury report indicates that the revenue estimates made at the time that the 1984 Act was enacted assumed that the mutual life insurance companies would pay $5.2 billion of Federal income tax for the 3-year period (55 percent of total estimated tax of the industry) and the stock life insurance companies would pay $4.3 billion of Federal income tax for the 3-year period (45 percent of total estimated tax of the industry).

The final Treasury report contains several possible explanations (originally set forth in the interim Treasury report) for the shortfall in the amount of Federal income tax paid for the 3-year period. The Treasury Department attributes the shortfall to difficulties in estimating receipts from the life insurance industry at the time that the 1984 Act was enacted, including: (1) difficulties relating to the complexity of the changes in the treatment of life insurance companies under the 1984 Act; (2) unpredictable changes in taxpayer behavior; (3) significant changes in industry products and practices; and (4) limitations with respect to the data available in 1984.

The final Treasury report also notes that in determining the amount of Federal income tax paid by the life insurance industry, it may be appropriate to focus on the Federal income tax paid before credits and before losses attributable to affiliated corporations that are not life insurance companies. The final Treasury report indicates that the amount of Federal income tax paid by the stock life insurance companies for 1984, 1985, and 1986 would have increased by $1.5 billion (from $4.4 billion to $5.9 billion) and the amount of Federal income tax paid by mutual life insurance companies for 1984, 1985, and 1986 would have increased by $0.4 billion (from $4.2 billion to $4.6 billion) if credits and non-life losses had not been taken into account.[14] Therefore, if it is appropriate to de-

[14] *See*, final Treasury report, Table 3.5, p. 20. Based on data provided by the mutual life insurance sector not previously available to the Treasury Department in making this estimate, the Treasury Department notes that estimates for the mutual segment of tax after credits and after non-life losses may be $4.5 billion (instead of $4.2 billion) and tax before credits and non-life losses may be $5.0 billion (instead of $4.6 billion).

termine the amount of Federal income tax paid by life insurance companies before credits and before taking into account losses of non-life affiliates, then the stock life insurance companies paid a greater percentage of the total Federal income tax paid by the life insurance industry for 1984, 1985, and 1986 than the percentage that is listed in Table 2.

B. Summary of Treasury Department Analysis of Differential Taxation of Stock and Mutual Life Insurance Companies

In addition to data on the amount of Federal income tax paid by life insurance companies, the final Treasury report includes an analysis of the differential taxation of stock and mutual life insurance companies under present law (sec. 809 of the Internal Revenue Code). The final Treasury report recognizes that stock and mutual life insurance companies are in direct competition with each other and argues that the tax system should not place either sector at a competitive disadvantage relative to the other. Although the taxation of economic income would achieve competitive balance, the final Treasury report acknowledges that the economic income of life insurance companies is not easily measured due to the difficulty in identifying equity returns in dividends paid to participating policyholders.

The final Treasury report notes that in enacting section 809, Congress attempted to tax the economic income of mutual life insurance companies. In determining the economic income of mutual life insurance companies, Congress believed that a portion of the policyholder dividends of a mutual life insurance company is a distribution of corporate earnings that should not be allowed as deduction to the mutual life insurance company. However, the final Treasury report notes that, although returns to participating policyholders of both stock and mutual companies should be treated similarly, Congress did not address the issue of identification and appropriate taxation of equity-like returns from dividends of participating policies issued by stock life insurance companies. The final Treasury report indicates that this is one reason that section 809 fails to achieve equal tax treatment of stock and mutual life insurance companies.

The final Treasury report indicates that section 809 contains both theoretical and practical flaws. At the operational level, the final Treasury report criticizes section 809 for basing the tax of a mutual life insurance company on the performance of the 50 largest stock life insurance companies and on all other mutual life insurance companies. A further criticism is that the income imputed to mutual life insurance companies under section 809 is based on short-term changes in the relative earnings rates of the stock and mutual segments of the industry. In addition, as a result of the "true-up," the Federal income tax of any mutual life insurance company for any year is recomputed in a later year.

On a theoretical level, section 809 has been criticized by proponents of the prepayment analysis. According to the prepayment analysis, equity returns on participating policyholder dividends are properly deductible since capital contributions corresponding to that equity were received in the form of taxable premiums, and, therefore, life insurance companies in effect prepaid tax on these equity returns.[15] The final Treasury report contains a discussion of the prepayment analysis and the criticisms thereof and concludes that the prepayment analysis calls into serious question the necessity of imputing income to mutual life insurance companies under section 809. The final Treasury report indicates that, although there remains some uncertainty regarding some assumptions of the prepayment analysis, the prepayment analysis generally demonstrates that, in the absence of section 809, equity returns of participating policyholder dividends bear an appropriate amount of corporate tax.

The final Treasury report, however, stresses that the prepayment analysis does not address the issue of the tax advantage enjoyed by participating policyholders receiving dividends (a portion of which is an equity return) relative to stockholders receiving dividends. The final Treasury report provides that policyholder equity income should be treated commensurately with stockholder equity income.

Finally, the final Treasury report recognizes that by issuing cash value policies, life insurance companies act as financial intermediaries and life insurance companies are in increasing competition with other financial intermediaries. Therefore, the final Treasury report asserts that in determining the proper Federal income tax treatment of life insurance companies, Congress should seek greater consistency in the tax treatment of income flowing through life insurance companies and income flowing through other financial institutions.

