[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: TAXATION OF INSURANCE PRODUCTS AND COMPANIES

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet[1] was prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in their review of various tax reform proposals. This pamphlet is one of a series of tax reform pamphlets. It describes and analyzes tax provisions and proposals relating to the tax treatment of insurance products and companies.

The pamphlet describes present law tax provisions and the various tax reform proposals made by President Reagan ("The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department Report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals. Each part of the pamphlet includes an analysis of the tax-related issues.

The first part of the pamphlet discusses insurance products and tax issues affecting the owners of insurance products. The second part discusses life insurance companies. The third discusses property and casualty insurance companies, and the fourth part discusses tax-exempt organizations engaged in insurance activities.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Insurance Products and Companies* (JCS-41-85), September 20, 1985.

I. TAXATION OF INSURANCE PRODUCTS

A. Life Insurance Products

1. Inside Buildup

Present Law and Background

In general

Historically, many life insurance products have combined two benefits—insurance protection and investment. For example, under a traditional whole life insurance contract, the buildup of cash value resulting from premium charges in excess of the current cost of the insurance protection in the early years of the policy, together with credited earnings, allows the payment of premiums that are less than the current cost of the insurance protection in later years.

This buildup of cash value as a result of the crediting of earnings (commonly referred to as inside buildup) is not taxed to the policyholder under present law unless the contract is surrendered prior to maturity, and then only to the extent the cash surrender value exceeds the aggregate premiums and other consideration paid. Recently, this characteristic of tax deferral and potential tax exemption has been emphasized and marketed by some companies as a way to shelter investment income from tax. Also, products have been designed to offer a rate of return on investment that is competitive with other financial products (such as money market accounts and mutual funds). Thus, life insurance companies directly compete with banks and other financial intermediaries for individual investors' funds.

Types of life insurance products

The traditional purpose of life insurance has been to protect the policyholder's beneficiaries (usually the policyholder's family) against a loss of income and costs arising from the death of the person whose life was insured. For many people, life insurance and other forms of insurance are not considered primarily as forms of investment nor as component parts of a financial portfolio. However, an investment component of life insurance has long been acknowledged in case law.[2]

Life insurance products that, in varying degrees, involve elements of both pure insurance protection and investment income (inside buildup) are summarized briefly in the following descriptions.

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[2] See, e.g., *New York Life Ins. Co. v. Statham*, 93 U.S. 24 (1876), observing an analogy between a life insurance company's reserve fund and a bank deposit.

Term insurance

Term insurance is a contract that furnishes life insurance protection for a limited term. The face value of the policy is payable if death occurs during the stipulated term of the contract. Nothing is paid if the individual on whose life the insurance is provided survives to the end of the term. Premium charges only cover the risk of death so little or no cash value builds up over the term of the policy. For any given amount of life insurance, premium charges increase with the policyholder's age. Term insurance policies are most frequently issued for a period of one year, although a term insurance policy may provide protection for a shorter period (such as the duration of a plane flight) or a longer period (such as the life expectancy of an individual). Although these contracts are primarily protection contracts, the leveling of a premium over a long period of years produces a small cash value that increases to a point and then declines to zero at the termination of the contract.

Whole life insurance

A whole life insurance contract provides for the payment of the face value of the policy upon the death of the insured; payment is not contingent upon death occurring within a specified period. Such protection may be purchased under either of two principal types of contract: (1) an ordinary life contract, or (2) a limited-payment life contract. The chief difference between the two is the method of payment.

The ordinary life contract assumes that premiums will be paid throughout the insured's lifetime. In the early years, the annual level premium is in excess of the amount required to pay the current cost of the insurance protection, i.e., the current cost of term insurance in an amount equal to the difference between the face amount of the policy and its cash value. The balance that is retained by the company, at interest, produces a fund which is called the cash value of the policy. This cash value reduces the insurance element in later years when the annual level premium would no longer cover the annual cost of term insurance in the face amount. The cash value accumulation continues until reaching the face value of the policy at maturity (which occurs when the insured reaches a specified age, typically age 95 or 100).

Under the limited-payment life contract, premiums are charged for a limited number of years. After the premium payment period, the cash value of the policy, together with interest credited, is sufficient to pay the cost of term insurance protection for the remainder of the period that the policy is in effect. The premium under such a contract will be significantly larger than the aggregate amount of premiums paid during the same period under an ordinary life contract so that the company can carry the policy to maturity without further charges. The extreme case is the single premium whole-life policy.

The insurance element in a whole life policy is the difference between the face amount and the cash value. The cash value that accumulates at interest to maturity of the contract is the investment element in the policy. This savings or investment feature is also characteristic of other permanent plans of life insurance, such as universal life and variable life insurance (see the discussion of these types of life insurance below).

Universal life

Universal life insurance is a product that retains the investment and insurance features of traditional life insurance products, while disclosing the charges for insurance and the interest rate earned to the policyholder. Universal life is distinguished from traditional products in that the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates that may change from time to time above a floor rate guaranteed in the contract.

A universal life insurance policy generally offers the policyholder a choice of the following two basic death benefits: (1) a fixed face amount, or (2) the sum of a fixed amount plus the cash value of the policy as of the death of the insured.

In a universal life policy, the investment element is the cash value that accumulates at interest, which interest may be adjusted above a minimum guaranteed rate to reflect market interest rates to investors.[3] As under a whole life insurance policy, the insurance element of a universal life policy is the difference between the prescribed death benefit and the cash value.

Variable life

A variable life insurance policy incorporates both the investment and insurance elements of traditional whole life insurance policies. The distinguishing feature of variable life is that the cash value of the policy effectively is invested in shares of a mutual fund. Changes in the cash value will reflect the value of assets at the time the cash value is computed. In certain variable life insurance policies, the death benefit may also vary with the value of the underlying investment account.

Premiums from variable life insurance purchase units in a segregated investment account managed by the insurance company. A variable life insurance contract is a security subject to the Securities Act of 1933.

Universal variable life insurance

A recently developed insurance product combines the flexible features of universal life insurance and the investment options of variable life insurance. This new product is referred to as universal variable, variable universal, universal II, or variable II.

A universal variable contract gives the policyholder a choice of funds into which the cash value of the contract can be invested. It also features a flexible arrangement for paying premiums under

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[3] Universal life insurance has been described as having "earned its place in the list of portfolio alternatives . . . [as] a permanently tax sheltered vehicle, offering attractive leverage at death with the essential risk element centered on fluctuating interest rates." Howard I. Saks, "Single-premium Universal Life Draws Attention as Interest Rates Plummet," 12 *Estate Planning* 308, 310 (September 1985). See also "Firms Offering 'Universal Life' in Benefit Plans," *The Wall Street Journal* 31 (May 9, 1985).

which the policyholder can decide how much to apply to insurance and how much to savings, can change the face amount of the policy, and can vary the amount and frequency of premium payments. Often, such a policy provides that a guaranteed death benefit will be paid upon the death of the insured, regardless of investment earnings.

Inside buildup

The investment component of a life insurance premium is the portion of the premium not used to pay the pure insurance costs (including the operating, administrative, overhead charges, and profit of the company). This amount, which is added to the cash value of the policy, may be considered comparable to an interest-bearing savings deposit. The cash value of the life insurance is credited with interest. This amount of interest is called the inside buildup, and under present law it is not taxed as current income of the policyholder.

The life insurance companies reflect the amounts credited to the cash values of their policyholders in computing their life insurance reserves. Increases in insurance company reserves are deductible from insurance company income. Thus, this investment income is not subject to tax when earned at the company or the policyholder level. The tax-free treatment of this income at the company level has been justified as appropriate on the ground that the money really belongs to the policyholder, not to the company.

In many circumstances, the investment income credited to the account of the policyholder is never taxed. For example, the proceeds of the policy paid upon the death of the insured (including investment income credited to the policy) are excluded from the beneficiary's income (sec. 101). Further, the proceeds of life insurance are frequently excluded from the gross estate of the insured (sec. 2042).

Under other circumstances, a portion of the investment income earned may become subject to tax. For example, if a policy is cashed in (or surrendered) in exchange for its cash surrender value, or if distributions are made in some other fashion, these amounts are taxed as ordinary income to the extent that the cumulative amount paid exceeds the policyholder's basis (i.e., the investment in the contract (secs. 72(e)(5)(A) and 72(e)(6)(A))). The investment in the contract is the difference between the total amount of premiums paid under the contract and the amount previously received under the contract that was excludable from gross income. Under these rules, the portion of investment income that was used to pay for term insurance protection is not subject to tax.

The investment income may become subject to tax in certain other instances. For example, any cash that a policyholder receives as a result of an exchange of policies under section 1035 is subject to tax to the extent that there is income in the contract. Similarly, if a distribution is made to a policyholder on account of a reduction in future benefits under a life insurance contract, the distributions may be taxed as ordinary income to the policyholder to the extent there is investment income in the contract.

The investment income also increases the amount that the policyholder may borrow from the life insurance company by using the policy as collateral. Generally, the interest paid by the policyholder on these loans is deductible on the policyholder's income tax return as interest expense. Thus, the policyholder is able to engage in tax arbitrage by deducting currently the cost of investing in a tax-deferred (or tax-exempt) asset.

Administration Proposal

Under the Administration proposal, a life insurance policyholder would include in interest income for a taxable year any increase in the excess of the policy's cash surrender value over the policyholder's investment in the contract during the taxable year. Thus, owners of life insurance policies (other than variable life insurance policies) would be treated as having constructively received any increase in the cash surrender value of their policies (taking into account any surrender charge or penalty). A policyholder's investment in the contract would be equal to the total gross premiums paid less (1) total policyholder dividends and other distributions under the policy, and (2) the total cost of renewable term insurance under the policy.

Policyholders with variable life insurance policies would be treated as owning a pro rata share of the income and assets of the separate account underlying the variable policy. Consequently, the policyholder would not be taxed on the unrealized appreciation of assets underlying a variable policy. A proportionate share of realized gains and other income would be taxed to the policyholder as ordinary income or capital gains, depending on the character of the gains in the separate account. Any explicitly stated surrender charges would be an offset to realized gains and other income.

The Administration proposal would be effective after December 31, 1985, for inside buildup credited to policies issued on or after the date of committee action. In addition, inside buildup would continue to be exempt from tax for policies issued before the date of committee action to the extent the death benefit is not increased above the sum of the level of the death benefit on the date of committee action and any additional death benefit required for the policy to continue to qualify as a life insurance contract for purposes of Federal tax law.

Other Proposals

1984 Treasury report

Under the 1984 Treasury report proposal, owners of any type of life insurance policy would be treated as having constructively received the cash surrender value of the policies. The amount that would be includible in income would be the same as would be included under the Administration proposal for policies other than variable life insurance policies. No difference in treatment for owners of variable life insurance policies was recommended, unlike the Administration proposal.

The investment component of long-term life insurance contracts would be eligible for any general savings incentive available to comparable investments. As a result, the increase in cash surrender value during a taxable year would be permitted to be designated as a contribution to an individual retirement arrangement (an IRA) and would not be treated as taxable interest income to the extent the inside buildup is less than the limit on deductible IRA contributions for the year.

S. 409 and H.R. 800 (Bradley-Gephardt) and H.R. 2222 and S. 1006 (Kemp-Kasten)

Under the Bradley-Gephardt and Kemp-Kasten bills, gross income during a taxable year would include the sum of (1) the increase in cash surrender value of any life insurance contract during the taxable year, (2) policy withdrawals during the year, (3) the cost of term insurance protection provided under the contract during the year, and (4) any policyholder dividends received during the year, to the extent the sum of those four amounts exceeds the amount of premiums paid during the policy year under the contract. If the amount of the premiums paid during the policy year exceeds this sum, the excess premiums paid are carried forward and treated as paid during the next policy year under the contract.

Additional possible proposals

It has been suggested that the tax treatment of life insurance policies could be modified in several ways.

First, the definition of life insurance contained in section 7702, which was enacted in 1984, could be amended to further limit the type of products for which the tax benefits associated with life insurance would be available. Under section 7702, a contract is treated as life insurance if it approximates a traditional single premium policy. Congress could consider limiting the favorable tax benefits to life insurance policies that approximate the traditional level premium pattern. This could be accomplished by amending section 7702 to limit the permissible ratio of cash value to death benefits at any given age on a qualifying contract to the ratio that would exist under a traditional level premium plan of insurance.

Another possible amendment to section 7702 would be to amend the cash value corridor contained in section 7702(d)92). Presently, this corridor permits accumulation of cash values in a life insurance contract in excess of the amount necessary to fund the current death benefits over the life of the beneficiary.

Some have suggested that the Administration proposal could be modified by permitting a limited amount of investment income earned on life insurance policies to be subject to existing tax rules. Amounts credited in excess of this amount would be subject to tax currently. In computing the amount credited to a policyholder, the increase in cash value would be increased by the cost of term insurance protection provided during the taxable year. The annual amount excluded could be either a fixed dollar amount of income, or an amount that would be earned on a whole life policy of a specified face amount for the taxpayer.

An additional modification that has been suggested relates to the ordering rules for withdrawals from life insurance contracts. Under present law, withdrawals generally are treated first as a tax-free return of amounts invested in the contract. Alternative rules such as those applicable to annuity contracts could be applied to life insurance contracts, under which amounts withdrawn are treated first as made out of taxable income.

Analysis

Two basic objectives have been cited as the justification for current taxation of inside buildup: (1) the need to treat the products of each type of financial intermediary equally under the tax laws, and (2) the elimination of the tax deferral (and possible tax exemption) on investment earnings possible with life insurance that benefits primarily higher income individuals. The Administration proposal would accomplish these objectives by separating life insurance contracts into their component parts, i.e., term life insurance and cash value buildup.

Treatment of financial products

Taxing the inside buildup of life insurance policies would eliminate their tax-favored status and would make them more equivalent, for tax purposes, to other types of investment vehicles offered by financial intermediaries. This tax-favored status arises from the tax deferral and potential tax exemption of investment earnings on cash value buildup of life insurance contracts. Such a change would tax the investment component of life insurance contracts in the same manner as the tax treatment under present law of savings deposits or analogous investments in other financial intermediaries.

For example, the individual owner of a bank certificate of deposit is subject to tax on the interest income credited annually to the certificate. The same tax treatment applies to certain other forms of investment, the income on which is reinvested, e.g., the purchase of additional shares in a mutual fund. In addition, for example, interest on zero coupon bonds (and other types of original issue discount obligations) accrues for tax purposes as it is earned, even though it is not actually credited to an account for the owner.

Those who oppose the Administration proposal to tax inside buildup argue that analogies to other investment arrangements offered by financial intermediaries fail to recognize the character and importance of permanent life insurance. First, they argue that the purchase of permanent life insurance is similar to the purchase of a home or other investment under which the appreciation in value is not taxed until the investment is sold. They suggest that comparisons to certificates of deposit or investments in a mutual fund fail to recognize that the savings component of life insurance is a long-term investment.

In addition, some point out that the goal of having individuals maintain adequate death benefit protection should be encouraged through tax incentives. It is argued that, without the existing tax benefits, policyholders would switch from whole life insurance to term insurance coverage. Although policyholders could afford the term insurance premiums while they are young, the costs might not be affordable in later years. This argument assumes that the reduction in premiums resulting from the purchase of term rather than whole life insurance would not be saved to reduce the burden of the increased cost of the needed insurance protection in those later years.

Those who support this view point out that the Administration proposal continues to encourage individual retirement saving by proposing an increase in the spousal IRA deduction limit. They argue that this provision is designed to protect spouses in the event of the death of the working spouse, just as permanent life insurance is designed to protect against the risk of death. Thus, they argue, it would be inconsistent to tax the inside buildup of life insurance.

Limitation on tax deferral

The present law definition of life insurance products places broad limits on the use of life insurance as a tax-favored investment, but it still is possible to design an insurance policy that meets the statutory definition and that provides cumulative investment earnings substantially in excess of cumulative costs of insurance at currently prevailing interest rates. In these situations, the cost of pure insurance coverage is relatively small relative to the inside buildup on the contract.

Supporters of taxing inside buildup argue that the benefits of tax deferral of earnings on investment-oriented life insurance policies are used most extensively by relatively high-income individuals, who save a larger percentage of after-tax income. Some of these policies, when combined with a planned pattern of borrowing by using the policy as collateral on a loan from the insurance company, have been marketed as "risk-free" tax shelters. It is further asserted that middle- and lower-income individuals tend to purchase term insurance (which does not provide an investment component), or a level premium whole life policy with a smaller face amount (which has a smaller investment component). Accordingly, it is argued that the present-law tax treatment of inside buildup of life insurance tends to favor high-income taxpayers, who are able to benefit most from the opportunity for tax sheltering.

There are alternative methods to accomplish the goals of limiting tax advantages currently available to owners of insurance policies. In addition to renewable term insurance, the present-law treatment of whole life policies could be retained if the investment component is used only to help finance level premiums in the later years of the contract. This option would retain the traditional tax advantage of life insurance for most middle-income taxpayers, while eliminating the benefit of tax deferral under flexible premium contracts such as universal life. It also would allow the policyholder to pay a constant premium over the life of the policy, in contrast with term insurance premiums that otherwise would rise steeply for older policyholders.

Under this approach, the tax-preferred treatment of life insurance would be available to the extent the investment income is comparable in amount to the cost of insurance over the life of the policy. It is argued that, under such circumstances, the necessary linkage between the preferential tax treatment and the long-term insurance coverage would be present. By comparison, investment income earned on policies in excess of the cost of insurance coverage under the policy would be taxed to the policyholder. The tax benefits arising under present law for these policies are greater than would occur if the cost of term insurance were made deductible. Alternatively, the rules governing policyholder loans could be made more stringent (see the discussion below relating to policyholder loans), in ways that would reduce some of the motivation for excessive investment orientation in life insurance policies.

Those who oppose any change to the current definition of life insurance argue that present law restricts the design of life insurance products to those designs that have been used for many years. They also argue that the definition of life insurance enacted in 1984 was a carefully crafted compromise that should not be modified until and unless experience shows that it fails to accomplish its objective.

2. Policyholder Loans and Partial Withdrawals

Present Law and Background

Life insurance policies normally permit the policyholder to borrow amounts from the life insurance company up to the cash value of the policy. Until repaid, the policyholder loan reduces the proceeds payable to the policyholder in the event of a surrender of the policy or to the beneficiaries in the event of the death of the policyholder.

For tax purposes, policyholder loans are generally treated as loans and are not treated as withdrawals from the policy, even if the loans are not repaid prior to the death of the insured. Moreover, interest paid on policyholder loans generally is deductible by the policyholder even though the policy's inside buildup has not been included in income.

Interest on policy loans is not deductible if the borrowing is pursuant to a plan of systematic borrowing of the cash value of the policy (sec. 264). This disallowance does not apply if no part of at least four out of the first seven annual premiums is paid with borrowed funds (4 out of 7 rule), or if the indebtedness was incurred in connection with a taxpayer's trade or business.

By comparison, present law provides that a loan from a qualified pension, profit-sharing, or stock bonus plan generally is treated as a taxable distribution from the plan to the extent (1) the loan exceeds a specified amount (the lesser of $50,000 or one-half of the participant's accrued benefit) or (2) the time for repayment exceeds five years. Further, present law treats any loan from a deferred annuity contract as a distribution without regard to the amount of the loan. Loans from individual retirement arrangements (IRAs) are not permitted.

Generally, if a policyholder withdraws cash from a life insurance policy, the taxpayer is treated as recovering first the investment in the policy. Only after the entire investment has been recovered is the excess amount withdrawn subject to tax. However, a special rule in the definition of life insurance provides that, under certain circumstances, if cash is withdrawn from a policy as a result of a reduction of future benefits under the policy, the transaction is treated as an exchange of policies under section 1035. Consequently, the cash will be treated as income (i.e., boot) in an exchange transaction and subject to tax.

Administration Proposal

The Administration proposal does not recommend any specific changes relating to the tax treatment of policyholder loans. It is argued that no special provisions relating to policyholder loans would be needed if the annual increase in the cash value of a life insurance policy would be made taxable.

However, the Administration proposal would generally limit the amount of interest, excluding interest on a principal home mortgage, that could be deducted during a taxable year, to $5,000 above net investment income. This provision could operate to reduce or eliminate the deduction of interest payments on policyholder loans.

Other Proposals

1984 Treasury report

Under the 1984 Treasury report proposal, policyholder loans and partial withdrawals under a life insurance policy would be treated as a distribution of income to the policyholder to the extent of any previously untaxed income credited to the policy at the time of the loan or withdrawal. Policyholder dividends and similar distributions would not be treated as withdrawals under the policy. The amount treated as a taxable distribution would be limited to the excess of the policy's cash surrender value over the policyholder's investment in the contract; a policy's cash surrender value would be determined net of any surrender charge or penalty. The policyholder's investment in the contract would equal the sum of premiums paid for the contract less the sum of the aggregate amount of policyholder dividends and similar distributions, and the total cost of term insurance protection after December 31, 1985.

The proposal would apply to policyholder loans and partial withdrawals made after December 31, 1985. With respect to policyholder loans outstanding on that date, loan balances remaining unpaid on January 1, 1991, would be treated as new loans.

S. 409 and H.R. 800 (Bradley-Gephardt)

Under the Bradley-Gephardt bill, the proposed limitation on the consumer interest deduction could reduce the deductibility of interest paid on a policyholder loan to the extent that the policyholder's total nonbusiness interest (including the amount on a policy loan) exceeds investment income.

S. 411 and H.R. 373 (Roth-Moore)

Under the provision to limit interest deductions by individuals, nonbusiness interest would be allowed as a deduction to the extent that it does not exceed the qualified housing interest for the taxable year. This provision could limit the deduction of interest on a policyholder loan.

H.R. 2222 and S. 1006 (Kemp-Kasten)

No deduction would be allowed for any consumer interest. The term consumer interest would not include interest on indebtedness from which the proceeds were used exclusively on residential housing or to pay educational expenses of the taxpayer and dependents. Depending on the purpose of the policyholder loan, interest payments on the loan might not be deductible.

Additional possible proposal

It has been suggested that policyholder loans on insurance contracts could be treated as taxable distributions of the insurance contract's cash value (to the extent of the inside buildup).

Alternatively, limits similar to the limits on nontaxable loans from qualified pension plans could be placed on policyholder loans, to the extent the loan is made to an individual policyholder.

Analysis

The proposal to treat policyholder loans as taxable distributions (to the extent of cash value) was included in the 1984 Treasury report proposal as a complement to the proposal to tax the inside buildup of life insurance policies. As a result, the tax deferral on inside interest buildup that occurred before the effective date of that proposal would continue only as long as the policyholder did not borrow any portion of the policy's cash value. If the proposal to tax the inside buildup of a life insurance policy is not enacted, it is argued that this proposal to treat policyholder loans as distributions would be needed permanently in order to restrict the availability of tax-deferred amounts for current consumption without a corresponding income inclusion. Similar proposals were considered in connection with the life insurance provisions of the Deficit Reduction Act of 1984.

Some have suggested that life insurance policies with a heavy investment orientation frequently are purchased for the purpose of using the untaxed inside buildup for borrowing. Many such policies are designed so that they satisfy the so-called 4 out of 7 rule to avoid the section 264 limitations on the deductibility of interest on borrowing under life insurance contracts. Other policies are designed for the purpose of borrowing the cash balance for subsequent personal use, whether for college expenses, purchase of a home, emergency medical needs, or a family vacation.

The safe-harbor provisions contained in section 264(c) were designed to permit the deduction for interest on certain nontax-motivated loans. Recently, however, life insurance companies have marketed their plans not only by pointing out the benefits of tax-deferral, but also by emphasizing the present tax benefits under maximum borrowing provisions. Although these plans literally fall within the safe-harbor rules, an investor can obtain substantial tax sheltering of outside income through tax-deductible policy loan interest payments that are funded primarily through tax-free investment earnings on a policy. Some insurance products are now marketed almost solely on the basis of this tax arbitrage opportunity. In light of such marketing activities, the need for any safe-harbor rules arguably should be reexamined.

Some suggest that if the increase in the cash value of a life insurance policy is borrowed on a systematic basis, the arguments used to justify the tax preferred treatment of life insurance are absent. That is, policyholder borrowing results in little or no net cash remaining in the contract, and the inside buildup cannot be used to pay a constant dollar death benefit to the beneficiaries. Thus, the goals of encouraging saving and encouraging provision for one's family through purchase of life insurance are not being served. Similarly, the rationale that inside buildup should not be currently taxed to policyholders as income because it is not received in cash is also no longer accurate in the case of policyholder loans. It is argued that the policyholder has realized the income, since the cash is in the policyholder's possession without restriction on its use. Under this theory, policyholder loans should be taxed currently as distributions and the basis recovery rules should be reversed so that the loan is first treated as income. Such a rule would treat policy loans under a life insurance contract in a manner similar to the current treatment of loans from qualified pension plans and deferred annuities.

Those opposing changes to the rules governing policyholder loans argue that those loans should not be treated differently from other loans. For example, a homeowner is not treated as realizing gain on a home if the homeowner borrows money using the equity in the home as collateral. It is also argued that any stricter rules governing policy loans would discourage individuals from purchasing life insurance even where borrowing is not contemplated.

3. Investment Income on Deferred Annuity Contracts

Present Law and Background

In general

Fixed annuities.—In a fixed annuity contract, the insurance company agrees, for a cash consideration (in single or multiple premiums), to make specified payments during a fixed period or for the duration of a designated life or lives. A deferred annuity is an annuity contract under which the periodic payments begin, if at all, only after a specified period elapses after purchase of the contract. A deferred annuity has two phases: an accumulation phase and a payout phase. An immediate annuity is an annuity contract under which periodic payments begin immediately upon purchase. An immediate annuity only has a payout phase.

Most annuity contracts contain a refund feature stated either in terms of a guaranteed number of annuity payments whether the annuitant lives or dies, or in terms of a refund of the purchase price (or some portion thereof) in the event of the annuitant's early death (prior to the annuity starting date).

When the number and amount of future annuity payments are based on a contingency (e.g., the survival of the annuitant), the contract contains an insurance element. Prior to the annuity starting date, a deferred annuity contract is an investment contract for the accumulation of a principal sum that may be applied to provide periodic payments after the annuity starting date. After the annuity starting date, payments may be a liquidation of the accumulation amount together with interest (fixed term annuity), or of an amount that may be more or less depending on mortality experience (life annuity).

Variable annuities.—An annuity contract in which the amount of each periodic income payment may fluctuate is called a variable annuity. The fluctuation may be related to the market value of certain securities, a cost-of-living index, or some other variable factor.

During the accumulation phase of such a contract, premiums are invested in units of a segregated investment account (similar to the purchase of units in a mutual fund). The cash value of the contract will fluctuate with the increase or decrease in unit value associated with the segregated investment account. At the annuity starting date, the accumulated total number of units credited to the contract are used to fund income payments. Instead of providing for payments of a fixed number of dollars, the variable annuity provides for the payment each month or year of the current value of a fixed number of annuity units. Thus, the dollar amount of each payment depends on the dollar value of an annuity unit when the payment is made. Although the company may assume a mortality risk under a variable annuity for life, the annuitant assumes the entire investment risk. Variable annuities, like variable life insurance contracts, are securities subject to the Securities Act of 1933.

The investment component of a variable annuity contract can be viewed as similar, in many respects, to a product of a regulated investment company (mutual fund, money market fund, etc.).[3a] Generally, as in the case of investors that acquire investment company products, contractholders of variable annuities bear the investment risk. As stated above, a variable annuity for life also contains an insurance element.

Administration Proposal

The owner of a deferred annuity contract would include in income for a taxable year any increase in the excess of the contract's cash value over the owner's investment in the contract during the taxable year. Thus, the owner of such a contract (other than variable contracts) would be treated as in constructive receipt of the cash value of the contract.

The owner of a deferred variable annuity contract would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable contract. As a result, the owner would not be taxed on the unrealized appreciation of assets underlying a variable contract. Explicitly stated surrender charges would be offset against realized gains and other income.

The proposal would become effective for investment income credited after December 31, 1985, to policies issued on or after the date of committee action.

[3a] Deferred annuities have been described as "purely . . . capital accumulation vehicles prior to the commencement of distributions." Richard W. Skillman, "The Impact of TEFRA and the 1984 Act on 'Inside Buildup' Under Life Insurance Products," 43 N.Y.U. Annual Inst. on Fed. Taxation 40 (1985).

Other Proposals

1984 Treasury report

Under the 1984 Treasury report proposal, owners of all deferred annuity contracts would be treated as being in constructive receipt of the cash value of their contracts, without exception for variable annuity contracts. The increased cash value of the contracts would be eligible for any general savings incentive available to comparable investments, e.g., designating the increased cash value as a contribution to an IRA.

Additional possible proposals

Some have suggested that, if the inside interest buildup on deferred annuity contracts is not taxed until distributed, it would be appropriate to make two changes in the tax treatment of deferred annuity contracts.

The first proposed change would be to place a limit on the amounts that an individual can invest in deferred annuity contracts on a tax-favored basis.

The second proposal would be to change the restrictions on withdrawals from deferred annuity contracts to correspond to the restrictions imposed on withdrawals from tax-qualified pension, profit-sharing, and stock bonus plans and IRAs.

Analysis

The Administration proposal has been developed to remove tax deferral as a factor in competition among various investment products offered by financial intermediaries. The proposed change would remove tax benefits that make investments in deferred annuities more attractive than investments in savings instruments offered by other industries. The Administration's proposal reflects the view that the insurance element of a deferred annuity is of minimal importance, compared to the investment element. Some believe that the proposed changes would place various savings instruments on equal competitive grounds, would enhance competition according to the financial benefits that each instrument provides to the saver, and would serve to broaden the tax base.

By proposing different treatment for a variable annuity product, the Administration proposal would distinguish it from a savings deposit and would place the unrealized gain (or loss) on the same competitive grounds as the treatment of an investment in a mutual fund. These are considered to be closely competitive savings instruments because both rely on changes in the value of assets owned by a fund. When the gains are not realized annually, it is difficult to find practical methods of valuation which could be used to make accurate annual adjustments in asset values when current market prices fluctuate. Valuation is not the concern, however, in the case of regular payments such as interest, where it is possible to determine the amount of interest which should be taxed. A broader question is whether nonrecognition of unrealized, accrued capital gains and losses makes these savings instruments more favored than other savings instruments.

Those who argue that limits should be imposed on the amounts that could be invested annually in deferred annuities point out that limits are imposed on most tax-preferred forms of savings that are used for retirement planning. For example, a taxpayer cannot set aside more than $2,000 annually in an IRA. By comparison, there are no limitations currently imposed on the amount that can be invested annually in deferred annuities.

Under current law, amounts withdrawn from an annuity contract before the owner of the contract reaches age 59½ are subject to a 5-percent additional income tax. This penalty is not imposed if the withdrawal takes place over a term of at least 60 months. By comparison, an owner of an IRA is subject to a 10-percent additional income tax for any withdrawal made before the owner reaches age 59½. An exception is made only for withdrawals after the owner's death or disability. Some argue that the penalties for early withdrawal of funds from a deferred annuity contract should be the same as those imposed on withdrawals from other forms of retirement savings, such as IRAs.

Those who oppose the Administration proposal to tax the inside buildup on deferred annuity contracts argue that deferred annuities are unique vehicles for assuring financial security in retirement because, unlike any other form of retirement savings, they guarantee a stream of retirement income that cannot be outlived. They argue that the present tax treatment of deferred annuities should be continued so that individuals will continue to have an incentive to provide for their own retirement income security. They also argue that the tax benefit of deferred annuities is not as generous as the treatment accorded other forms of retirement savings, such as IRAs, because the amounts used to purchase deferred annuities are not deductible.

Supporters of the Administration proposal argue that it is necessary to eliminate, or at least to limit, the extent to which individuals can invest in deferred annuities, in order to encourage broad-based retirement savings programs, such as qualified pension plans. They point out that, if an individual who owns a company can make unlimited investments in deferred annuities, the individual will not have an incentive to provide retirement benefits to employees under a qualified pension plan. Those who support this view argue that it is the tax-free growth of earnings, rather than the current deduction of amounts used to purchase the investment, that provides the greatest tax benefit in the case of long-term savings.

On the other hand, those who oppose the Administration proposal contend that Congress examined the tax treatment of deferred annuities during TEFRA and DEFRA and added restrictions on such annuities to ensure that they would be used for retirement savings purposes. In so doing, they believe Congress articulated its belief that it is appropriate to encourage such retirement savings through tax incentives. Thus, they argue, it is inappropriate to eliminate the tax benefits accorded deferred annuities.

B. Other Insurance Products

1. Deduction for Policyholder Losses

Present Law and Background

A taxpayer generally may deduct a loss sustained during the taxable year and not compensated for by insurance or otherwise (sec. 165(a)). If a casualty or other event occurs which results in a loss, and the taxpayer has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, such as an insurance claim, then the loss may not be deducted until it can be ascertained with reasonable certainty whether or not the reimbursement will be received (Treas. Reg. sec. 1.165-1(d)). Losses due to a casualty that reduces the value of property not used in a trade or business generally will be deductible only to the extent such losses for the year exceed ten percent of the taxpayer's adjusted gross income. Courts have generally held that losses covered by insurance are not deductible (if there is a reasonable prospect of recovery), even if the insurance proceeds are not paid in the year the loss is incurred.

Administration Proposal

Under the Administration proposal, taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. In other words, electing taxpayers would be allowed to deduct the loss in the taxable year the loss is incurred as if the loss were uninsured. Insurance proceeds would be taxable income when received, but an exclusion would be given to the extent of any portion of the loss that was not previously deductible. Present law would continue to apply to nonelecting taxpayers. The proposal would be effective for all losses incurred in taxable years beginning after 1985 that are insured under policies issued after 1985.

Analysis

Those in favor of this proposal assert that it takes account of the time value of money in circumstances where a taxpayer sustains an otherwise deductible loss which is covered by insurance, but the insurance claim is not paid until a year subsequent to the year when the loss was sustained. Under present law, the amount of the claim, when ultimately paid, generally would not reflect the income lost because the insured did not have the use of the money (i.e., the insurance proceeds) from the time the loss was incurred until the time the claim was paid. The insurer, not the insured, would receive the benefit of that income unless a current loss deduction were permitted, as set forth in the proposal. If the Administration's qualified reserve account system were enacted, the lost income of the insured for which a current deduction would be permitted would essentially be offset by income taxed to the insurer under the qualified reserve account method.