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[15] The prepayment analysis is discussed in greater detail in Part IV, *infra*.

IV. CRITICISMS OF THE DIFFERENT TREATMENT ACCORDED STOCK AND MUTUAL LIFE INSURANCE COMPANIES UNDER PRESENT LAW

Failure to achieve anticipated revenue

As summarized in Part III of this pamphlet, the final Treasury report indicates that the 1984 Act changes to the Federal income tax treatment of life insurance companies resulted in the payment of less Federal income tax for 1984, 1985, and 1986 than was anticipated at the time that the 1984 Act was enacted. In addition, the final Treasury report indicates that the total Federal income tax paid by the mutual segment of the industry was less than anticipated.

It has been argued that present law should be modified in order to obtain additional Federal income tax from the mutual segment of the industry. In this connection some maintain that the failure of present law to obtain the anticipated tax from the mutual segment of the industry has resulted in the mutual life insurance companies enjoying a competitive advantage over the stock life insurance companies. Thus, this competitive advantage could continue if present law is not modified to impose a greater tax burden on the mutual segment of the industry.

On the other hand, others believe that present law provides stock life insurance companies with a competitive advantage because under the prepayment analysis, the earnings of mutual life insurance companies are subject to a corporate-level tax, and, consequently, present law improperly imputes income to mutual life insurance companies. It is further contended that it is inappropriate to focus on the total amount of tax that is paid by each segment of the life insurance industry, and that the Federal income tax should more accurately measure the economic income of each life insurance company whether stock or mutual.

Some have asserted that the 55 percent revenue target for the mutual segment of the industry was to apply only for 1984 and that, even if the target was to apply after 1984, this target was inappropriate based on the composition of the life insurance industry in 1984. Further, it is argued that the reason that the amount of Federal income tax paid by the mutual segment of the industry for 1984, 1985, and 1986 was less than estimated was due to errors in the estimation process and also the lower profitability of the mutual companies compared to stock companies during the 3-year period.[16]

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[16] Some have suggested the following reasons to explain why the estimates overstated the amount of tax to be paid by mutual life insurance companies for 1984, 1985, and 1986: first, that the estimates overstated the amount of equity of the mutual life insurance companies, and, therefore, the estimates assumed that section 809 would impute a larger amount of income to

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In response, others have argued that it is appropriate for Congress to establish a revenue target for each segment of the life insurance industry due to the difficulties in determining the proper treatment of policyholder dividends and, consequently, the economic income of a mutual life insurance company. It is asserted that Congress has historically considered stock and mutual life insurance companies as separate segments in determining how life insurance companies should be taxed and how much revenue should be paid by each segment. It is further contended that a 55 percent mutual target was intended to apply at least throughout the entire estimating period and that this target was appropriate based on the composition of the life insurance industry in 1984. Finally, it is argued that the failure of present law to achieve the 55 percent mutual target is primarily attributable to deficiencies in the operation of present law and not to the relative profitability of each segment of the industry.

Theoretical criticism

A theoretical criticism of imputing an equity return to a mutual life insurance company or disallowing a deduction for a portion of the policyholder dividends of a mutual life insurance company that has been raised in recent years is known as the prepayment analysis.[17] According to the prepayment analysis, imputing an equity return or limiting the deductibility of policyholder dividends is unwarranted as a means of providing for the proper taxation of a mutual life insurance company because a portion of the premiums received by a mutual life insurance company is a contribution to the capital of the company. Because all premiums are includible in the gross income of a mutual life insurance company, a mutual life insurance company has effectively prepaid tax on its earnings which justifies a full deduction to the company when the earnings are paid to policyholders as policyholder dividends.

Some have disagreed with the conclusions reached through the application of the prepayments analysis on the grounds that the assumptions underlying the prepayments analysis do not reflect the actual operation of mutual life insurance companies or the historical Federal income tax treatment of mutual life insurance companies. It is contended that the premiums of mutual life insurance companies historically have not, and currently do not, contain a capital contribution, and that, even if they did, the premiums of mutual life insurance companies have historically not been subject to Federal income tax as received.

Critics of conclusions reached under the prepayment analysis also point out that from 1921 through 1957, life insurance companies were only taxed on net investment income that was not alloca-

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mutual life insurance companies; second, that the estimates did not take into account net operating losses that were created under the "stopgap" provisions of the Tax Equity and Fiscal Responsibility Act of 1982; and finally, that the estimates failed to take into account the large amount of capital gains recognized by both segments of the industry during the 3-year period.

[17] This theory is attributed to Michael J. Graetz. *See* Graetz, "Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential," in M. Graetz (ed.), *Life Insurance Company Taxation: The Mutual vs. Stock Differential* (1986).

ble to policyholders ("free investment income"), and, consequently, the premiums of mutual life insurance companies were not subject to tax during this period. In addition, they claim that under the Life Insurance Company Tax Act of 1959 (which was generally effective for taxable years beginning after 1957 and before 1984), mutual life insurance companies were essentially taxed only on the amount of their taxable investment income.