Opponents of the proposal would argue that it is inappropriate for taxpayers' loss of income on the amount of the insurance reimbursement to be deductible when the income has never been subject to tax. A more appropriate solution, some argue, would be for the insurer to take account of income earned in the period between occurrence of the loss and payment of the insurance claim for it by adjusting the amount of the payment.

Opponents also argue that the proposal would not eliminate the discrepancies in the tax treatment of commercial and self insurers. For example, premiums for business related insurance would in many cases be deductible, whereas amounts set aside for self-insurance would generally not be deductible.

Even where commercial insurance is not purchased in the context of a business, unintended discrepancies in tax treatment could arise between taxpayers under the Administration proposal. Present law limits the amount of a loss deduction to the taxpayer's basis in the property; thus, taxpayers with a low or zero basis in property would be entitled to a negligible or zero loss deduction, yet others might be able to deduct the full cost of the property in the year of loss. Another limitation is imposed on nonbusiness casualty loss deductions: to be deductible, the amount of the loss must exceed ten percent of the taxpayer's adjusted gross income. Taxpayers not meeting this requirement would not be able to deduct losses currently. Those who oppose the Administration proposal argue that the change in treatment of policyholder losses should not be adopted unless a conscious decision is made to coordinate the tax treatment of commercial insurance, self-insurance arrangements, and uninsured losses.

2. Structured Settlements

Present Law and Background

Present law excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments (sec. 104). Under this exclusion, a person who recovers damages for an injury is not subject to tax on the amount he receives. The person liable to pay the damages may assign to a third party (a structured settlement company) the obligation to pay the periodic payments. The portion of the amount received by that third party for agreeing to the assignment that is used to purchase assets to fund the liability is not included in that party's income (sec. 130).

Generally, the structured settlement company purchases an annuity (referred to as a qualified funding asset) to fund its obligation to make periodic payments. The basis in the qualified funding asset is zero and any gain recognized on disposition of the asset is treated as ordinary income. However, the structured settlement company is entitled to a corresponding deduction for payments to the injured party.

The overall effect of these rules is that no taxpayer is subject to tax on the investment income earned on assets used to fund the periodic payment of damages for personal injuries.

Administration Proposal

Under the Administration proposal, third-party assignees of liabilities to make periodic personal injury damage payments would include the full amount of consideration received from the assignor in gross income. An assignee purchasing an annuity contract to fund its liabilities to an injured party would be treated as the owner of the annuity and would be taxed on the income component of all amounts paid to it under the terms of the annuity contract. The assignee would be given an election concerning the tax treatment (i.e., the timing of its deduction). First, it could elect to treat the purchase of an annuity used to fund its liabilities to an injured party as a deductible expense at the time of the purchase. Second, it could instead treat each payment to the injured party as deductible at the time the payment is made. As a result, under the proposal, the third party assignee would be taxable on the investment component of payments to the injured party. The proposal would be effective for all assignments entered into after 1985.

Analysis

Supporters of the Administration proposal assert that the current tax rules erode the tax base and create an incentive that subsidizes the liability of tort feasors, rather than assisting the innocent victims. Under a structured settlement, an injured party receives periodic cash payments which are not subject to tax. If this party had received a lump sum settlement of the claim, the settlement demanded would have to be sufficient to produce larger periodic cash payments, since the investment income on these payments generally would be subject to tax. It is argued that the overall effect of structured settlements appears to be a significant reduction in the amount the wrongdoer must pay to satisfy the claim against it.

Some argue that the overall cost in lost revenues far outweighs the advantage in increased efficiency of claim resolution under structured settlements. Furthermore, while an exclusion from income for the amount of personal injury damages is appropriate, they argue that Congress did not intend that injured persons also receive tax-free investment income on the annuity contract used as a funding vehicle for the entire period over which they are paid damages. Income on the contract is taxed to no one, and they believe this exclusion merely serves to enrich structured settlement companies. Thus, the provision constitutes an increasingly significant tax expenditure which is not appropriately targeted, and should therefore be changed.

Additionally, those who support the Administration proposal point out that the premature accrual rules added by DEFRA, which reduce the tax benefits of self-insuring tort liabilities, have exacerbated the tax incentive to utilize structured settlement agreements. Consequently, they argue that it is appropriate to repeal the structured settlement provisions to coordinate the tax treatment of tort liabilities.

Advocates of the existing tax structure of structured settlements support the complete exemption of investment income under section 104 on periodic personal injury damage payments. They suggest that the rules for structured settlement agreements were enacted in 1982 in conjunction with the periodic payment rule of section 104 to encourage parties to personal injury litigation to settle claims in a manner that would prevent injured parties from dissipating lump sum awards. By use of structured settlements, the injured parties would be assured a source of income to support themselves for a substantial period of years. They assert that the tax incentive (i.e., the exemption of investment income) by which it is effected should be retained.

II. TAXATION OF LIFE INSURANCE COMPANIES

A. Reserves

Present Law and Background

Life insurance companies generally are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves in a calendar year. The deduction for an increase in reserves takes into account increases due to both premiums and interest credited to the reserves. The net increase (or net decrease) in reserves is computed by comparing the closing balance to the opening balance for reserves in the same year.

For purposes of determining life insurance company taxable income, life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under federally prescribed rules. In computing the federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used along with the prevailing State assumed interest rate and the prevailing National Association of Insurance Commissioners ("NAIC") standard tables for mortality or morbidity. Companies generally are allowed, under these rules, to recognize the minimum reserve that most States would require them to put aside, but no more than that amount unless the net surrender value is greater. To avoid State-by-State variations, the rules prescribed in the Code are based on the general guidelines recommended by the NAIC and adopted by a majority of the States.

For life insurance contracts, the Commissioners' Reserve Valuation Method (CARVM) that is in effect when the contract is issued must be used. The interest used to accrue growth of the reserve must be the prevailing State assumed interest rate, which means the highest assumed interest rate permitted in at least 26 States as of the beginning of the calendar year in which the contract is issued. Mortality tables describe the probability of death at each annual age, based on historical experience, and the Code requires use of the most recent tables prescribed by the NAIC for life insurance contracts which has been permitted in at least 26 States. Companies are allowed a three-year lag after adoption by 26 States before a new mortality table is required for Federal tax purposes.

Administration Proposal

Under the Administration proposal, the reserve held for any life insurance contract would be limited generally to the net cash surrender value of the contract. Thus, a life insurance company would be allowed annually to add to its reserves, policy by policy, only the amount that the net cash surrender value increases. This recommendation would become effective with respect to policies sold after December 31, 1985.

The Administration proposal would provide a special rule that deals with current annuity contracts that may not be surrendered for cash.

Analysis

Under the Administration proposal, a life insurance company would be allowed to deduct only the increase in policyholder reserves for which it currently becomes liable. Analogously, the proposal to tax the inside buildup of the policyholder's investment in a policy also is essentially an attempt to assure that the income reflected in the increased cash surrender value of the contract would not escape taxation at both the company and policyholder levels. The proposal to tax the policyholder share of the cash buildup includes recommendations to protect the policyholder's investment in the contract from taxation.

Supporters of the Administration proposal believe that this proposal would make the income tax treatment of life insurance companies and depository institutions more equal. It has contended that the proposal would measure life insurance company taxable income more accurately. If this change were enacted, companies could either raise premium charges in order to continue earning similar after-tax profits or could accept lower after-tax profits in the event premium increases would be considered inadvisable.

Present Federal tax law partly reflects the concern of State regulatory authorities that life insurance companies hold adequate reserves to meet their potential liabilities. That concern, which has historical antecedents in the early years of State regulation, is met by computing reserves on the basis of conservative mortality tables and assumptions about long-term interest rates. However, required use of the least conservative assumptions limits the extent to which overstated reserves would lead to tax deferral. The focus of those who support the Administration proposal is primarily on the amounts needed to make cash payments under all life policies and treats the cash value of each life insurance policy as a form of savings deposit that may be withdrawn, or borrowed against, at any time. Alternatively, supporters can be viewed as asserting that the cash value is the best estimate of the present value of the insurance company's future liabilities.

In viewing the purpose of life insurance reserves in this way, some contend that the present law treatment of reserves leads to excessive tax deferral and reduced effective tax rates for life insurance companies or higher after-tax profits.

The proposed treatment of life insurance company reserves is consistent with the Administration proposal to revise present-law treatment of bad debt reserves of commercial banks and thrift institutions and to limit their deductions for losses on loans to actual payments. The Administration proposal would also limit the reserve deductions of property and casualty companies. Some believe that the Administration proposal to limit life insurance company reserve deductions and to tax the inside buildup on life insurance is essentially equivalent to the proposed qualified reserve account

(QRA) method for property and casualty insurance. Thus, they argue that these changes would create a more level playing field among all financial intermediaries by establishing equivalent tax rules for related entities and products.

Critics of the Administration's proposal argue that it fails to reflect the correct present value of the company's future liabilities under their policies. In essence, they argue that the Administration's proposals ignore the long-term insurance function of the companies.

Those who oppose the Administration proposal argue further that change in the treatment of reserve deductions for life insurance companies is inappropriate in light of the overall restructuring of life insurance company taxation in 1984 under DEFRA. They point out that DEFRA removed the discretion that life insurance companies previously had in computing reserves, while retaining a recognition of reserves as an obligation for future insurance benefits. They agrue that a fundamental change in the tax treatment of these companies should not be made without a reevaluation of the impact of such a change on the careful balancing of the DEFRA provisions on the various segments of the life insurance industry.

B. Special Deductions

Present Law

A life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI). A special life insurance company deduction and a small life insurance company deduction each result in a reduction of the tax rates on LICTI. These deductions were enacted in 1984 as part of the Life Insurance Company Tax Act[4] because it was believed necessary to ameliorate the sudden, substantial increase in a company's tax base. The change occurred because a three-phase taxable income computation that was in effect previously provided many forms of tax deferral which were replaced with a single-phase system consistent with generally applicable corporate tax law.

The small life insurance company deduction is taken first as a deduction from the tentative LICTI, i.e., LICTI before special deductions. This deduction is 60 percent of tentative LICTI up to $3 million, and it is reduced by 15 percent of tentative LICTI that exceeds $3 million. The maximum deduction allowed is $1.8 million, and it phases out so that it becomes zero at $15 million. Only life insurance companies with gross assets of less than $500 million are allowed to take this deduction, and all life insurance companies that are members of the same controlled group are treated as one company, eligible for one small company deduction; the deduction is allocated proportionately among the members of the group which have a positive tentative LICTI.

A life insurance company is also allowed a special life insurance company deduction of 20 percent of its tentative LICTI (in excess of the small company deduction) for any taxable year. General corporate tax rates—graduated through $100,000 and 46 percent above

[4] Title II of the Deficit Reduction Act of 1984.

that amount—then apply to LICTI after reduction by the deductions. As is true for the small company special deduction, members of a controlled group that are taxed as life insurance companies are treated as one company. The special deduction applies only with respect to income resulting from a company's life insurance business. Special rules were enacted to distinguish life insurance business income eligible for the deduction from other income of a life insurance company.

Administration Proposal

Under the Administration proposal, the special life insurance company deduction and the small life insurance company deduction would be repealed for taxable years beginning after December 31, 1985.

Analysis

The Life Insurance Company Tax Act of 1984 was intended to be a restructuring of the income taxation of life insurance companies. In the process of restructuring, many tax deferral provisions were repealed and, consequently, the life insurance industry would have been subject to a substantial increase in tax liability. Special deductions were added to the Act in order to reduce its impact on the taxable income of life insurance companies. In addition, these special deductions were designed to produce a tax burden on life comparable to that imposed on other financial intermediaries. Those who support the Administration proposal argue that, as the special provisions that reduce the taxes of the competing financial institutions are eliminated, any claimed need for the life companies' special deduction because of inter-industry competition disappears.

The Administration proposes to repeal these provisions because they are inconsistent with the general theme of the proposals to bring about general base-broadening by eliminating special tax deferral devices and to treat competing financial activities equally.

Increases in tax liability that would result from repeal of the special deductions and the subsequent rise in taxable income would be offset to some extent by the proposed reduction in the corporate income tax rate from 46 percent to 33 percent.

Opponents of the Administration proposal contend that the special deduction for life insurance companies is an integral part of the DEFRA provisions restructuring life insurance company taxation, which should not be altered until the new provisions are given time to work. They argue futher that the special deduction replaced a number of prior-law deductions, which recognized that the long-term nature of the life insurance business makes an annual measuring of economic income difficult.

Finally, those oppose the Administration proposal agrue that the small life insurance company deduction should not be repealed because it would increase dramatically the tax burden on small life insurance companies and would affect the relative tax burdens, of various segments of the life insurance industry.

III. TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES

A. Background

The theory of insurance

The classic purpose of insurance, including property and casualty (also referred to as property and liability) insurance, is to pool the probable cost of the same types of risks of loss over a large number of policyholders (whether individuals or businesses). Where an insurance pool is operated by an insurance company, the total premiums (plus income earned on premiums invested) should equal the total amount paid under the terms of the policies (plus necessary operating costs and profits of the insurance company).

In determining the premium to be charged to its customers, an insurance company attempts to calculate the amount that will be sufficient, with interest earnings, to pay the policyholder's pro rata share of costs, which include the benefits paid to all policyholders, operating costs, and profits of the insurance company. The company estimates the amount that will be paid to policyholders for a group of losses on the basis of historical experience relating to the incidence and the value of the losses incurred. This experience is used in projecting the probability of a loss and the amount of potential liability. Although any one policyholder faces a random likelihood of experiencing an insured loss, in the case of a large group of policyholders, it is possible to make a more accurate prediction of the average policyholder loss.

The company's objective is to estimate its payments over the period during which the risks are pooled so that there is a balance of receipts and disbursements (including profit). If perfect balance were achieved, insurance companies would be simply providing a service to the policyholders and not bearing any risk. Perfection, however, is not achieved, and insurance companies may bear risks that extend into the future, because the estimates are uncertain, new theories of liabilities may develop under the law, inflation may increase the amount of any loss, or investment earnings may fall short of expectations.

Characteristics of the industry

Property and casualty insurance companies in 1983 held more than $249.1 billion in assets, which were invested primarily in tax-exempt and taxable bonds and common stock. Premium receipts were $93 billion in that year.

From 1974 to 1983, net income before taxes (and before dividends to policyholders) of all property and casualty insurance companies varied between $76.6 million and $8.6 billion. During this period, the average annual rate of return in the property and casualty industry was 11.3 percent, but the annual rates of return varied between 2.4 and 19.0 percent.[5] In comparison, the average rate of return for all industries during the same period was 13.2 percent. In 1984, the property and casualty industry reported a net loss (rather than an underwriting loss) of $3.8 billion (after dividends to policyholders).[6]

Worldwide premium volume (outside of Eastern European Bloc countries) was about $466 billion in 1982. The United States share of the world property and casualty insurance market is the greatest among all countries at about 48 percent of the worldwide volume in 1982, which is greater than the combined premium volume of the next 19 largest insurance-writing countries.

In the United States, approximately 44 percent of insurance written by property and casualty companies covers automobile liability and physical damage. A large portion of this insurance (about 84 percent) covers private passenger automobiles. Workers' compensation is the next major line of property and casualty insurance at approximately 13 percent, and home and farm owners' multiple peril insurance is the third largest category at 12 percent of the total. Approximately 3 percent of the premium volume in 1983 was attributable to accident and health insurance. Other lines of property and casualty insurance include inland ocean marine coverage, commercial multiple peril, surety and fidelity, burglary and theft, crop and hail, boiler and machinery, glass, aircraft, accident and health, and liability and property damage nuclear insurance.

Many property and casualty insurance losses are not paid during the year in which the loss is incurred. For some types of property and casualty insurance business, such as automobile property damage insurance, the time between occurrence of the loss and payment of the claim is quite short and the business is referred to as short tail. On the other hand, for certain types of business, such as medical malpractice insurance, the period of time between occurrence of the loss and payment of the claim can be quite long. In this case, the business is referred to as long tail.

The following table shows the time patterns of loss payments for various major lines of business of the property and casualty insurance industry:

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[5] See *1984–85 Property/Casualty Fact Book*, Insurance Information Institute (1984), at 20. These rates of return are based on Generally Accepted Accounting Principles (GAAP) so that comparison to other industries will be relevant. However, the figures are generally estimates because many insurance companies do not report on the GAAP basis.

[6] A.M. Best Company, Inc., *Best's Aggregate and Averages* (1985).