On the other hand, others argue that under the Life Insurance Company Tax Act of 1959, mutual life insurance companies were overtaxed and that this overtaxation more than compensated for the failure of the pre-1959 Act law to tax the portion of the premiums received that was a contribution of capital to mutual life insurance companies. Furthermore, it is contended that the taxation of mutual life insurance companies under prior law should not be relevant in determining the proper tax treatment of such companies for the future.

As a final theoretical matter, the prepayment analysis does not address the favorable Federal income tax treatment of policyholders of mutual life insurance companies with respect to the portion of the policyholder dividends that are a return of company earnings. It has been suggested by some that the favorable treatment of the distributed earnings of a mutual life insurance company at the policyholder/owner level may justify the imposition of a proxy tax at the mutual life insurance company level.

Operational criticisms

As explained above, one of reasons given for the enactment of section 809 was the desire to determine the earnings of a mutual life insurance company that are distributed to policyholders through policyholder dividends in order to provide a more accurate measure of the economic income of a mutual life insurance company. Section 809 has been criticized by some because the amount of tax paid by any mutual life insurance company for any taxable year depends not only on its own performance but also on the performance of the 50 largest stock life insurance companies and the performance of all other mutual life insurance companies. Section 809 has also been criticized by some as having the effect of treating the mutual segment of the life insurance industry as a single taxpaying entity, an effect which has been referred to as the "socialization effect."

Section 809 has also been criticized on the operational level for a variety of other reasons. Some maintain that the operation of present law is subject to manipulation by mutual life insurance companies and that the manipulation of present law is one of the primary reasons that present law fails to achieve the revenue anticipated at the time of the 1984 Act. For example, it is asserted that a mutual life insurance company is able to reduce the amount of its equity in order to decrease the Federal income tax payable for any taxable year. By contrast, others contend that section 809 acts as a disincentive to maintain adequate surplus for the protection of policyholders.

Finally, it is believed by some that section 809 is excessively complex thereby resulting in significant compliance costs to taxpayers and significant administrative costs to the Internal Revenue Service. For example, the recomputation or "true-up" of the differential earnings amount has been criticized for attempting to achieve a level of precision under a tax structure that is by its nature arbitrary.

V. PROPOSALS TO MODIFY THE FEDERAL INCOME TAX TREATMENT OF LIFE INSURANCE COMPANIES

Numerous proposals to modify the Federal income tax treatment of life insurance companies, their owners and their customers have been suggested to address criticisms of present law. These proposals may be grouped into three general categories: (A) repeal of section 809, without a replacement or substitute; (B) alternatives to section 809; and (C) modifications to section 809.

A. Repeal of Section 809

One suggestion for addressing the issues arising in connection with section 809 has been to repeal it altogether, without any replacement or substitute. Although the final Treasury report recommends adoption of a substitute for section 809, the report does describe repeal of section 809, without any substitute or replacement, as a possible option. The final Treasury report suggests that, if enacted, the repeal should be accomplished over two years so that the tax owed (or refund due) from the true-up under section 809 for the last year for which section 809 is in effect would not be eliminated. The final Treasury report also notes that repeal of section 809 alone would reduce Federal tax receipts and states that a revenue offset would be required.

Arguments for the proposal

o Some argue that, if the prepayment analysis (described in Part IV, above) is correct, then section 809 is inappropriate and should be repealed. Under this analysis, it is asserted that mutual life insurance companies have prepaid tax by previously including in income premiums that constituted, in part, contributions to capital. Therefore, it is argued, imputing income to mutual life insurance companies on the grounds that a portion of the policyholder dividends of mutual life insurance companies constitutes a return on equity taxable to the company is incorrect.

o Some argue that the repeal of section 809 would eliminate the problems with the operation of section 809. For example, repeal of the provision would address concerns that taxation of mutual life insurance companies' income under present law is needlessly complex; that the provision is wrongly based on a revenue target rather than on principles of accurate measurement of economic income; that the provision "socializes" the mutual segment of the industry and that small mutual companies' tax is unduly influenced by large ones' profits; that mutual companies' tax should not be determined on the basis of stock company earnings rates; and that the lag in data availability and the resulting "true-up" of mutual company tax in a later year is undesirably cumbersome.

Arguments against the proposal

o Opponents argue that repeal of section 809, without any substitute provision, would be a windfall to the mutual segment of the life insurance industry and would provide an unfair competitive advantage by reducing that segment's tax substantially below the tax paid by the stock segment. It is similarly argued that repeal would increase the Federal budget deficit by reducing revenues.

o Others argue that premium income has not been accurately measured and taxed in the past under subchapter L, and that consequently amounts received as capital by mutual companies were not actually taxed. Consequently, it is argued, it would be improper to assume that corporate-level tax has been prepaid. Therefore, if section 809 were repealed, a substitute would be needed.

B. Alternatives to Section 809

Several proposals have been advanced as substitutes or replacements for section 809. These proposals are based on an assumption that section 809 would be repealed.

The theory advanced for some of the proposals is that returns on insurance company equity should not be deductible at the company level, but present-law section 809 has too many operational or other flaws to achieve this objective. An alternative theory advanced for some options is that policyholders, like shareholders, theoretically should have to include in income the portion of the policyholder dividend representing a return on corporate equity, and that therefore a company-level tax should be substituted for present-law section 809 as a proxy for taxing policyholders. This theory could apply to policyholders of mutual life insurance companies, policyholders of mutual and stock life insurance companies, or policyholders of all insurance companies.