Time Pattern of Loss Payments by Major Lines of Business of Property and Casualty Insurance Companies, 1975 to 1983 Experience

Time between payment and loss	Payments as Percent of Losses Incurred by Line of Business [1]					
	All policies	Auto liability	Other liability	Medical malpractice	Workers' compensation	Multiple peril
Same year	36.7	36.0	12.1	5.8	27.4	56.2
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 year	10.5	14.4	11.4	9.0	12.7	5.1
3 year	8.3	9.0	13.1	12.1	8.8	4.5
4 year	4.6	4.5	9.9	10.3	4.9	2.3
5 year	3.2	2.6	8.3	10.6	3.6	1.4
6 year	2.4	1.2	7.0	8.1	2.9	1.3
7 year	1.4	0.9	6.5	3.3	1.4	0.7
8 year or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred [2]	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

[1] As an example of how to read this table:
81.6 percent of total losses and loss expense incurred on all policies in 1980 were paid by the end of 1983 (36.7+26.1+10.5+8.3). Only 73.3 percent of total losses and loss expense incurred on all policies in 1981 were paid by the end of 1983 (36.7+26.1+10.6). Assuming constant payment streams across years, 8.3 percent of losses and loss expense incurred are paid in the third year following the year in which the loss was incurred.

[2] The payment stream is discounted at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because the payments eight years or later are discounted for only eight years, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

Source: Office of the Secretary of the Treasury; unpublished tabulations from Schedule P of the insurance companies' annual statement from A. M. Best Company.

Property and casualty insurance can be written on either an occurrence basis or a claims made basis. If insurance is written on an occurrence basis, the property and casualty insurer agrees to indemnify policyholders for all losses occurring during the period of coverage. For example, if a doctor is covered by medical malpractice insurance written on an occurrence basis and the event giving rise to the loss occurs in the period of coverage, the insurance company will cover the loss even if the claim by the injured patient is not made until several years later.

On the other hand, if insurance is written on a claims made basis, then the property and casualty insurer is liable only for losses for which claims are actually made during the period of coverage. Generally, the period between the earning of a premium and the payment of the loss will be shorter when business is written on a claims made basis rather than on an occurrence basis.

The trend in certain long-tail lines of business, such as medical malpractice or commercial liability, is to write business on a claims made basis. The reason for this trend generally is that it is easier to price premiums for insurance written on a claims made basis.

State regulation of property and casualty insurance companies

Generally, insurance companies are regulated by the States to protect the policyholders and other intended beneficiaries of the policies of the companies. The nature of insurance generally requires that a policyholder pay premiums in advance of the period for which insurance protection is to be provided. If an insurance company is to satisfy its obligations to its policyholders, the insurer must have sufficient assets to satisfy the claims arising under its policies.

Today, all States have insurance regulatory agencies. The insurance commissioners, through their national organization, the National Association of Insurance Commissioners (NAIC), have achieved a degree of uniformity in insurance laws and regulations.

Some States regulate premium rates. Generally, these rules require that rates be adequate, reasonable, and not unfairly discriminatory. All States, however, do not follow the same practice with respect to rate setting.

States also regulate the type of investments that an insurance company may make in order to provide for company solvency and liquidity. In some States, a property and casualty insurance company chartered by the State is required to invest an amount equal to minimum capital requirements in Federal, State, or local government bonds, or bonds or notes secured by mortgages or deeds of trust on improved, unencumbered real estate. In such States, assets equal in value to 50 percent of unearned premium and unpaid loss reserves also must be invested in restricted securities of similar high quality. These requirements apply both to companies chartered by the regulating State as well as companies chartered elsewhere but operating in that State. Insurance companies may also invest their surplus (i.e., their assets in excess of minimum capital requirements and reserve liabilities).

In evaluating the solvency of insurance companies, the principal liability to be taken into account is the reserves that must be established to satisfy liabilities arising under a company's policies. Reserves must be established for unpaid losses and unearned premiums. Unpaid losses are claims arising as a result of insured events that have already occurred, but that have not been paid. These losses include provisions for claims that have been incurred but not reported (IBNR), as well as for claims which have been reported to the company but have not been paid. The ultimate cost of each claim is not always known precisely, and various estimating procedures have been created to determine the necessary reserves. Unearned premiums represent the amount of premiums that have been paid or collected in advance, but that are allocable to a future period of protection. Reserves for unearned premiums are computed generally on the basis of gross premiums and do not take into account any deduction for expenses already incurred or paid.

Historical background of taxation of property and casualty industry

A company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies is taxed under specific provisions of the Code (subchapter L) that are applicable solely to insurance companies. Insurance companies have traditionally taken two primary forms of ownership: stock and mutual. Stock companies are owned by their shareholders, while mutual companies do not have shareholders per se but rather are owned by the policyholders. For tax purposes, insurance companies generally have been classified into four groups: (1) life insurance companies[7]; (2) mutual insurance companies (other than life), and certain marine insurance companies and certain fire or flood insurance companies; (3) insurance companies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies; and (4) insurance-type entities that are exempt from tax under section 501(c), such as fraternal beneficiary societies, voluntary employees' beneficiary associations, local benevolent life and mutual associations, and certain mutual insurance companies other than life or marine.

Stock property and casualty insurers have been subject to virtually the same tax rules since 1921. Gross income of these companies includes underwriting income, investment income, and gains and losses (to the extent deductible by other corporations) from sales of assets. Special rules have been added defining the underwriting income of these companies. Under these rules, inclusion of premium income may not occur when it is received, but is generally deferred until premiums are earned. Losses incurred are allowed as current deductions on the basis of estimates as to their occurrence and their amount.

Before 1942, most mutual property and casualty insurers were exempt from taxation. Mutual insurers that were not exempt from taxation were taxed in the same manner as corporations, with certain special deductions. From 1942 through 1962, a formula approach to the taxation of mutual insurance companies did not take underwriting income or loss into account. Generally, the tax of these companies was the higher of (1) a tax at regular corporate

[7] Sec. 816(a) provides a special definition of a life insurance company.

rates on net investment income, or (2) a tax of one percent of gross investment income and net premium income reduced by tax-exempt interest and policyholder dividends. Capital gains were not included in this calculation.

Since 1963, the tax treatment of mutual insurance companies has been similar to the treatment of stock insurance companies (i.e., companies listed in category (3), above), but mutual insurance companies have been allowed to defer tax on a portion of their underwriting income.

Stock property and casualty insurance companies

Stock companies are subject to tax under rules similar to those applicable to ordinary corporations, although this result is accomplished through two special provisions in the Code which override the general corporate taxation provisions (secs. 831 and 832). The primary difference between the taxation of a stock property and casualty insurer and other taxpayers is in the timing of the inclusion of premiums and the allowance of deductions. Rather than following the generally applicable Federal tax accounting rules, the taxation of insurance companies generally follows State insurance department accounting rules.[8] Thus, the Annual Statement filed with State regulatory authorities is the governing standard for determining the timing of taxable income.

Although the courts have described property and casualty companies as accrual method taxpayers, there are significant exceptions to the accrual rules. For example, under the usual rules, income must be accrued at the earlier of (1) the time all events have occurred that determine the right to income and the amount of income can reasonably be ascertained, or (2) the time the income is received and is subject to the recipient's control. Property and casualty insurance premiums, however, are included in income only as earned and not when payment is received. Generally, unearned premiums are those amounts that cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Thus, in comparison to other taxpayers, property and casualty insurers do not recognize income at the time premiums are paid.

Expenses generally are deductible by accrual method taxpayers when all events have occurred that fix the fact of liability and the amount of liability can reasonably be ascertained. Further, certain expenses are not considered to have accrued before the time that economic performance has occurred. For example, in the case of a liability of the taxpayer that requires payment to another person and arises out of any tort, economic performance occurs as the payments to such person are made. Insurers, however, may deduct estimated losses and expenses on the occurrence of an insured event, even though the liability is not fixed or determinable and may be contested by the insurer. Whether an insured event has occurred may be estimated on the basis of the same statistical population and distribution that provides the basis for insurance. Frequently,

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[8] Compare *Western Casualty and Surety Co.* v. *Commissioner*, 571 F.2d 514 (10th Cir. 1978), aff'g, 65 T.C. 894 (1976), and footnote 24 in *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148, 161 (1977).

a deduction will be allowed prior to the time that economic performance has occurred.

Taxpayers generally may not deduct an amount if the expenditure is considered to be a capital expenditure. However, insurers are permitted to deduct acquisition expenses such as agents' commissions and premium taxes in the year a policy is issued rather than over the term of the policy or the expected life of the policy and renewals.[9]

Mutual property and casualty companies

Since 1963, the taxation of mutual property and casualty insurance companies has been similar to that of stock companies with two major distinctions. First, certain mutual companies are permitted to defer a portion of underwriting income, which is accumulated in an account called the Protection Against Loss (PAL) account. This account does not represent an actual reserve established by the company on its books or a specific allocation of assets to be held as protection against losses. Generally, use of the PAL account does not result in a permanent deferral, but rather permits the company to defer taxation of a portion of its income for a given taxable year for up to five years. Amounts added and withdrawn annually from the PAL account may, in effect, maintain a constant level of deferred income in the PAL account.

Second, certain small mutuals are exempt from income tax or are taxed only on investment income.

The case law and Internal Revenue Service rulings have identified the following criteria as indicative of mutuality:[10]

(1) there is common equitable ownership of the company by its members;

(2) the policyholders have the right to be members to the exclusion of others and to choose the management;

(3) the company's sole business purpose is to furnish insurance substantially at cost; and

(4) the members have the right to the return of premiums which are in excess of the amount needed to pay losses and expenses.

[9] *See* Rev. Rul. 70-552, 1970-2 C.B. 141, and Rev. Rul. 82-69, 1982-1 C.B. 102.
[10] See, e.g., Rev. Rul. 74-196, 1974-1 C.B. 140.

B. Property and Casualty Insurance Company Taxation

1. Reserve Deductions

Present Law and Background

Under present law, the taxable income of a property and casualty insurance company (whether stock or mutual) is the sum of its underwriting income or loss and its investment income or loss. In computing its underwriting income, the company may deduct from its gross premiums the "losses incurred" for the taxable year (Code sec. 832(c)(3)). Another item deducted is the increase in "unearned premiums" for the year (sec. 832(c)(4)(B)). Both of these items reflect the accounting conventions generally imposed under State law.[11] These accounting conventions require the establishment of reserves for losses incurred and for unearned premiums.

State law reserve requirements generally are intended to promote insurance company solvency rather than to provide an accurate measure of economic income for any given year. As a result, these rules do not take account of the difference between the time the reserve for losses incurred is to be established (i.e., the year in which the event covered by insurance occurs) and the time when the items are released from the reserve (i.e., the year in which claims are satisfied or otherwise extinguished). Thus, the amount initially included in the reserve is generally equal to the amount which it is estimated will be paid as a claim in a future year, without any reduction to take account of the income earned on the reserve assets in the intervening period.[12]

Since the tax deduction for losses incurred is based on the statutory measure of losses incurred, the timing of the tax deduction also does not take account of the difference in time between the year when the insured event occurs and the year when the claim is satisfied.

The amount deductible as an addition to a reserve for losses incurred includes several categories. All of them reflect insurance losses which have not been paid by the company. First, losses incurred include claims arising from insured events that have occurred and been reported to the insurance company, but which have not yet been satisfied by payment to the claimant. Thus, losses incurred include those which may be still in litigation. In addition, losses incurred include the category of losses which have

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[11] See National Association of Insurance Commissioners ("NAIC")-approved annual statement form (often called the yellow blank) used by property and casualty insurance companies for financial reporting. The accounting techniques used in preparing this annual statement are referred to as statutory accounting principles (SAP), and generally are more conservative than generally accepted accounting principles (GAAP) and the cash and accrual methods of tax accounting.

[12] In the case of claims for losses incurred, the amount added to the reserve is the company's estimate of the probable amount of the losses which will be paid.

been incurred but not reported ("IBNR" losses). The company lacks specific information concerning the occurrence of the insured event giving rise to IBNR losses; thus, this component[13] of the addition to reserves for losses is, of necessity, an estimate.[14] Thus, in effect, a property and casualty insurance company may deduct, as additions to reserves, the full amount of actual and estimated insurance losses it expects to pay, and the deduction is allowed in the year the losses are incurred or are estimated to have been incurred, rather than the year in which they are paid or have accrued under generally applicable principles of tax accounting.

Administration Proposal

Under the Administration proposal, a property and casualty insurance company's deduction for unpaid losses with respect to a line of business during a taxable year would be limited to the amount it credits to a "qualified reserve account" ("QRA") for that line of business.

Any amount can be credited to a QRA at the close of any taxable year.[15] If the total amount credited to a QRA exceeds the statutory reserves for unearned premiums, IBNR losses, and claims filed (for the line of business for which the QRA is established) in any year, the excess must be currently included in the company's income. The Administration's QRA proposal would not require a company to discount its reserve deduction to take account of the difference in timing between the deduction for the loss and the payment of the claim. The Administration proposal would accomplish essentially the same result as discounting deductions to reflect the time value of money, by providing that each QRA reserve established by a company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. No additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

A QRA would merely be a bookkeeping entry and a company would not be required to set aside assets in an actual account. A separate QRA would be required for each line of business of the company.

In determining the amount to be added to each QRA for the year, the company's after-tax rate of return during a given taxable year would be calculated as the total net investment income of the company (including tax-exempt income) for that year, reduced by taxes attributable to that income, divided by the average total surplus and reserves of the company for the year. To the extent a

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[13] Other components of the reserve deduction are also estimated.

[14] Under the normal rules of accrual method tax accounting, the all-events test must be met before a deduction may be accrued. The all-events test provides that "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy (Treas. Reg. sec. 1.461-1(a)(2)). In addition, under the all-events test, a contested liability may not be deducted unless the taxpayer has transferred money or other property beyond his control to provide for the satisfaction of the liability (sec. 461(f)). In addition, an accrual method taxpayer may not generally accrue a deduction before the time economic performance has occurred (sec. 461(h)). In the case of workers' compensation and tort liabilities of the taxpayer, for example, economic performance occurs as payments are made to satisfy the liability.

[15] This description reflects Treasury Department modifications to the Administration proposal since its publication in May 1985.

property and casualty insurance company is able to increase its after-tax income through investment in tax-exempt securities, its reserves would grow more quickly. This would require the company either to take smaller initial reserve deductions or realize greater income from the release of reserves when the amounts credited to a QRA exceed the statutory reserves.

Under the Administration proposal, a company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate QRA. Thus, if the reserve was insufficient to cover all claims, the excess claims would produce a net deduction when paid.

The proposal would be effective for all losses incurred in taxable years beginning after 1985 that are insured under policies issued after 1985.

Other Proposals

1984 Treasury report

Under the 1984 Treasury report proposal, a company would be required to use a reasonable discounting method for calculating its deduction for unpaid losses (unlike the Administration proposal, which does not require discounting). Thus, a company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's after-tax rate of return on its investment assets. A company would establish separate discounted loss reserve vintage accounts for each line of business for each year, for purposes of determining its deduction for losses incurred under the 1984 Treasury report proposal. These vintage accounts would be closed out after a specified number of years, and reserve amounts in excess of claims paid would be included in the company's income.

GAO report

In a 1985 report, the General Accounting Office (GAO)[16] proposed that, in order to assure that the property and casualty insurance industry's revenues and expenses are more closely matched for purposes of measuring taxable income, the amount of loss reserves should be discounted in calculating the loss reserve deduction. Under the GAO report, the discount rate would be based on a five-year moving average of each company's pre-tax net return on its investment portfolio. The GAO asserts that use of the moving average would avoid fluctuations that could occur from year to year if only an annual rate were used. Income earned on the initial reserve amount in each subsequent year (determined in accordance with this average pre-tax rate of return) would be added to the initial reserve, and deducted for tax purposes, thus exempting from taxation this amount of income earned on the initial reserve. The GAO report recommends appropriate phase-in procedures to miti-

[16] General Accounting Office, *Congress Should Consider Changing Federal Income Taxation of the Property/ Casualty Insurance Industry (GAO/GGD-85-10), March 25, 1985.*

gate a large one-time transitional tax increase due to discounting reserves. The GAO proposal, when fully phased in, would raise less revenue than the QRA proposal over the long term.

Analysis

Both the 1984 Treasury report and the GAO report recommend the discounting of unpaid loss reserves for purposes of determining the amount deductible as losses incurred by a property and casualty insurance company. The Administration proposal does not require the discounting of reserves, but offers an alternative approach that produces a result that is similar, in economic terms, to the 1984 Treasury report proposal.

Some of the issues that have been raised with respect to the Administration proposal, as well as the 1984 Treasury report and the GAO report, include the following:

(1) whether it is appropriate to reflect the time value of money in unpaid loss reserve deductions for Federal tax purposes when statutory accounting does not require companies to reflect the time value of money;

(2) whether the proposals constitute an application of the cash method of accounting and whether it would be appropriate to do so;

(3) whether the proposals amount to a double tax on investment income or a tax on tax-exempt income;

(4) whether the proposals will cause property and casualty insurance companies to shift the additional tax burdens to policyholders through premium increases;

(5) whether the proposals will cause increased foreign competition from insurers and reinsurers not subject to U.S. tax and adversely affect the balance of trade;

(6) whether the proposals create additional complexity in the tax law and impose an administrative burden on taxpayers;

(7) whether, under the proposals, the capacity of U.S. insurers to offer property and casualty insurance will decline;

(8) whether it is appropriate to consider reducing the differences in tax treatment between commercial property and casualty insurance and self-insurance;

(9) whether a premium tax should be considered in lieu of any of the proposals; and

(10) whether a proration approach should be considered in lieu of any of the proposals.

Time value of money

In general.—The time value of money is generally the difference between the nominal dollar amount of a liability to pay an amount today, and the present value of the liability to pay the same amount at some time in the future. For example, the present value of the liability to pay $1 ten years from today is the amount that must be invested so that, with interest, $1 is available in ten years.

Under present law, the rules relating to reserve deductions for property and casualty insurance companies do not reflect the time value of money. If a loss covered by property and casualty insurance is incurred during the current taxable year, but the claim is not expected to be paid until a subsequent year, then the company is entitled to deduct the estimated amount of the claim to be paid without regard to the time value of money. For example, if the estimated amount of a loss incurred currently is $1,000, but the loss is not paid for five years, then the amount of money needed currently to pay the loss is less than $1,000. Assuming a company's after-tax rate of return on investments is about 8 percent, $679 set aside currently will grow to $1,000 in 5 years. Under present law, the property and casualty insurance company is not limited to deducting $679 currently; rather, it may deduct $1,000 currently, as a reserve for an incurred loss, to pay a $1,000 claim in 5 years.

Qualified reserve accounts.—In contrast to the discounting proposals of the 1984 Treasury report and the GAO report, the Administration proposal recommends the QRA system, which would not specifically require discounting of unpaid loss reserves. The QRA proposal suggests, like the discounting proposals, that present law does not achieve proper matching of income and expenses due to its failure to account for the time value of money between the year when the deduction for loss reserves is allowed, and the subsequent year when the loss is paid. In effect, the QRA proposal would produce the same result, for tax purposes, as if the funds needed to pay a claim against a taxpayer were invested in a separate trust fund, which had the same investment yield as the insurance company's assets and the same tax rate, but could hold no more than the insurance company's statutory reserve for the claim.

The QRA approach would generally work as follows. For example, assume a company receives a premium of $679 on January 1 for coverage during the calendar year. A $1,000 loss is incurred during the year, but the claim is not paid until five years later. Assuming that the company's after-tax rate of return is about 8 percent, a reserve of only $679 would be needed in the year the loss is incurred to produce a payment of $1,000, five years later. Thus, when the company receives the premium, it may choose to deduct a reserve amount of $679 and, consequently, would have no current net income or loss. During the ensuing five years, the income considered to be earned on the reserve amount would not, under the QRA proposal, constitute deductible additions to the loss reserve. Hence, this income would be subject to tax, if not otherwise excludable (i.e., as tax-exempt investment income) or offset by other deductions, such as net operating loss carryovers.

Alternatively, under QRA, the company could take an initial reserve deduction of more than $679; for example, it could take a $1,000 deduction as an addition to its QRA. Consequently, in the year the $679 premium is earned, a $1,000 addition to the QRA would be deducted, and the company would have a $321 underwriting loss from this transaction. If the $1,000 loss were not paid until five years later, then in each intervening year an amount equal to the company's after-tax return on the $1,000 would be added to the QRA on a nondeductible basis. Thus, in the second year, $80 would be added to the QRA. If the statutory reserve amount were $1,000, amounts in excess of $1,000 added to the QRA (e.g., the $80) would be immediately released and included in the company's income each year. Over the five years, about $470 representing the company's after-tax return on the reserve, would be released from the reserve and taxed to the company. In addition, the company would be taxed on its income actually earned (assuming it was not tax-exempt income, or offset by net operating loss carryovers). Because the company overestimated the amount of the initial reserve necessary to pay the $1,000 loss in five years, it is taxed on more income, during the five year period, than the income that would have been taxed if the initial reserve deduction had been correctly discounted. Upon payment of the claim, the company would deduct the amount paid and would simultaneously include in income the amount released from the QRA (which in this case would both be $1,000, generating no net income or loss).

Under QRA, the company could alternatively take an initial reserve deduction of less than $679. If it took a $500 initial reserve deduction, it would have $179 of current underwriting income. Over the five year period before payment of the $1,000 claim (assuming an after-tax rate of return of about 8 percent), the company would make nondeductible additions that would raise the reserve account from $500 to about $735. The income considered to be earned on the reserve would be subject to tax (if not otherwise excludable or offset by other deductions). Upon payment of the $1,000 loss, the reserve balance would be only $735; hence, the company would have a net deduction of $265 upon paying the claim.

Comparisons of the proposals.—The QRA proposal can be distinguished from the GAO discounting proposal on several grounds.[17] First, the QRA proposal would not actually require any discounting of the company's loss reserve in determining the amount deductible. Second, to the extent the QRA does not accurately reflect the company's after-tax rate of return, the amount of the loss, or the time it is ultimately paid, then an adjustment to the company's income is automatic at the time the loss is paid (or at the time the amount in the QRA exceeds the permitted statutory reserve, if earlier than the time the loss is paid).[18] That is, during the period from the time the loss is incurred to the time it is paid, amounts equal to the after-tax return on the initial reserve amount are credited to the QRA; if the sum of these amounts and the initial addition to the reserve exceed the amount of the loss when it is ultimately paid (or alternatively exceeds the amount of the permitted statutory reserve before it is paid), then the excess is included in income; similarly, any deficit in the reserve is deductible at the time the loss is paid. The GAO discounting proposal, by contrast, would not incorporate this automatic adjustment to the company's income in the case of an excessive initial reserve deduction.

Those who support the Administration proposal argue that the QRA approach takes account of the time value of money, so as to

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[17] It is also informative to compare the 1984 Treasury discounting proposal to the Administration's QRA proposal. The 1984 Treasury proposal would require after-tax discounting of loss reserves, whereas the Administration proposal would not actually require any discounting. However, the economic effect of the Treasury proposal and the Administration proposal are similar to each other and are distinguishable from the pre-tax discounting proposed by GAO. That is, under the GAO proposal, investment income earned on the amount set aside as an unpaid loss reserve would not be taxed to the company, whereas, under the other two proposals, such investment income would be taxed to the company.

[18] This automatic adjustment would also occur under the 1984 Treasury proposal to apply an after-tax discount rate and prohibit deduction of additions to the reserve. The adjustment would not, however, be automatic under the GAO proposal.

measure accurately the economic income of the insurance business. They argue that the QRA is economically equivalent to the tax rules allowing accrual basis taxpayers a deduction for a liability only when economic performance has occurred. Consequently, it is asserted that use of the QRA approach guarantees that an insurance company is not taxed more favorably than its policyholders would be if they self-insured their risks.[19] They suggest that the present-law treatment of losses essentially creates an interest-free loan from the Federal Government to a property and casualty insurance company because the company is entitled to the interest-free use of the deferred amounts (i.e., the difference between the estimated loss and the present value of the estimated loss) during the period of deferral.

Proponents point out that the QRA method permits the company to decide whether or not to discount reserves and, if the company does not discount, the QRA method recaptures the tax benefits of accelerated deductions. On the one hand, if the company's estimate of the present value of a loss exceeds the actual present value, then the amount credited to the QRA will exceed the amount necessary to pay the claim and the company will have additional taxable income. On the other hand, if the company's estimate is low, then it will be entitled to claim an additional deduction when the loss is paid. Supporters of this approach claim that these adjustments in income or deductions ensure that the tax treatment of the transaction will be equivalent to the treatment that occurs if a company's estimate of the present value of a loss had been correct, and will produce an accurate measure of economic income for tax purposes.

Opponents of the QRA method argue that the method creates tax liabilities which bear little or no relationship to economic income. They suggest that the QRA approach fails to recognize the special nature of property and casualty insurance underwriting. Thus, they say, the present-law tax rules applicable to property and casualty insurance companies recognize the general principle in casualty insurance that policyholders pool their funds for the purpose of paying losses currently sustained by some of the policyholders, unlike whole life insurance in which the risk relates to saving, rather than compensation for current loss.

Further, some claim that the QRA method, by producing a tax result equivalent to discounting reserves, is inappropriate because loss reserves represent economic losses that have already occurred. The full amount of loss reserves should be deductible even in the case of losses which the company can only estimate, they argue, because it is expected that claims for such losses will ultimately be paid. These opponents claim that the QRA method fails to achieve a proper matching of income and expenses.

Other opponents of the QRA proposal say that it constitutes an indirect premium tax because it does not permit insurers currently to deduct the full amount of a loss. Thus, they argue, the system would not permit insurers to net the full amount of their expenses (including losses incurred) against their premium income, with the

[19] For taxpayers (other than insurance companies) who are liable to pay an amount in the future, the economic value of the future deductions is equal to the economic value of the deductions allowed under the QRA approach.

result that they are taxed on premiums rather than on actual economic profit.

Discounting loss reserves.—Differing views have been expressed as to the relative merits of discounting loss reserves. The GAO report recommends use of a pre-tax discount rate to determine the present value of the loss reserve deduction, while the Treasury report proposal essentially provides an after-tax discount rate.[20] Applying either type of discount rate would give an initial reserve deduction that is smaller than present law allows. A pre-tax rate would generally be higher than an after-tax rate with the result that the initial discounted reserve deduction applying a pre-tax rate would be smaller than if an after-tax rate were applied. Under the GAO proposal, intervening income earned on the initial reserve would be added to the reserve, and deducted from income, for the year earned for tax purposes. Under the Treasury report, on the other hand, no additional reserve deduction would be permitted for income allocated to the initial reserve account.

Some argue that use of a pre-tax rate and allowance of additional deductions for investment income earned on reserves results in a proper matching of income and expenses. They argue that, in effect, the initial reserve represents the portion of the premium that must be invested in order for the company to have sufficient assets when the expected claim must be paid. The remainder of the premium represents an economic profit to the insurance company. The investment income earned thereafter could be viewed as an amount earned on behalf of the future beneficiary of the policy. The investment income earned after the loss is incurred cannot properly be viewed as income of the company, these persons argue. Rather, it should be treated as the income of the person who has incurred the insured loss, and to whom the insurance proceeds (including the intervening investment income) will ultimately be paid. By analogy to interest credited by a bank to its depositors, these persons suggest it would be appropriate for income earned on the discounted reserve, which is expected to be applied to ultimate payment of the insurance loss, to be deducted as earned, and not taxed to the property and casualty insurance company. These persons point to the Administration proposal in the life insurance area to tax policyholders on the inside buildup (i.e., investment income) in the life insurance policy.

Others argue, however, that such a pre-tax discounting system is flawed, in that it provides an incentive to overestimate the amount of the loss and to underestimate the time which will pass until the claim is paid. Similarly, such a system penalizes overestimation of the period until the claim is paid and underestimation of the amount of the loss. For example, if the initial amount of the loss reserve were set too low, the total amount of the reserve, including income allocated to it and deducted during the period preceding payment of the loss, would be less than the total amount of the loss; conversely, if the initial loss reserve were set too high, the

[20] Although the Administration proposal does not require any explicit discounting, the overall economic effect of its QRA proposal is equivalent. This is the consequence of both increasing the reserve on a nondeductible basis by the company's after-tax return and taxing any excess balance in the reserve when the reserve account is terminated (or when it exceeds the statutory reserve amount).

total amount reserved (including intervening income added to the reserve) would exceed the amount of the loss in the year the loss was paid. Thus, it is argued, such a system would encourage overreserving and would tend to promote deferral and, hence, undertaxation of economic income.[21]

More importantly, it is argued, the GAO pre-tax system of reserving would allow income earned on reserves to escape taxation entirely, because additions to reserves would be deductible by the insurance company. Thus, investment income could escape taxation at the company level. It would also escape taxation at the policyholder level. Unlike interest credited by a bank to its depositors, the income credited to reserves is generally not taxable to the policyholder or any other claimant under the policy, and is ordinarily excluded from the loss claimant's income when the loss claim is paid.[22] The QRA system, by contrast, would not permit tax-free addition to loss reserves of amounts earned as income on the reserves, and would therefore tax the investment income at the company level.

Application of cash method of accounting

Opponents of QRA argue that it improperly applies the cash method of accounting to property and casualty companies. They point out that, under QRA, premiums would continue to be taxed as earned, while the amount of the deduction for loss reserves would be limited to take account of the fact that the loss claim will be paid in a future year. Thus, they argue, the QRA proposal, in effect, imposes the cash method of tax accounting and does not accurately match income and associated expenses. They also claim that the QRA method is inconsistent with other portions of the Administration proposal denying the use of cash method accounting to all other businesses with gross receipts over $5 million. That portion of the proposal is grounded on the notion that the cash method of accounting is not in accord with generally accepted accounting principles and frequently fails to reflect the economic results of a taxpayer's business for the year. It can also fail to achieve matching of the timing of the tax consequences to the payor and the payee, for example, in the same transaction.

Proponents of the QRA proposal, on the other hand, argue that QRA is appropriate for property and casualty companies. Application of the cash method of accounting (or its equivalent) would not cause mismatching in the timing of items of income and deduction, but rather would achieve improved matching because it would essentially defer the deduction for losses until economic performance (payment) has occurred.

They also point out that premium income is taxed only as earned, and the deduction for losses should similarly be deferred (or discounted) to reflect payment in the future. The general rule already applicable to accrual basis taxpayers other than insurance companies similarly defers deductions until economic performance

[21] The GAO approach could be modified to recapture reserve balances in excess of statutory reserves, which would tend to limit over-reserving.

[22] If a portion of the insurance reimbursement represents gain, it is taxable.

(e.g., payment) occurs. This rule produces the same economic effect as QRA.

It is also pointed out that the QRA approach results, generally, in tax at the company level on investment income earned on reserves for losses incurred. Although the loss reserve is established only for losses considered to have been incurred, the loss may be paid in a year subsequent to the year it is considered incurred. The person to whom it will be paid may not be ascertained in the year the loss is considered to be incurred for purposes of determining the company's reserve deduction.

Investment income earned between the time of occurrence and the time of payment may not be clearly traceable to any particular person who suffered a loss, when that income is received by the company. Thus, it is argued, it is appropriate to subject this investment income to tax in the hands of the recipient insurance company. Otherwise, this investment income will escape taxation entirely because it is often not subject to tax when ultimately paid to the person who suffered the insured loss.

Some argue more broadly that property and casualty insurance companies should not be considered as financial intermediaries, and thus should not be viewed as receiving investment income on behalf of insurance claimants or policyholders who have not yet been paid for insured losses. Rather, property and casualty insurance companies should be subject to tax on investment income they earn, just like any other corporation would be subject to tax on income from investments. Those who hold this view argue that investment income earned on an unpaid loss reserve does not belong to policyholders or claimants but to the company; they contend that the QRA approach is a proper method for measuring a property and casualty company's investment income. Because the investment income is not taxed to the policyholder or loss claimant (unlike interest paid by banks to depositors), they argue it should properly be taxed to the company.

On the other hand, those who oppose this view argue that, whether or not the QRA approach is proper, investment income earned on loss reserves most properly belongs to those who have incurred the insured losses which the reserves represent. Under this theory, the insurance company is like a financial intermediary, such as a bank, earning investment income on behalf of others. Thus, any income earned on reserves composed of premium receipts is properly the income of those persons who incur losses which are reimbursed by insurance. Some say it is proper to tax the company on this income as a proxy for taxing unascertained persons who have suffered losses. Those supporting QRA as a proxy for taxing investment income to the ultimate recipient argue that premium rates will be adjusted so that the insureds, rather than the insurance companies, will ultimately bear the economic burden of that tax. Others say it is unfair to tax the company on income properly belonging to someone else, and these advocates take the position, therefore, that the QRA system is unfair to companies.

Those who believe that QRA would tax insurance companies on investment income properly belonging to policyholders or claimants may nevertheless acknowledge an analogy to section 265. Section 265 disallows an interest deduction on borrowings to purchase or carry obligations bearing tax-exempt interest. The amount estimated and set aside by a property and casualty company as a loss reserve to pay losses incurred may be viewed as borrowed from the claimant, to the extent it represents a deferred obligation to pay. By analogy to the rule deterring borrowing to finance tax-exempt investments, some assert that it is inappropriate to permit the company to obtain tax-free income on loss reserves.

Taxation of investment income

Some opponents of the QRA proposal argue that it imposes a double tax on investment income at the company level. An example of this double tax effect, they argue, is as follows.

Assume a company receives a premium on January 1 for coverage during the calendar year. A $1,000 loss is incurred during the year, but the claim will not be paid until five years later. Assume the company takes an unpaid loss reserve deduction equal to the statutory reserve amount (e.g., $1,000) in the first year. Income earned on this $1,000 reserve amount would be subject to current taxation (if not otherwise tax-exempt or offset by other losses or expenses). In addition, the reserve would be credited with a nondeductible amount equal to the company's after-tax return on $1,000; but since this addition exceed the statutory reserve amount already in the account, it will immediately be released from the reserve and included in income.

The foregoing, some argue, illustrates that the QRA approach could impose a double tax on income. By requiring nondeductible additions to loss reserves to be made on the basis of the company's after-tax rate of return, they contend that the company may even be taxed on investment income at the same time that it experiences underwriting losses.

Opponents have also suggested that the QRA method would, in effect, impose tax on income which would otherwise be tax-exempt, such as interest on municipal bonds which is exempt from tax under section 103. They assert that it would be unfair to tax property and casualty insurance companies on income from investments which is exempt from tax in the hands of other taxpayers.