The various proposals described below may be based on either or both of these rationales, or upon other theories.

1. Life insurance company investment earnings tax with shareholder dividends-paid credit

The Treasury Department, in the final Treasury report, recommends that section 809 be repealed and replaced with a tax based on net investment income that applies to all life insurance companies (including life insurance company subsidiaries of non-life insurance corporations). Under this proposal, life insurance companies would pay a tax equal to one percent of the net investment income of life insurance contracts. The final Treasury report asserts that this one-percent rate (combined with the shareholder dividends-paid credit discussed below) would raise approximately the same revenue from life insurance companies for fiscal years 1990-1991 as is expected to be raised under section 809. In order to maintain revenue neutrality in later years, the final Treasury report states that the rate should be increased to slightly over two percent.

Under the Treasury proposal, the tax would be separate from the income tax on gain from operations after policyholder dividends. Net operating losses, and credits unrelated to net investment income, would not be allowed in calculating this tax; however, a deduction against investment income would be allowed for dividends received from affiliates.

In calculating net investment income under the proposal, investment income would be broadly defined to include all interest, dividends, and net capital gains from all life insurance subgroup assets. Investment income would be reduced by prorating investment income according to the ratio of reserves on life insurance contracts to total reserves, for the purpose of applying the tax only to investment income attributable to life insurance contracts. Net investment income would calculated as a fixed percentage of investment income.

Under the Treasury proposal, stock life insurance companies would be allowed a dividends-paid credit for shareholder dividends paid which are attributable to life insurance contracts. This credit would be allowed only against the new investment earnings tax, and would be equal to 15 percent of shareholder dividends paid. According to the final Treasury report, this rate is intended to account for lower effective tax rates of shareholders, and assumes that approximately 70 percent of dividends are directly taxable to individuals, and that the average marginal tax rate of these individuals is approximately 22 percent.

Arguments for the proposal

o Proponents assert that the double taxation of equity returns of stock company shareholders would be eliminated with the dividends-paid credit. Consequently, such returns paid to stock life insurance company shareholders would be treated in the same manner as returns paid to participating policyholders.

o It is argued that the tax treatment of income from financial products offered by financial institutions would be made more consistent by providing that investment income flowing through life insurance companies is taxed at least once at either the corporate or individual levels.

o It is argued that, by taxing investment income of all life insurance companies, the proposal achieves the proper treatment of all participating policies, whether issued by stock or mutual life insurance companies. Thus, it is argued, although participating policies of stock companies do not give policyholders the ownership rights that stock ownership (or ownership of a mutual company participating policy) would, nevertheless, dividends paid on such policies represent in part a return on corporate equity and should be treated the same as dividends paid on participating policies of mutual companies.

Arguments against the proposal

o Opponents argue that, because the proposal would tax net investment income of a life insurance company with respect to all life insurance contracts, not just contracts issued by mutual life insurance companies that provide ownership rights, the proposal is a disguised tax on the inside buildup of life insurance products.

o Opponents criticize the proposal as improperly characterizing certain policies sold by stock companies as policies that pay a return on corporate equity. Opponents argue that such policies do not represent ownership of corporate equity, do not entitle the policyholder to vote or exercise other ownership rights, and do not pay dividends directly related to corporate profitability. Thus, it is argued, it is improper to treat policyholder dividends on such policies like policyholder dividends on mutual company policies.

o Some have argued that it is unfair to suggest that only one level of tax be paid on insurance income, while two levels of tax are required for distributed income of other corporations, under the two-tier system of taxation generally applicable under present law.

o Some argue that the credit for dividends paid under the proposal raises difficult tracing issues in the case of inter-corporate payments. For example, when a dividend is paid by a stock company to a mutual company parent, it is unclear under the proposal whether the credit is allowed. The proposal does not specify whether the credit is allowed only when earnings are paid outside the affiliated group. It is also unclear whether the credit is available when stock company earnings are paid out, indirectly, through a mutual company to its policyholders.

o Some assert that a shareholder-level credit, rather than a company-level credit or deduction, most accurately accomplishes the goal of obtaining at least one level of tax on any particular type of corporate income that is distributed. The reason for this assertion is that a company-level offset (unlike a shareholder-level one) could eliminate both the company- and distributee- levels of tax where the company deducts (or credits) an amount paid to a non-taxpayer (such as a tax-exempt organization).

2. Percentage tax on equity as proxy tax at the company level

Another corporate-level tax proposal is also described in the final Treasury report. Under this approach, a separate proxy tax for mutual life insurance companies would be imposed at the rate of 0.625 percent of the mutual company's section 809 equity base. A corresponding (but lower rate) proxy tax for stock companies would be 0.125 percent to account for the relatively smaller share of equity-like returns to stock company participating policyholders. The equity base for each stock company would be the amount attributable to participating policies.