Those who support the QRA proposal point out that the function of the QRA method is to take account of the time value of money, so as to measure economic income from the insurance business. It is argued that an insurance company that receives a premium payment has income to the extent that the premium exceeds the company's expenses. It is argued that the expense of satisfying future claims is the amount which will produce the cash necessary to pay claims, when after-tax investment earnings are added to the amount originally set aside. The investment income subsequently earned represents an additional profit that should be taxed. To the extent that present law allows a deduction for loss reserves without taking account of the lapse of time between the year of the loss reserve deduction and the year the loss is ultimately paid, then it is argued that present law overstates the deduction and understates income.

Thus, the proponents of QRA argue, it is proper to impose tax on the recipient of this income (i.e., the company). The QRA approach would accomplish this result by means of requiring that nondeductible additions to loss reserves be made on the basis of the company's after-tax return on investment. Rather than imposing a double tax on income, they suggest that the QRA proposal simply requires that the company be subject to tax on investment income earned on reserves for losses incurred. The company, under QRA, may not shelter actual economic income by offsetting investment income against underwriting losses arising from the difference between reserve deductions reflecting statutory accounting and premiums (discounted to reflect the time value of money, known as "cash flow underwriting").

The proponents of the QRA proposal also assert that any apparent tax on tax-exempt income results only by comparison to the mismeasurement of income under present law in computing the initial reserves for unpaid losses. These people argue that the correct deduction for unpaid losses should be limited to the present value of the amount to be paid, determined by discounting in accordance with the company's after-tax rate of return. If the deduction were limited to this amount, then any income exempt from tax would not increase the company's tax liability. However, QRA allows taxpayers to deduct amounts in excess of this amount; the excess reserve present when the claim is paid (or when the statutory reserve is exceeded) is then subject to tax. It is argued that any apparent tax on exempt income merely reflects the recapture of the excess tax deductions resulting from permitting nondiscounted reserves to be used initially. In this manner, QRA serves to tax actual economic income, rather than the amount of income which is taxed under present law which is based on conservative statutory accounting requirements.

Premium increases

It has been asserted that the QRA proposal (and the GAO proposal) would cause the premiums charged by property and casualty companies to increase. Those opposed to the proposals argue that, especially in long-tail lines of business such as medical malpractice and other tort liability insurance where premiums are already high, the industry would be hurt and social policy would be harmed, were premiums further increased to cover tax liability. Moreover, they argue, the level of liability insurance premiums is often subject to State regulation, and it may be difficult or impossible to obtain permission from these regulatory authorities for an increase in premiums.

Proponents of revision counter that present law unfairly favors property and casualty insurance companies over self-insurance arrangements. They argue that the actual premiums charged reflect the tax benefits that the insurance company enjoys under present law, and that premium discounts consist, in part, of a rebate of the tax benefits to the insureds. They contend that intense price competition has led to excessive premium reduction, funded by tax benefits, in the property and casualty insurance industry in recent years. As a consequence, in the case of taxpayers whose situation may permit them to choose between self-insurance and commercial insurance, the decision between them tends to be determined as a result of indirect tax consequences rather than economic factors.

These proponents assert that present law results in a mismatching of income and expenses because a deduction is allowed for the full amount of a loss incurred which is expected to be paid in a future year. This mismatching causes undertaxation of the income of property and casualty companies, in effect granting them an interest-free loan from the Federal Government. As a result of this tax subsidy, premiums are lower than they otherwise would be. Thus, these persons contend, any increase in premiums would probably be the result of more accurate measurement of income for tax purposes.

Foreign competition

Opponents of the proposals suggest that premium increases which may result if the proposals were implemented could place U.S. property and casualty insurers at a competitive disadvantage in the world market. These persons argue that foreign insurers not engaged in business in the U.S., who are not subject to U.S. income tax on the insurance of U.S. risks, would be able to price insurance lower than would U.S. companies subject to tax under any of the proposals. Similarly, foreign reinsurers would also have a competitive advantage in comparison to U.S. insurers and reinsurers. Thus, opponents argue, an increase in tax on U.S. insurers and reinsurers would have the result of transferring business to foreign insurers not subject to tax in the United States. This transfer of insurance business to foreign insurers would have three effects, they argue. First, it would reduce the insurance issued by U.S. insurers. Second, it could conceivably have the effect of reducing, not increasing, net revenues from the property and casualty insurance industry, due to an overall reduction in profitability or decline in capacity of companies subject to U.S. income tax. Third, it could have an adverse impact on the balance of payments.

Under present law (secs. 4371-4374), an excise tax is imposed on the payment of premiums for insurance (at the rate of 4 percent) or reinsurance (at the rate of 1 percent) of a U.S. risk by a foreign insurer not subject to U.S. income tax,[23] but the excise tax on certain insurance transactions may be waived under certain recent U.S. tax treaties (such as the treaties with the United Kingdom and with France). Rules that would have expanded the application of this excise tax instituted a withholding mechanism, and made the applicable rate a uniform four percent passed the Senate in 1984, but were not ultimately included in the Deficit Reduction Act of 1984.[24]

If foreign competitors not subject to U.S. tax were to become a more significant competitive force,[25] others suggest that it might

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[23] The Internal Revenue Service has taken the position that premiums for insurance and reinsurance of U.S. risks by foreign corporations are not subject to the 30-percent tax which applies to U.S.-source fixed or determinable annual or periodic income of foreign corporations not engaged in business in the United States. Rev. Rul. 80-222, 1980-2 C.B. 211.

[24] Rules to this effect were reported out of the Senate Finance Committee in 1984 as part of S. 2062, but these rules were not ultimately included in the Deficit Reduction Act of 1984. See, Senate Committee on Finance, "Explanation of Provisions Approved by the Committee on March 21, 1984" (S.Prt. 98-169), 98th Cong., 2d Sess. 395 (1984); and see H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 948-9 (1984).

[25] Some suggest that a premium tax applied to all premiums paid for insurance of U.S. risks could eliminate the threat of foreign competition (absent treaty exemptions); see *Comparison to premium tax*, infra.

be appropriate to include premiums for insurance or reinsurance of a U.S. risk among those items subject to a 30-percent U.S. tax in the hands of a foreign corporation not engaged in a U.S. trade or business (sec. 881).[26] If insurance of U.S. risks by foreign insurers were subject to tax as noneffectively connected U.S. source income taxable at the rate of 30 percent, then (absent treaty protection) foreign insurers would not be likely to retain any competitive advantage over domestic insurers insuring U.S. risks, were any of the above proposals to become law.

Opponents of this concept contend that it would harm U.S. insurers by limiting the availability of foreign reinsurers willing to reinsure U.S. risks. They argue that normal business channels would be disrupted, especially in cases where a foreign company is especially equipped to handle a particular risk. They further argue that the present state of the law in this area is longstanding and it would be inappropriate to change it.

Complexity and administrative burden

Opponents of the QRA approach (and opponents of discounting proposals) suggest that the proposal increases the complexity of taxation of insurance companies and adds to their administrative burdens by requiring an additional set of financial records just for tax purposes. Although many of the figures needed to calculate a property and casualty company's tax liability under present law can be derived from existing financial data, some argue that QRA would introduce complex and burdensome bookkeeping requirements. In addition, some argue that it is possible that State regulatory agencies would conform to QRA accounting were it adopted for Federal tax purposes, that this would be detrimental to the solvency of property and casualty companies, and that it may lead to an increased number of business failures of such companies.

Those who favor these proposals, on the other hand, contend that the likelihood of State regulatory agencies—whose aim is to foster insurance company solvency—adopting the QRA approach is extremely remote. As for the increased recordkeeping requirements, they suggest that the proposals would not require significant increases in recordkeeping beyond what is already required to be kept for financial reporting purposes and for purposes of estimating incurred but unpaid losses. They point out that the QRA calculations are tied to information already reported on a company's annual statement. Although the proposals might introduce slight additional complexity, they argue that the improvement in the accuracy of income measurement outweighs possible additional complexity.

Decline in capacity, chronic underreserving and poor financial condition of the industry

Those opposed to the QRA proposal contend that the proposal should not be applied to property and casualty insurers, especially at this time, because the industry has recently undergone signifi-

[26] In conjunction with the 30-percent tax, withholding at the same rate is also generally required (sec. 1442), absent overriding treaty provisions.

cant financial losses and cannot absorb additional tax liability.[27] They also contend that increased tax liability would reduce assets and, pursuant to state law reserve requirements, reduce the amount of insurance business a company would be permitted to write. Further, they contend, present law properly measures economic income because chronic underreserving for losses results in *de facto* discounting of the deduction for loss reserves. Thus, present law achieves "rough justice," they argue. Therefore, the imposition of either discounting or the QRA system would, in fact, cause overtaxation of property and casualty insurers.

Supporters of the proposals point out that, taking into account tax-exempt investment income, the industry has generally experienced economic profitability in recent years (except 1984), despite underwriting losses.[28] Given the cyclical nature of the industry, they suggest that it is inappropriate to continue the present-law rules merely because the industry may be at the low point of a business cycle.[29] They also assert that a tax subsidy, which they assert present law provides, is an inappropriate means of increasing a company's assets and hence increasing its volume of business. Supporters also contend that, contrary to the assertions of those who favor current law, accuracy of income measurement would be improved if the QRA proposal were adopted.

Comparison to self-insurance

Supporters of the QRA proposal contend that present law distorts the choice between buying insurance and self-insuring by granting tax advantages to the former. They suggest that the QRA system, in conjunction with other proposed changes regarding loss deductions,[30] would tend to equalize the tax treatment of property and casualty companies on the one hand, and self-insurers on the other hand.

It is also argued that, under the current system of deducting loss reserves, many taxpayers are able to enjoy many of the economic benefits of accruing tax deductions before economic performance has occurred by purchasing insurance protection for risks previously self-insured.[31]

Thus, some argue, if an insurance company is allowed to deduct the undiscounted estimate of the claims to be paid, it would receive the same tax benefits as the insured could realize if it were allowed to accrue the deduction prematurely. In a competitive industry, insurance premiums may be reduced to the point that the insurers

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[27] The property and casualty industry as a whole experienced an overall loss in 1984 (see section A, *supra*).

[28] See section A, supra.

[29] The property and casualty insurance industry has been described as having a "traditional roller-coaster underwriting cycle." *1984-85 Property/Casualty Fact Book,* Insurance Information Institute (1984), p. 6.

[30] The Administration proposal would also permit a current loss deduction for otherwise deductible losses compensated for by insurance (where the insurance proceeds were not paid until after the year of loss). Insurance proceeds corresponding to the amount deducted would be includible in income. These changes, which would also tend to equalize the tax treatment of property and casualty policies with self-insurance, are discussed in more detail in section IV, below.

[31] After the enactment of the Deficit Reduction Act of 1984, taxpayers who self-insure risks cannot accrue an expense until economic performance has occurred. Thus, generally, taxpayers may deduct the cost of premiums paid for insurance which constitutes a business expense, whereas self-insurers of such business risks may not deduct amounts set aside as self-insurance in advance of the time a loss is incurred.

can purchase insurance at a price below the true economic cost of the insurance protection, because of what is viewed as a tax subsidy inherent in permitting deductions for undiscounted loss reserves. This economic benefit (in the form of lower premiums) could, in the case of substantial purchasers of insurance, approximate the excess value of the tax deduction for undiscounted reserves. Thus, it is argued, present law provides benefits to purchasers of insurance (in the form of a tax subsidy which reduces premium costs) which is not available to those who self-insure.[32] Supporters of the QRA approach assert that it would tend to reduce or eliminate this tax subsidy and thus would tend to make the tax law more neutral regarding the choice between self-insurance and commercial insurance.

Opponents of the QRA proposal argue that the comparison of insurance offered by property and casualty companies to self-insurance is inappropriate, because there are substantial differences between the two arrangements. For example, self-insurers are not subject to State-imposed requirements such as reserve requirements, premium taxes, financial reporting, and restrictions on investments. The primary difference, it is argued, is that the insured policyholder has transferred its risk of loss to someone else, while the self-insurer has not. These differences justify the differences in tax treatment between property and casualty companies (who may deduct loss reserves) and self-insurers (who generally may not).

Comparison to premium tax

Some have suggested, as an alternative to the discounting and QRA proposals, that it would be preferable to impose a premium tax. That is, an excise tax equal to a certain percentage of gross premiums received would be imposed on all property and casualty insurance companies, in addition to the income tax provisions to which they are currently subject.

Those who favor this idea believe that a premium tax would be a simple method of causing property and casualty insurance companies to pay tax on income which may escape tax under the current system. They argue that it would achieve rough justice without the complexity of the discounting or QRA proposals, especially if the rate of the tax were lower for short-tail lines of insurance business, where there is generally a relatively short period between the time a loss is incurred and the time it is paid. Some States now have premium taxes in effect, and this mode of taxation would, therefore, be familiar and easily applied at the federal level, they argue. Further, some believe that imposing a premium tax could alleviate the possibility of increased competition from foreign insurers (and

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[32] There are further contrasts between the tax treatment of self-insurance and of commercial insurance under present law. For example, liabilities of most taxpayers (including self-insurers) may not ordinarily be deducted if contested (see Treas. Reg. sec. 1.461-2(a)), but an insurance company may nevertheless deduct loss reserves attributable to liabilities which may be contested. As another example, most taxpayers (including self-insurers) may not deduct, as a loss, an amount in excess of the adjusted basis of the property destroyed (see Treas. Reg. sec. 1.165-1(c)). Thus, it is possible that a taxpayer with a low or a zero adjusted basis for uninsured property that is destroyed could be denied a loss deduction altogether. See also Part I-B-1, supra, concerning the Administration proposal to permit taxpayers a current deduction for insured losses and to treat insurance proceeds as income subject to tax.

also tax-exempt organizations), if premiums for all insurance of U.S. risks were subject to the tax.

Others contend that, although a premium tax may achieve rough justice, it may also be viewed as regressive and as an inaccurate means of taxing real economic income. They argue that a premium tax is not an appropriate substitute for an income tax, because it would not permit deductions for real costs of doing business. Thus, it could apply even where a company has actual economic losses, and could have an unfair impact on the profitable and the unprofitable sectors of the property and casualty industry.

Supporters of a premium tax believe that it would not have an unfair or differing impact in different sectors of the industry, and would not give any particular insurance company a competitive advantage over any other one, because the premium tax could probably be passed through to consumers. Thus, they argue, it would tend to have a uniform impact on all the companies' competitive postures, regardless of their other tax attributes. Because a premium tax could not be offset by current underwriting losses or by net operating loss carryovers, it would not have a different impact on companies with those tax attributes than on those without them.

Those opposed to a premium tax argue that it would impose a competitive disadvantage upon commercial insurance, when compared to self-insurance. If the premium tax were passed through to insurance purchasers, it would raise the cost of premiums, and create an inducement for self-insurance.

Others argue, however, that present tax law favors the purchase of commercial insurance over self-insurance, at least with respect to insurance for a trade or business, because premium payments may often be deductible, while reserves set aside for self-insurance are generally not deductible. If it raised the cost of premiums, then they suggest a premium tax would have the effect of mitigating the balance, under present law, favoring commercial insurance, and would be more economically neutral. Those holding this view believe that the tax law should not furnish incentives affecting taxpayers' choice between commercial insurance and self-insurance.

Opponents of a premium tax further argue that, even if it were initially imposed at a uniform, low level, it could later be altered or raised in a manner which could jeopardize current practices and lines of business written in the property and casualty insurance industry. Thus, these persons argue, a premium tax could become extremely inequitable and burdensome and could threaten the profitability of the industry. These persons argue that a premium tax is therefore inappropriate.

Other opponents of a premium tax argue that a single uniform tax rate would bear no necessary relation to the tax benefits that critics of the current tax rules assert to be realized by property and casualty insurers. In particular, they argue that it would be inappropriate to impose the same rate of premium tax on short-tail and long-tail lines of business.

Supporters of a premium tax recognize that the tax rate chosen may not capture precisely the economic benefits of the current reserve deductions. However, they argue that the relative simplicity of the premium tax outweighs the imprecision. They also suggest that different premium tax rates could be imposed for different lines of insurance, to take account of the differing time periods which elapse between occurrence of losses and payment of claims in short-tail and long-tail lines.

Comparison to proration approach

Under present law, property and casualty insurance companies are not required to prorate earnings (taxable and tax-exempt) between policyholders and the company for purposes of determining the company's taxable investment income. By contrast, present law does require that life insurance companies prorate earnings.

Some have suggested, as an alternative to the QRA and discounting approaches, that a proration rule should be imposed on the investment income of property and casualty insurance companies. Under this approach, the tax-exempt income of the company would be prorated between policyholders and the company. The policyholders' share of tax-exempt income would be treated as earned on behalf of the policyholders and used to satisfy loss expenses, thereby making a greater portion of the company's investment income subject to tax. One possible mechanism for accomplishing this result would be an add-on tax at the company level.

Those who oppose this approach argue that it is inappropriate to increase the taxable investment income of companies by a proration approach. They argue that it is unfair to deny property and casualty insurance companies the benefit of tax-exempt investments in which all other taxpayers are free to invest.

Those who favor the proration approach argue that proration is based on the concept that a portion of the company's investment earnings are held for the policyholder. Some say it is proper to tax the company on this income as a proxy for taxing the unascertained policyholders who have incurred the losses. Those who support this approach argue that premium rates will be adjusted so that the policyholders, rather than the insurance companies, will ultimately bear the economic burden of that tax.