The final Treasury report provides that the mutual company rate under this option assumes that shareholder-like dividend payments by mutual life insurance companies are 4.5 percent of the section 809 equity base, that the average marginal tax rate of individual taxpayers is approximately 20 percent, and that the percentage of policyholder dividends received by taxable individuals is approximately 70 percent. The final Treasury report also asserts that the proxy tax rate for stock companies would contain arbitrary assumptions because empirical data from which to determine an appropriate tax rate does not exist. The proxy tax under this option would be separate from the regular corporate income tax and would not be subject to reduction by income tax losses or credits, because it is intended as a proxy for including the policyholder dividend in income at the policyholder level. The final Treasury report notes that a proxy tax approach could be imposed alone or in combination with other alternatives.

Arguments for the proposal

o Some argue that an examination only of the prepayment analysis at the company level, regardless of whether the prepayment analysis is correct, ignores the issue raised by the non-includability of policyholder dividends in policyholders' income. If policyholder dividends represent, in part, a return on corporate equity, it is argued that to be consistent with the treatment of earnings of other, non-insurance corporations, a second level of tax should be imposed on the recipient, even if the earnings have already been taxed at the corporate level, and regardless of whether the payor is a stock or a mutual company. This approach, it is argued, would treat all distributed corporate earnings equally. In the case of policyholder dividends, it is argued, it is preferable for reasons of administrative convenience and ease of collection to impose this tax at the corporate level rather than upon the recipient.

o Proponents argue that it is appropriate to impose the proxy tax at a lower rate on stock than on mutual life insurance companies, because it is presumed that a portion of stock company corporate earnings have been (or will be) taxed to the recipients as non-excludable shareholder dividends.

Arguments against the proposal

o Opponents argue that the proxy tax approach is a disguise for taxing inside buildup of life insurance contracts. It is argued that the approach taxes amounts paid or credited under life insurance policies, and that this is particularly true in the case of stock life insurance companies that pay returns on corporate equity to corporate shareholders.

o It is argued by some that repealing section 809 and substituting a proxy tax, if the rate of the proxy tax is set to preserve the revenue derived under present law, would shift the Federal income tax burden in the industry significantly away from the mutual segment and towards the stock segment, and that this is unfair given the relative size of each segment.

3. Imputation of income based on a percentage of equity

Other proposals that have been suggested are structured as an inclusion in income of a percentage of equity.

a. Percentage of equity

Under one such proposal, each mutual or stock insurance company would be required to include 1 percent of its equity that is deemed to be attributable to dividend-paying business (as defined in section 808) in its gross income. For mutual life and mutual property and casualty companies, all equity would be deemed to be dividend-paying business. For stock life insurance companies, equity would be deemed to be attributable to dividend-paying business in proportion to the company's premiums received from such business as compared to total premiums. Equity for purposes of this tax would generally be defined in a manner that is consistent with the definition of equity under section 809 of present law. For this purpose, dividend-paying business is defined as any contract which provides for the payment of policyholder dividends as defined under section 808 of the Code.

If the proposal is found to raise less revenue that would retention of present-law section 809, it has been observed that additional base-broadening measures designed to measure insurance company income more accurately could be added to the proposal.

b. Alternative ratio for allocating equity

An alternative method that has been suggested for allocating equity to section 808 participating business, under a proposal to adjust taxable income based on a percentage of equity, is to use the ratio that reserves for this business bear to total reserves. Total tax reserves would be defined as section 807 items. Section 808 business reserves would be defined as section 807 reserves, less reserves for permanent life, immediate or matured fixed, flexible or single premiums, individual accident and health contracts, and supplemental contracts involving life, accident or health contingencies.

c. Modification for small companies

A modified version of this proposal would provide for a graduated rate of tax to reflect the size of the company, based on an assumption that small and mid-sized companies do not pay equity returns at as high a rate as large companies, because the small and mid-sized companies tend to retain earnings to support growth.

Arguments for the proposals

o Proponents argue that, if returns on insurance company equity are to be taxed, it is fair to tax all items that, in substance, constitute returns on equity. Thus, it is argued, all amounts treated as policyholder dividends under present law should be examined, regardless of whether the company issuing the policy is a stock or a mutual company. Similarly, it is argued, policyholder dividends of all insurance companies, not just life insurance companies, should be examined, although, it is asserted, non-mutual property and casualty companies normally do not issue policies that provide for policyholder dividends.

o Some argue that a equity tax approach can be supported on the ground that an additional company-level tax can serve as a proxy tax, compensating for the failure of present law to require inclusion of policyholder dividends in the income of policyholders, even if the tax is not calculated separately from regular income tax. Thus, they argue, the equity tax has the desirable corollary effect of tending to resolve the disparity in treatment at the recipient level.

o With respect to providing a graduated rate under an equity tax proposal, in the case of small companies, it is argued that present law provides special rules both for small life insurance companies (*e.g.*, the small life insurance company deduction), and for small property and casualty companies (*e.g.*, exemption for very small property and casualty companies and the election to be taxed on investment income only, for other small property and casualty insurance companies).