2. Limiting Policyholder Dividend Deduction for Mutual Companies

Present Law and Background

Under present law, property and casualty insurance companies (whether stock or mutual)[33] are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such (Code sec. 832(c)(11)). Stock companies may not, however, deduct dividends paid to shareholders. Policyholder dividends and shareholder dividends are treated differently for tax purposes at the distributee level as well as at the company level. Policyholder dividends are generally considered price rebates and are not taxable distributions (unless the insurance premiums were deducted by the policyholder). Dividends paid to shareholders in their capacity as shareholders, on the other hand, constitute ordi-

[33] Stock companies are owned by their shareholders, while mutual companies generally do not have shareholders, but rather are owned by the policyholders. See Part III-A, above.

nary income to the recipient shareholders to the extent of the distributing corporation's earnings and profits.

This distinction between policyholder and shareholder dividends also exists in the case of life insurance companies. Under section 809, deductible policyholder dividends paid by mutual life insurance companies are reduced by an amount intended to reflect the portion of the distribution allocable to the companies' earnings and profits (as distinguished from the proportion which is a policyholder rebate). Thus, mutual life insurance companies may not deduct the portion of a payment to a policyholder which represents a distribution of company profits to him in his capacity as an owner of the company.

Administration Proposal

The Administration proposal would require the deduction for policyholder dividends of mutual property and casualty companies to be reduced in a manner similar to the reduction applicable to mutual life insurance companies. The proposal states that additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provides to mutual property and casualty companies and to set the appropriate deduction limitation.

This proposal would be effective for taxable years beginning after 1985.

Analysis

Policyholder dividends paid by property and casualty insurance companies have been treated as price rebates for tax purposes. Consequently, they have been deducted by the insurance company. The proposal would treat a portion of the policyholder dividends paid by a mutual company as a distribution of earnings and profits of the company. Under general tax rules applicable to corporations and shareholders, a distribution of earnings and profits is not deductible by a corporation, and generally would be includible as ordinary income by a distributee.

Supporters of the proposal assert that it increases fairness in taxation of property and casualty insurance companies in several ways. First, it prevents mutual companies from deducting amounts which actually constitute distributions of corporate earnings and profits.[34] Further, the proposal would place stock and mutual companies on a more even footing with respect to each other. Mutual companies would not have the competitive advantage of being permitted, in essence, to deduct distributions of corporate profits.

Those who oppose the policyholder dividend deduction limitation argue that such a rule has enormous practical difficulties in application, as can be demonstrated in the life insurance area. Devising an appropriate methodology and ratio for determining the relative profits of stock and mutual property and casualty insurance com-

[34] In addition, denial of policyholder dividend treatment for a portion of mutual company distributions could change the treatment at the shareholder level from exclusion to inclusion in income (or as in the life insurance area, impose a proxy tax at the company level) for the portion of the distribution attributable to corporate earnings.

panies could be quite difficult, and moreover the figure could change over time.

In addition, opponents of changing the policyholder dividend deduction assert that many small mutual property and casualty insurance companies serve the function of pooling local risks and distributions from them could not readily be identified as corporate profits rather than price rebates. Thus, they argue, such a rule would be difficult to administer in practice.

3. Protection Against Loss Account for Mutual Companies

Present Law and Background

Mutual property and casualty insurance companies are permitted deductions for contributions (which are merely bookkeeping entries) to a protection against loss ("PAL") account (Code sec. 824). The amount of the deduction is equal to the sum of one percent of the underwriting losses for the year plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. The account is established for a 5-year period and, in effect, gives a 5-year deferral of a portion of mutual company underwriting income. The intent of Congress in enacting the PAL provision was to provide mutual companies with a source of capital to enable them to compete with stock companies. While stock companies may enter capital markets and issue new stock to raise money in the event of catastrophic loss, a mutual company may not do so. The 5-year partial income deferral provides a source of capital not available to stock companies.

Administration Proposal

The Administration proposal would repeal the deduction for contributions to a PAL account for taxable years beginning after 1985. Amounts currently held in the account would be included in income no later than ratably over a 5-year period.

Analysis

Supporters of retaining the PAL account deductions for mutual companies urge that the PAL account furnishes a cushion against unexpected losses which could otherwise drive small mutual insurers out of business. These small mutual companies serve local clients who may have no other alternative and might otherwise be unable to obtain insurance. Thus, it is argued, small mutual companies should be aided by retaining the PAL account.

Those who favor repealing the PAL account rules suggest that it is unnecessary to afford this cushion to mutual companies with large underwriting losses, because their tax liabilities are already substantially reduced, perhaps to the extent of generating loss carryovers. In addition, the PAL rules do not actually require that any account actually be maintained to protect against losses; rather, the only protection is afforded in the form of tax savings, these persons note. Thus, the utility of the PAL is greatest for those mutual companies for whose use it was least intended: those with current taxable income who can benefit from deferral. It is also argued that stock companies may not readily be able to raise funds in capital markets when their financial prospects are dimmed by catastrophic losses, and that consequently, one of the justifications for the PAL account may lack support. Thus, the function of the PAL tax account is of questionable validity, these persons argue, and the PAL account should be phased out.

4. Special Exemptions, Rates, and Deductions of Small Mutual Companies

Present Law and Background

Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of their gross receipts. Mutual companies with certain gross receipts not in excess of $150,000 are tax-exempt (sec. 501(c)(15)). Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and may be taxed solely on investment income. This provision does not apply to any mutual company that has a balance in its PAL account, or that, pursuant to a special election, chooses to be taxed on both its underwriting and investment income. Additionally, small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income.[35]

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay a lower tax. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is imposed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

Mutual companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Administration Proposal

The special tax exemptions, rate reductions, and deductions of small mutual property and casualty insurance companies would be repealed. The proposal would be phased in over a 5-year period starting with the first taxable year beginning after 1985.

Analysis

Opponents of repeal argue that these special exemptions, rates and deductions for small mutual property and casualty insurance

[35] Also, organizations called reciprocal underwriters or interinsurers generally are taxed as mutual insurance companies, subject to special rules (see sec. 826).

companies encourage entry into the business and assist small (often new) companies in staying in business. To the extent that it is a desirable social policy to encourage risk shifting and risk distribution through mutual companies, it could be argued that these preferences which encourage their proliferation should be retained.

Those who support repeal of these special exemptions, rates and deductions suggest that it is preferable to place small mutual companies on a par with other property and casualty insurance companies, and with other small companies (i.e., those with income below $75,000) which would be taxed at lower, preferential rates under the Administration proposal.[36] They also assert that the present law applicable to small mutual companies is inordinately complex and should be simplified. Others also argue that these preferences exacerbate distortions in current tax law which favor third-party insurance over self-insurance; the choice between these two options should be available on a more neutral basis than current law permits.

5. Limitation on Losses

Present Law and Background

Under present law, there generally is no overall restriction on the filing of consolidated returns by property and casualty insurance companies with other noninsurance corporations otherwise eligible to file consolidated returns (sec. 1504). By contrast, in the case of life insurance companies that file consolidated returns with non-life insurance companies, section 1503 restricts the portion of non-life insurance company losses which may be used to offset life insurance company income. Thus, property and casualty insurers with substantial underwriting losses due to the application of statutory accounting and to investment in tax exempt bonds, for example, may in some cases be permitted to file a consolidated return with a manufacturing company with substantial taxable income. Under these circumstances, the special tax accounting provisions applicable only to insurance companies effectively become available to manufacturing concerns. As a consequence, loss deductions calculated under the special tax accounting rules for property and casualty insurance companies may be utilized to offset the noninsurance income of affiliated corporations.

If such insurance companies do not file consolidated tax returns with non-property and casualty insurance affiliates, under present law, they may still be able to shelter all or a part of their own investment income from taxation by means of underwriting losses arising from loss reserve deductions calculated under statutory accounting principles.[37] If such deductions exceed taxable investment income (for example, if a substantial part of the company's investment income is tax-exempt interest on municipal bonds), loss carryforwards and carrybacks may be generated.

[36] Present law also affords graduated preferential rates to small corporations (with income below $100,000).

[37] See discussion of loss reserve deductions in Part III–A, above.

Administration Proposal

None.

Possible Proposals

It has been suggested that a limitation or prohibition could be placed on the utilization of loss deductions of a property and casualty insurance company to offset the noninsurance income of an affiliated corporation on a consolidated return.

It has also been suggested that underwriting losses in excess of claims paid not be permitted to offset investment income of property and casualty insurance companies, but rather that such underwriting losses be permitted to offset only underwriting income (i.e., primarily premium income). Net underwriting losses (in excess of claims paid) for any taxable year of a company would be suspended, and allowed in later years when the items represented by suspended deductions are actually paid.

Analysis

Consolidated returns

Some have argued that consolidation of stockholder-owned property and casualty corporations with noninsurance corporations permits the transfer of tax benefits beyond that contemplated under the consolidated return rules. Specifically, these persons contend that the differences in tax accounting rules applicable under present law to property and casualty insurers, on the one hand, and other types of businesses, on the other hand, gives rise to unintended anomalies in the consolidated return situation. Thus, these persons may argue, if changes such as the Administration's QRA proposal are not enacted, it may be appropriate to prevent property and casualty insurers from filing consolidated returns with corporations engaged in other businesses.

Proponents of prohibiting utilization of property and casualty insurance company losses against non-property and casualty income of affiliates in consolidated tax returns also argue that such utilization adversely affects independent insurers. If insurance losses, generated by artificially low or below-cost premium charges, can be utilized to offset non-insurance income of a consolidated group, independent (non-consolidated) insurers are placed at a competitive disadvantage in pricing premiums. In addition, they argue, present tax law provides an incentive for acquisitions of property and casualty insurance companies by other corporations seeking this benefit of consolidation.[38]

Opponents argue that it is unfair to limit the availability to property and casualty insurers of tax benefits, such as consolidation, which are available to other taxpayers. They suggest that the affiliation of dissimilar businesses presents issues much broader in scope than it would be appropriate to address in the context of accurate income measurement (and proper matchup of income and

[38] See Richard Morais, "Skinning the Cat," *Forbes* (April 22, 1985), at 121. Some have suggested clarifying the effect of making an election under sec. 338 to step up the basis of the acquired corporation's assets, or increasing recapture requirements, to limit such acquisitions.

expenses) of property and casualty insurance companies. They also argue that, in the consolidated return context, shifting other tax benefits (e.g., accelerated depreciation) is tolerated, and therefore shifting of the tax benefits arising from special tax accounting rules for property and casualty insurers should also be tolerated. In addition, they argue that current widespread underwriting losses are part of a business cycle inherent in the property and casualty industry,[39] and it would therefore be inappropriate to change the tax law (currently permitting consolidation) solely in response to a predictable downturn in a business cycle.

Those who believe that the Administration's QRA proposal would largely eliminate distortions and mismeasurement of income of property and casualty insurers under present law argue that, if the QRA proposal is enacted, it would not be necessary to limit the availability of such insurers' losses on consolidated returns.

Limitation on underwriting losses

Some advocate a rule which, instead of preventing or limiting property and casualty insurers from transferring the benefits to other businesses by means of consolidated returns, would simply limit the current deductibility of net underwriting losses in excess of claims paid against investment or other income. Such underwriting losses would be deductible only against underwriting (primarily premium) income. Under this approach, the primary tax benefit transferred by the companies through the use of consolidated returns would not be transferable. Thus, a broad rule limiting consolidation would not be needed, supporters argue. They also argue that expenses and losses remain ultimately deductible (when paid), and would not be disallowed. At the same time, they argue, a limitation on currently deductible tax losses might make property and casualty companies less attractive as targets of tax-motivated acquisitions.

Opponents of such a rule suggest that it would not effectively limit property and casualty companies' sheltering of their investment income (i.e., through tax-exempt investments). Opponents suggest that the proposal would permit companies to escape taxation through tax-exempt investments, in situations where the companies are actually quite profitable in an economic sense.[40] Some assert that a simple rule preventing the offset of any underwriting loss against investment income would be appropriate, but others point out that such a rule could be quite harsh, if a company had a real net economic loss for the year, yet still incurred a tax liability on investment income (which could not be offset by the current underwriting loss).

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[39] The property and casualty insurance industry has been described as having a "traditional roller-coaster underwriting cycle." Insurance Information Institute, *1984-85 Property/Casualty Fact Book* (1984), at 6.

[40] See the discussion under *Comparison to proration approach* in Part III–A, above.

6. Expense Deductions and Reserve for Unearned Premiums

Present Law and Background

In computing the underwriting income of a property and casualty insurance company, present law permits a deduction for expenses incurred (sec. 832(b)(3)). These expenses include the premium acquisition expenses shown on the NAIC-approved annual statement. Thus, the company generally may currently deduct premium acquisition expenses. The company's deduction for expenses also includes a deduction for the increase in unpaid expenses,[41] which may not satisfy the all-events test normally applicable in determining the deductions of accrual-method taxpayers.

Although a current deduction is permitted for premium acquisition expenses, related premium income may be deferred. This deferral is accomplished by means of a deduction for reserves for unearned premiums.

Unearned premiums represent the portion of premiums paid during the year which are attributable to coverage in a subsequent year.[42] For example, a policyholder may pay an insurance premium that is sufficient to provide insurance protection for a period of time that extends beyond the end of the current year. Frequently, the policyholder has the option of paying periodic premiums or a single premium for a longer period of coverage. The single premium often will be discounted to reflect an interest factor to compensate for the earlier payment of the premium.

Thus, under present tax law, property and casualty insurance companies include premiums in income in the year they are received, but deduct the unearned portion of the premium, attributable to future coverage, which is put into the unearned premium reserve. In effect, the companies include gross premiums in income ratably over the period of coverage for which they are paid. At the same time, a current deduction is permitted for premium acquisition expenses, even though the related premium income may be deferred.

Administration Proposal

The Administration proposal would apply the QRA approach to the reserve for unearned premiums, as well as to loss reserves. Thus, QRA would adjust the company's income to the extent the reserve for unearned premiums is overstated due to the failure to take account of the lapse of time between the time the reserve amount is deducted, and the subsequent time the unearned premium is released from the reserve and included in the company's income.

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[41] See sec. 832(b)(6). Sec. 832(d) provides that double deduction of the same item is not permitted.

[42] The Internal Revenue Service has ruled, however, that retrospective rate credits do not qualify as unearned premiums. Rev. Rul. 73-302, 1973-2 C.B. 220.

Other Proposals

GAO report

The GAO report recommends that the deduction for expenses allocable to acquisition of premiums should be amortized over the same time period as the premiums are taken into income. These acquisition expenses would include agent and broker commissions, salaries of employees involved in underwriting and issuing policies, and medical and inspection fees. Amortizing these expenses over the period during which associated premiums are taken into income would provide a better matching of income and expenses than does current law, which permits immediate deduction of acquisition expenses and inclusion of premium income ratably over the period during which it is earned.

Additional proposal

Others have suggested a different treatment for unearned premium reserves. Under this approach, a portion of the unearned premium reserve would be accelerated and taken into income currently, rather than deferred. The portion accelerated would be that portion which would offset the currently expensed premium acquisition costs. Thus, if these acquisition costs generally constitute an amount equal to 20 percent of the unearned premium reserve, then 20 percent of the reserve would be required to be currently included rather than deducted and taken into income in the future. This reserve acceleration proposal could be phased in ratably over a five-year period, so that an additional four percent per year would be included in income over the five-year phase-in period.

During the phase-in period, the revenue generated by the proposals may be derived from taxpayers other than property and casualty insurers, due to a shift in the insurance companies' holdings of tax-exempt investments. Some have suggested that it would be appropriate, in order to eliminate the effect of the phase-in and to prevent the shift of insurance company investments, to provide a fresh-start adjustment so that only the increase in unearned premiums would be subject to the rule for taxable years beginning on or after the effective date.

Analysis

Expense deductions

Those supporting the GAO proposal argue that, in most cases, premiums to which acquisition expenses are allocable have also been actually received, but have not been taxed because of the unearned premium reserve deduction.[43] Therefore, it is appropriate to match expenses actually paid to premiums actually received, either on a cash basis (i.e., immediately upon receipt and payment), or on an accrual basis (over the period premiums are earned). Because it is argued that it is more accurate to accrue premium income over the period of insurance coverage, the GAO report would amortize the expenses associated with it over the same

[43] Supporters of the QRA proposal argue that there would be no such discrepancy under the QRA system, because QRA would apply to the reserve for unearned premiums.

period. It is argued that the administrative inconvenience to companies as a matter of recordkeeping should hardly be any greater, if they were required to amortize expenses, than it is under present law requiring them to amortize premium income.

On the other hand, those opposed to the proposal to amortize premium acquisition expenses argue that the proposal would create administrative inconvenience due to the difference in statutory and tax accounting for expenses, and would be unfair because it would not allow a current deduction for amounts currently paid. It could be further argued that many expenses generate goodwill or new customers (such as advertising or commissions paid to sales agents) that may produce additional business in the future. For taxpayers other than insurance companies, these expenses are frequently deductible in accordance with the applicable method of accounting.