Arguments against the proposals

o Some opponents criticize the premise that holders of policies issued by stock companies could be participating in returns on the company's equity. They argue that only shareholders can receive true returns on equity of stock companies.

o While it may be simpler than present law, the equity tax approach could be criticized for not going far enough in eliminating technical and mechanical issues relating to the definition of corporate equity, and to the measurement of return on equity. Opponents also assert that this approach continues the incentive for companies to reduce their equity artificially in order to reduce liability for the equity-based tax.

o Opponents of imposing an equity tax on all life insurance companies (including on stock companies) argue that such proposals could shift the burden of tax in the industry away from the mutual life insurance companies to the stock life insurance companies, and that this is unfair based on the relative size of the two segments. They argue that this may be the case even with the revenue gained by extension of an equity tax to mutual property and casualty companies.

o With respect to the proposal for a graduated rate tax for small companies, it is argued that in fact small companies do not pay equity returns at lesser rates than larger companies, and therefore should not be given a tax-based competitive advantage. If the equity tax is viewed as a proxy tax at the company level to compensate for non-inclusion of policyholder dividends at the recipient level, it is argued that there is no reason for distinguishing between policyholders of small companies and policyholders of large companies, because they all generally exclude policyholder dividends received under present law.

4. Imputation of income based on rate of stock company dividend payments

Some proposals would impute income based on dividend payment rates of stock life insurance companies, rather than imputing income based on a percentage of a company's equity.

a. GAO proposal

The General Accounting Office (GAO) has recommended that Congress repeal section 809, accept the prepayment analysis as valid at the company level, and impose a corporate-level tax on the earnings part of policyholder dividends of both mutual and stock life insurance companies.[18] Under this approach, the tax would be imposed on these earnings at the company level as a proxy for the tax on individual policyholders.

To calculate the earnings part of policyholder dividends, the proposal would provide that some portion of policyholder dividends would be included in the taxable income of mutual and stock life insurance companies. This portion would be based on the stockholder dividend payout behavior of stockholder-owned corporations.

[18] See "Draft Executive Summary of General Accounting Office Report on Taxation of Life Insurance Companies," reprinted in Daily Tax Report (BNA) No. 138 (July 20, 1989) at L-13-14.

Under the proposal, the portion of policyholder dividends that are includable in income would be reexamined periodically on the basis of industry experience.

b. Other imputation options based on stock company dividends

The final Treasury report describes a similar option that would impute income to life insurance companies based on the rate of stock company shareholder dividend payments. Under the approach described in the final Treasury report, such payments would provide a basis for determining an income adjustment without relying on annual comparisons of stock and mutual company earnings. Under this option as described in the final Treasury report, for mutual companies, the imputation to income would be 4.5 percent of the section 809 equity base. The imputation of income for stock companies would apply at a lower rate, such as 0.9 percent of equity, to reflect the relatively smaller share of equity-like returns to stock company participating policyholders. The equity base of each stock company would be the amount attributable to participating policies based upon the ratio of participating policy reserves to total reserves.

Arguments for the proposals

o It is argued that an imputation approach based on the rate of stock company dividend payments would not pose the difficulties in measuring equity that arise under present law and under substitute proposals that are structured as a percentage of equity.

o Some argue, in favor of the GAO proposal, that a tax based on independently measurable facts, like stock company dividend rates, is less subject to manipulation by taxpayers than a tax determined exclusively with respect to a percentage of the taxpayer's own equity.

Arguments against the proposals

o Opponents argue that an approaches that impute income to some companies based on the rate of dividend payments of other companies are inherently unfair in that they do not measure income of each company separately. Further, it could be argued that the shareholder dividend rate could be set to create a competitive disadvantage for mutual companies.

o Some argue that any proposal intended as a proxy tax at the company level to compensate for non-inclusion by policyholders could be viewed as a disguised tax on inside buildup of life insurance contracts, whether the proxy tax is structured as a percentage tax on equity, or as a imputation based on stockholder dividend rates.

5. Policyholder dividend limitations

Several other types of proposals apply the concept of a limitation on policyholder dividend deductions of mutual life insurance companies.

a. Deny deduction of a percentage of policyholder dividends

A policyholder dividend deduction limitation proposal was raised as a possible stopgap measure by Chairman Rostenkowski in connection with the markup of the 1989 budget reconciliation legislation in the Ways and Means Committee. Under the revised limitation provided in the proposal, the deduction for policyholder dividends of mutual life insurance companies (and certain life insurance companies owned by mutual life insurance companies) would be limited to 70 percent of the amount of otherwise deductible policyholder dividends.

b. Dividend deduction limit based on a percentage of gain from operations and dividends

Another proposal would limit the deduction for a mutual life insurer's policyholder dividends to a statutorily stated percentage of such dividends, but not in excess of a second limitation equal to a stated percentage of the mutual life insurer's gain from operations before dividends. Under this approach, each mutual life insurance company would deduct a stated percentage of all dividends paid (*e.g.*, 1/3), but this deduction could not exceed a stated percentage of a company's gain from operations before dividends (*e.g.*, 40 percent). For this purpose, policyholder dividends would be defined as under section 808 and gain from operations would include capital gains and losses.

A variation of this approach could also be applied for purposes of the alternative minimum tax.

c. Dividend deduction limit based on excess investment income

Under the proposal, a mutual life insurer would remain taxable on its total gain from operations, but it would not be permitted a deduction for policyholder dividends in excess of the amount of its tentative taxable income (*i.e.*, before any deduction of dividends) over its "excess investment income." This excess investment income represents the amount of investment earnings that are not needed by the company to meet its insurance commitments.

Under the proposal, each mutual life insurer would compute its excess investment income. Its excess investment income would consist of two components: (1) an investment return on the insurer's equity, and (2) a profit share (or a spread) on the investment return on all the insurer's assets other than the assets allocated to equity.

The investment return on equity would equal the product of a company's equity multiplied by a rate of return (the earnings rate). The earnings rate would be determined by dividing a company's net investment income for the taxable year by its total assets for the taxable year.

Equity would be defined as under section 809(b), with certain modifications. Net investment income would be defined as under section 812(c), but it would include net capital gains. A proration formula would also be included. Total assets would be defined as under former section 805(b)(4) of the 1959 Act.

The profit share of the investment return on all other, non-equity assets (total assets minus assets allocated to equity) would be determined. If total assets were 100x and equity was 10x, then non-equity (or investment) assets would be 90x.

Under the proposal, the earnings rate would be reduced by a statutory percentage (*e.g.*, 80 percent). This statutory percentage would be considered to represent the amount of investment income that a company would exclude from its tax base because it is needed to meet its insurance commitments. In the case of separate account business, it may be possible to use an insurer's actual profit from the business in lieu of the statutorily fixed portion.

Section 845, dealing with reinsurance transactions involving tax avoidance, would be clarified or expanded to preclude using reinsurance to recharacterize investment income as under-writing income, and other authority would be provided to prevent tax avoidance.

Arguments for the proposals

o It is argued that a percentage limitation on the deductibility of policyholder dividends has the advantage of ease of administrability by virtue of the simple percentage limitation on deductible policyholder dividends (based on an assumption that a percentage represents a deductible customer rebate). It is further argued that any opportunity to "zero out" can be eliminated by a second limitation based on gain from operations before dividends.

o Proponents of the excess investment income proposal argue that it accurately measures the portion of mutual life insurance company policyholder dividends that constitute a return on equity. It is argued that the proposal recognizes that a company realizes a profit from the investment income earned on assets dedicated to meeting its insurance obligations.

o Some who argue that a particular revenue balance between stock and mutual life insurance companies should be maintained assert that a policyholder dividend deduction limitation could accomplish that result.

o It is argued that, under a policyholder dividend deduction limitation proposal, a mutual life insurer will be taxed on a reasonable measure of its actual economic income, consistent with the total income approach of the 1984 Act.

Arguments against the proposals

o Some argue that any policyholder dividend deduction limitation does not acknowledge or address the theoretical concerns raised by the prepayment analysis, by the disparity in treatment of policyholders and shareholders, or by the issue of whether the tax system should provide special tax treatment of non-mutual types of participating insurance business.

o It could be argued that a percentage limitation on policyholder dividends, while relatively simple to administer, is unfair, because it does not accurately measure the returns on equity of each company individually.

o It is argued that some of the proposals could benefit mutual life insurers that sell low-premium policies with low dividends at the expense of those companies that sell high-premium policies with high dividends.

o Critics assert that the excess investment income proposal may not prevent the deduction of dividends that distribute earnings from mortality and expense savings (although it is argued that this problem could be compensated for by setting the profit share somewhat higher, or by other adjustments). In addition, the proposal can be criticized as a return to the complexity of pre-1984 Act law. Further, setting the profit share at a fixed percentage of investment return under the excess investment income proposal could be viewed as arbitrary and as possibly giving rise to inequitable results in some circumstances.

C. Modifications to Section 809

Several suggestions have been made to attempt to solve some of the perceived operational problems of present-law section 809 without making major changes in the taxation of mutual life insurance companies or other insurance companies, their owners or their customers.

1. Changes to equity base, imputed earnings rate and mutual company earnings rate

Clarify the equity base.—To clarify the computation of the equity base, the statutory definition of voluntary reserves would be expanded and strengthened. Specifically, voluntary reserves would be defined as including any amount that is set aside to mature or liquidate future claims or liabilities, unless the amount would be an accruable expense under the principles of section 461(h) or otherwise specifically deductible under the Code (*e.g.*, under section 807(c)). It may also be necessary to clarify the definition of "nonadmitted financial assets" by providing that such assets include all assets having a tax basis.

Correct the imputed earnings rate.—Under the proposal, a new imputed earnings rate would be provided. The new rate would be determined as a weighted average of the aggregate annual statement gain of the 50 largest stock life insurance company groups, divided by their aggregate equity, using the existing section 809 definitions of gain and equity with some modifications. The determination of this new rate on a weighted average basis is chosen, under the proposal, to parallel the determination of the mutual earnings rate on a weighted average basis. The two-year lag for data collection would be continued, meaning that, for example, the rate determined for 1987 would be used on tax returns for 1989.

Alternatively, the new rate could be determined annually from an "external" index of pre-tax rates of return on equity, such as the Standard and Poor's 400.

Company-by-company determination.—Each mutual life insurance company would determine its own earnings rate. The rate would be determined by dividing a company's own after-dividend earnings by its equity base. This would replace the all-mutual average earnings rate currently used in section 809 (the so-called socialization approach). To parallel the use of a new imputed earnings rate based on stock company performance of two years earlier, the mutual company's earnings rate used for a given taxable year would be based on its performance two years earlier.

In lieu of correcting the imputed earnings rate and providing a company-by-company determination, the differential earnings rate could be a rate fixed by statute. This rate could also be indexed to changes in some appropriate index. In addition, the initial rate could be determined based on estimates of what the rate would be for the first year, under the proposals to correct the imputed earnings rate and provide a company-by-company determination.

Technical refinements.—First, the "true-up" mechanism of present law would be deleted under the proposal (with a transitional rule retaining it for the year that the change in the law takes effect). Second, the proposal would provide legislatively that neither the differential earnings rate nor the recomputed differential earnings rate may be a number less than zero, and that a calculated negative rate may not be carried over. Third, regulatory authority to prevent avoidance through artificial equity reductions would be provided under the proposal.

Arguments for the proposal

o It is asserted that the imputed earnings rate that was fixed in the 1984 Act at 16.5 percent for 1984 and indexed to the stock earnings rate for subsequent years is too low, and should have been fixed at least 22 percent. Therefore, an adjustment to the imputed earnings rate under present law would be merited.

o The proposal, it is argued, would substantially simplify administrability of and compliance with section 809 without massive changes and without challenging its theoretical basis. In particular, it is argued that the use of a weighted average in determining the imputed earnings rate means that capital gains and losses, which are included in the imputed earnings rate and the mutual earnings rate, would be reflected in a manner that reduces mutual companies' incentive to realize such gains and losses in a way that distorts the determination of the rates and thereby decreases their tax liabilities.

Arguments against the proposal

o Critics of this approach assert that the proposal does not address the fundamental theoretical criticisms of section 809 raised by the prepayment analysis.

o It is argued that this approach does not address important operational criticisms of section 809, such as: that the provision is wrongly based on a revenue target rather than on principles of accurate measurement of income; that mutual companies' tax should not be determined on the basis of stock company earnings rates; and that the rule remains cumbersome to administer and comply with.

2. Two-year averaging method for stock and mutual earnings rates

In the final Treasury report, the Treasury Department notes that if Congress believes that section 809 is conceptually sound, and that the prepayment analysis is invalid, section 809 could be simplified.

Under this option, the final Treasury report states, a two-year averaging method for the earnings rate of both stock and mutual companies and the equity base of mutual companies would be adopted. The differential earnings rate would be the excess of the two-year average of the stock earnings rates for the preceding two years over the two-year average of the mutual earnings rates for the same two preceding years. The equity base would be the average equity base for the two preceding years. As under current law, mutual company deductions for policyholder dividends would be reduced by the amount of the section 809 adjustment. There would be no recomputation of the differential earnings rate.

Arguments for the proposal

o It is argued that this approach would eliminate the mismatching of earnings rates over the years, provide some averaging of yearly fluctuations in mutual company earnings rates, and eliminate the complex true-up mechanism of section 809.

o Proponents argue that the theory of section 809 is correct and that the only issue under present law is administrability of the provision.

Arguments against the proposal

o It may be argued that section 809 would still be complex and difficult to administer.

o Proponents of the prepayment theory would argue that the theory of the present law provision is wrong and attempts to make it operate more smoothly do not address the underlying issue.

APPENDIX. MUTUAL AND STOCK SHARES OF LIFE INSURANCE BUSINESS

The relative percentage of assets held by stock and mutual life insurance companies was one factor taken into account by Congress in 1984 in determining the allocation of Federal income tax between the stock and mutual segments of the life insurance industry. The 1984 Act required the Treasury Department to consider any data in addition to assets that may be relevant in determining appropriate segment balance including equity, life insurance reserves, other types of reserves, dividends paid to policyholders and shareholders, pension business, and gross receipts. The interim Treasury report contained data on all these items (except other types of reserves) as well as data on insurance in force, premium income, and investment income. The data from the interim report are summarized in Table 3.

Table 3. Summary of Treasury Department's Findings on Mutual and Stock Shares of Life Insurance Business [1]

	Percent of industry total			
	1972–75 average	1976–79 average	1980–83 average	1984
Mutual life insurance companies:				
Assets	66.2	63.2	58.9	56.3
Equity	50.3	47.8	46.6	41.6
Insurance in force	51.0	50.4	44.3	40.0
Insurance reserves	68.5	65.4	60.6	57.5
Premium income	51.2	49.4	40.5	43.4
Investment income	66.5	63.3	57.9	55.3
Policyholder dividends	88.9	89.0	88.1	90.4
Total receipts	55.2	51.3	49.9	49.7
Pension business [2]	69.3	67.2	62.2	60.4
Stock life insurance companies:				
Assets	33.8	36.8	41.2	43.7
Equity	49.7	52.2	53.4	58.4
Insurance in force	49.0	49.6	55.7	60.0
Insurance reserves	31.5	34.6	39.4	42.5
Premium income	48.8	50.7	59.5	56.7
Investment income	33.5	36.7	42.1	44.7
Policyholder dividends	11.1	11.0	11.9	9.6
Total receipts	44.8	48.8	50.2	50.3
Pension business [2]	30.8	32.8	37.9	39.6

[1] Statistics shown were derived directly from, or were estimated from, data compiled by the American Council of Life Insurance (ACLI). The interim Treasury report notes that the ACLI data are not directly comparable to the data derived from the results of the survey conducted by the Treasury Department and, consequently, the data may be misleading.

[2] "Pension business" refers to reserves for group annuities held by life insurance companies.

Source: Interim Treasury report, Tables 5–7 through 5–15.

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