Reserve for unearned premiums

Some have argued that, instead of amortizing expense deductions, all insurance company reserves for unearned premiums should be accounted for on a present value basis, under a QRA approach. When a property and casualty company receives premiums attributable to insurance coverage for a future year, the full amount, not the present value, of the premiums so allocable are added to the reserve for unearned premiums, and are deducted from underwriting income under present law. The company's reserve for unearned premiums is overstated to the extent the deduction exceeds this present value.[44] In addition, the policyholder prepaying the premium is not taxed on the value of any premium discount that the policyholder may have received. Those who favor a QRA approach argue that QRA is appropriate because it would apply a discount rate based on the company's actual after-tax rate of return.

In addition, supporters of the QRA approach argue that applying QRA to unearned premium reserves would generally reduce the present-law mismatching of premium income, which is deferred and expenses which are currently deducted. This occurs because the amount of premium income deferred under QRA would generally be less than under present law.

Opponents of applying a QRA approach to unearned premium reserves argue that the deferral effect of a full current deduction is insignificant, especially where the premium is earned in the immediately following year, as is often the case. In addition, it could be argued that requiring present-value calculations for the unearned premiums would create bookkeeping difficulties in trying to trace each premium payment to a particular subsequent year when it would be included in income.

Supporters of applying a QRA approach to unearned premium reserves suggest that the deferral effect under current law may not be insignificant if premium payments are, as a general matter, received in advance for a subsequent year of coverage; the impact could be significant, even though premium payments are made an-

[44] To the extent that a company prices single premiums at a discounted level to take account of the advance payment for future insurance coverage, amounts added to the unearned premium reserve may not be overstated.

nually, if the period of coverage typically extends beyond the taxable year the premium is received. Thus, although the period of deferral may not be long, the impact may be great if the amount of unearned premiums is consistently large from year to year. Proponents also suggest that there would not necessarily be substantial added bookkeeping work because records already have to be kept to ascertain the year in which amounts must be released from the unearned premium reserve.

Others support the proposal to accelerate 20 percent of the unearned premium reserve ratably over five years, as an alternative to the QRA approach. These persons argue that the acceleration proposal solves the present-law problem of mismatching of premium income and premium acquisition expense deductions.

Some have suggested that this acceleration proposal does not take account of the issues raised by the QRA proposal which would apply to loss reserves. It is argued that merely accelerating recognition of income on unearned premiums leaves unanswered a substantial question of mismeasurement of the income of property and casualty insurance companies, attributable to what is described as overstated loss reserve deductions.

Opponents also argue that the proposal would have a negligible impact on the problem of proper measurement of the companies' income if there were a five-year phase-in period, because it would not address the issue of their investments in tax-exempt securities. They point out that proponents of the phase in concede that, due to a likely increase in tax-exempt investments of the insurance companies, the proposal would not actually affect the tax liability of property and casualty insurance companies, but it could increase the tax liability of other taxpayers, due to the decreased availability of tax-exempt securities to investors *other* than property and casualty insurers. Thus, they argue, a phase in would not be appropriate; rather, only the annual increase in unearned premium reserves should be affected.

7. Repeal of Deduction for Abnormal Insurance Losses

Present Law and Background

Present law permits stock insurance companies to deduct capital losses against ordinary income, to the extent of abnormal insurance losses and payments of dividends and similar distributions to policyholders (Code sec. 832(c)(5)). Under this provision, property and casualty insurance companies can, in effect, convert capital loss to ordinary loss for tax purposes, to the extent of any net underwriting loss for the year.

Possible Proposal

It has been suggested that the deduction of capital losses against ordinary income to the extent of abnormal losses and policyholder dividends should be repealed.

Analysis

This special deduction of capital losses against ordinary income is intended to reflect economic reality when a company sells capital assets to cover negative cash flow occasioned by abnormal losses and by the payment of policyholder dividends.

Supporters of repealing this special treatment argue that State regulation, not tax law, should implement provisions to ensure the solvency of property and casualty insurance companies. Furthermore, a negative cash flow is not necessarily indicative of an overall economic or tax loss and, therefore, this provision gives an unwarranted benefit. In addition, it is argued that a similar tax benefit is not accorded to other industries experiencing a negative cash flow, or indeed to self-insurers experiencing a negative cash flow, and, therefore, the provision should be repealed because it is unfair.

Opponents of repealing the abnormal loss deduction argue that small insurers (which are numerous) could be forced into insolvency, should their assets fall below the level necessary to comply with State regulation. In the case of a property and casualty company, therefore, abnormal losses could have a more serious effect than in other types of businesses. It is argued that this special tax rule is important to the continuation of many small insurers, who may be the only source of insurance for their regional clientele. To protect small insurers, the deduction should be retained, some argue.

8. Definition of Insurance

Present Law and Background

Despite the special provisions (subchapter L) for taxing insurance companies, the Code does not contain a definition of "insurance."[45] The question of the definition of insurance has been considered by several courts (including the Supreme Court), but it is generally agreed that there is still no generally applicable definition.

Under the Supreme Court decision of *Helvering* v. *LeGierse*, 312 U.S. 531 (1941), it has been commonly understood that "risk-shifting" and "risk-distribution" are essential elements of a contract of insurance. Likewise, a transaction is one of insurance only if it involves an actual "insurance risk" when it is executed.

The concept of risk-shifting refers to the fact that a risk of loss is shifted from the individual insured to the insurer (and the insurance pool managed by the insurer). For example, under a fire insurance policy, the property owner's risk of loss from a fire (and the resulting damage costs) is shifted from the owner to the insurance company to the extent that the insurance proceeds from the contract will reimburse the owner for that loss. Despite the language in the *LeGierse* case, a more recent decision has raised the question of whether risk-shifting is still required in order to validate an insurance transaction. (See *Consumer Life Insurance Company* v. *U.S.*, 430 U.S. 725 (1977), in which the Supreme Court found that, although there was no significant risk-shifting, a transaction was valid reinsurance.)

The concept of risk-distribution might be considered fundamental to the theory of insurance, which relies on the law of large num-

[45] Sec. 7702 contains a definition of "life insurance contract." This provision does not define insurance for property and casualty insurance.

bers. That is, within a group of a large number of individual insureds who share a similar type of risk of loss, only a certain number will actually suffer the loss within any defined period of time. When a loss is suffered by any insured, each individual insured makes a contribution through the payment of premiums toward indemnifying the loss suffered.

Possible Proposal

It has been suggested that it may be appropriate to provide a definition of insurance for Federal tax law purposes.

Analysis

Retroactive liability coverage

The question of what constitutes insurance may have broad practical significance in many areas. One example is the situation of retroactive liability coverage under which a policyholder obtains insurance against a particular risk after the event of the risk has occurred. When the loss event (such as a fire) has already occurred, and both parties know it has occurred, one might question whether any shifting has occurred because the risk or possibility of loss has already become a certainty. Under such retroactive liability coverage, an actual loss is being shifted rather than merely a risk of loss. The uncertainties remaining are only the final determination of the size of the loss and the time of payment.

Ordinarily, the size of the loss is not an event that would be thought to involve an insurance risk. Focusing only on the economic realities of the transaction, the only risk assumed by the insurer under the retroactive contract seems to be an investment risk; that is, whether the insurer earns a sufficient amount on the premium dollars charged (taking into account any tax savings generated by the transaction) to pay the face amount of the policy some time in the future. The investment risk can be broken into two elements: (1) whether the company will earn the rate of return on the premium dollars that it anticipates; and (2) whether the company will have sufficient time to accumulate the necessary funds by the time it has to pay the claims. These elements of the investment risk are not unlike those assumed by a bank under any interest obligation.[46]

If retroactive liability coverage is treated as insurance, the tax accounting for such a transaction can make the contract profitable. The policyholder, in a business context, is entitled to an immediate deduction for a premium. At the same time, the insurance company selling the contract may deduct the liability for the incurred loss on an undiscounted basis. Arguably, then, the transaction takes advantage of what some argue is a mismatching of income and deductions under present law, as between two unrelated taxpayers and for a single taxpayer.

[46] Although investment risk has been recognized as an element of an insurance contract, the Supreme Court has said that "the assumption of an investment risk cannot by itself create an insurance provision under the Federal definition." *S.E.C.* v. *United Benefit Life Insurance Co.*, 387 U.S. 202, 211 (1967). Also, *Helvering* v. *LeGierse*, 312 U.S. 531, 542 (1941).

Captive insurance companies

The question of what is insurance also is central to an analysis of self-insurance plans and consideration of whether there can be valid insurance transactions between economically related parties. Generally, under present law, taxpayers are not allowed deductions for anticipated expenses or losses unless the liability is fixed and the amount reasonably estimated, and unless economic performance has occurred. Thus, although most types of insurance premium payments are deductible if they are insured in connection with the taxpayer's trade or business, amounts that are added to a self-insurance fund or account are not deductible. Aside from the fact that amounts set aside for self-insurance are not paid or incurred, self-insurance is not considered insurance because there is no economic shifting or distribution of the risk. Instead of merely setting aside funds within a company, a subsidiary might be formed as an insurance company to provide the insurance protection for the parent company. But such captive insurance companies might be viewed as highly evolved self-insurance arrangements.

Specifically, the Internal Revenue Service has ruled that the amounts described as premiums paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign subsidiary are not deductible premiums if the subsidiary does not also insure risks of insureds outside its own corporate family.[47] In contrast, the Service has also ruled that amounts paid by a domestic petroleum corporation to a foreign insurance company that provided insurance against certain petroleum industry risks only for its 31 unrelated shareholders and their subsidiaries and affiliates were deductible as insurance premiums.[48]

Recent case law has developed the identifying characteristics of a captive, which distinguish it from a true insurance arrangement. In the recent cases of *Humana, Inc. and Subsidiaries* v. *Commissioner,* T.C.M. 1985-426 (August 14, 1985) and *Mobil Oil Corp.* v. *U.S.*, — Cl. Ct. — (No. 358-78, August 1, 1985), the courts have indicated that the primary criterion in distinguishing a captive from a true insurance arrangement is the absence of risk-shifting. So long as a wholly owned subsidiary of the taxpayer bears the taxpayer's risk of loss, there has not been sufficient risk-shifting to constitute true insurance, premium payments for which could be deductible.[49]

Although the law is becoming clearer regarding what is an invalid "captive insurance arrangement" and the Service has issued

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[47] Rev. Rul. 77-316, 1977-2 C.B. 53. The Service concluded that because the insureds and the "insurance" subsidiary (though separate corporate entities) represent one economic family, those who bear the ultimate economic burden of the loss are the same persons who suffer the loss. Thus, the required risk-shifting and risk-distribution of a valid insurance transaction are missing. This position of the Service was favorably cited by the Ninth Circuit in *Carnation Co.* v. *United States*, 640 F.2d. 1010 (9th Cir. 1981) *cert. denied*, 454 U.S. 965.

[48] Rev. Rul. 78-338, 1978-2 C.B. 107. In addition to the fact that the 31 shareholders/insureds of the insurance company were unrelated, the ruling indicated that no one owned a controlling interest and no one's risk coverage could exceed 5 percent of the total risks insured. The ruling concluded that such an arrangement allowed the economic risk of loss to be shifted and distributed among the shareholders who comprised the insured group so that it constituted insurance.

[49] Cf. *Crawford Fitting Co.* v. *U.S.*, 606 F.Supp. 136 (N.D. Ohio 1985), in which sufficient risk-shifting was found where a risk was shifted to an insurance company which was only partially commonly controlled (i.e., the insurer was 80% owned by four separate corporations, in each of which the individual 100% owner of the insured corporate taxpayer had an interest).

rulings addressing what is a valid insurance arrangement, questions still remain. For example, how many unrelated shareholders/insureds are necessary in order to have sufficient risk-shifting and risk-distribution? Is the number of insureds important if the number of risk exposures is large? How much risk from unrelated insureds must a wholly owned captive insurance company assume in order to provide a valid insurance arrangement in which members of its own economic family can participate? Must the premium structure charged unrelated insureds generally contribute to the funding adequacy for potential claims arising from contracts with related insureds in order for there to be the risk-shifting and risk-distribution essential for a valid insurance arrangement? Whatever the rules are, do the same rules apply for reinsurance transactions between related parties? Thus far, the definition of insurance developed by the case law has not answered these questions.

Comparison to self-insurance

The Administration proposal would permit taxpayers to deduct losses, even if insured, in the year the loss occurs. Payment of the insurance benefit would constitute income.[50] Some would argue that no definition of insurance would be needed if this proposal were enacted, because self-insurers on the one hand, and purchasers of property and casualty insurance, on the other hand, would be taxed similarly. That is, both would be entitled to deduct the loss in the year it is incurred.

Others point out, however, that discrepancies would remain. In the case of insurance for business property, the policyholder would generally be permitted to deduct the premium in the year it is paid or accrued whereas a self-insurer would not be entitled to deduct amounts set aside as self-insurance in many cases. Thus, because of the continued deductibility of premiums for insurance in a business context, it may be desirable to adopt a definition of insurance even if the Administration proposal (which would tend to equalize the tax treatment of commercial and self-insurance) were adopted.

[50] This proposal is discussed further in Part I-B-1, "Deduction for Policyholder Losses," above.

IV. TAXATION OF TAX-EXEMPT ORGANIZATIONS ENGAGED IN INSURANCE ACTIVITIES

Present Law and Background

In general

Prior to 1894, the tax legislation enacted by Congress specified the entities subject to taxation. However, in 1894, when a flat income tax was imposed on corporations, an exemption from tax was provided for certain nonprofit charitable, religious, or educational organizations, fraternal beneficiary societies, certain mutual savings banks, and mutual insurance companies. Since 1894, the list of organizations eligible for tax-exempt status has been expanded considerably.

Present law specifies various standards that an organization must meet in order to qualify for exemption from Federal income taxation. These standards vary depending on the basis on which the entity is seeking exemption. Certain activities performed by an organization may make it ineligible for tax exemption.

In addition, an organization that is otherwise exempt from Federal income tax generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes. Specific exclusions from the tax are provided for certain types of income, including rents, royalties, dividends, and interest, except income derived from "debt-financed property." Any income from debt-financed property generally is subject to tax as unrelated business income in the proportion in which the property is financed by debt.

The sale of insurance by a tax-exempt organization generally would be considered the operation of an unrelated trade or business. However, under certain circumstances, certain tax-exempt organizations may provide insurance or insurance-type benefits to members either (1) without losing tax-exempt status or (2) without being subject to Federal income tax on income derived from insurance activities. Under present law, some tax-exempt organizations are expressly authorized to provide insurance to their members, while others that sell insurance have been historically treated as tax-exempt.

Organizations expressly authorized to engage in insurance activities

In general

For certain tax-exempt organizations, the provision of insurance or insurance-type benefits to members or to the general public forms the basis for the organization's exemption from Federal income tax.

Two types of insurance companies are expressly exempt from tax—(1) local benevolent life insurance companies (sec. 501(c)(12)) if at least 85 percent of their income is received from members for the sole purpose of meeting losses and expenses, and (2) mutual property and casualty insurance companies (sec. 501(c)(15)) if the gross amount received during a taxable year from premiums does not exceed $150,000. (See, also, the discussion in Part III–B–4, above.)

The provision of commercial insurance benefits by certain other tax-exempt organizations may also be considered to be substantially related to the organization's exempt purposes in particular circumstances.

Charitable organizations

An organization is exempt from Federal income tax if it is a corporation, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, educational, or certain other purposes.[51] An organization is not considered organized or operated exclusively for one or more of the exempt purposes unless it serves a public rather than a private interest.[52]

The providing of insurance benefits by an organization described in section 501(c)(3) generally would be considered a commercial activity which benefits a private, rather than public, interest and which would endanger the organization's tax exemption. However, at least one major organization, which provides life insurance and annuities to employees of tax-exempt educational institutions, has historically been considered a charitable organization by the IRS.[53]

The IRS has also held that a trust created by a tax-exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the hospital is operated exclusively for charitable purposes.[54] However, if two or more unrelated tax-exempt organizations pool funds for the same purpose, the organization holding the pooled funds is not entitled to tax exemption because the activity (i.e., the provision of insurance) is inherently commercial in nature.[55]

Under present law, many health maintenance organizations (HMOs) are treated as exempt from Federal income tax as charitable organizations. The Tax Court has held that an HMO that provided health care to members on a prepaid basis and to non-

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[51] Code section 501(c)(3).

[52] Treas. Reg. sec. 1.501(c)(3)-1(d)(1).

[53] The Office of Chief Counsel of the IRS was asked to review a proposal to revoke the exempt status of this organization, which is engaged in providing pension and insurance benefits to employees of tax-exempt educational institutions. GCM 34701, CC:I:I 3589 (undated). The Chief Counsel's office stated that two primary factors supported the revocation of the organization's exempt status. First, the organization is similar to a mutual insurance company because most of the operating expenses are now covered by premium payments, rather than grants from another tax-exempt organization. This could provide the basis for arguing that the organization no longer accomplishes its objectives in a charitable manner. Second, the organization's activities no longer benefit a distressed class of individuals and the organization's only basis for exemption would be that it advances education by enabling participating educational institutions to provide retirement programs to its employees at a cost lower than the cost would be if the institutions ran their own programs or purchased insurance from commercial insurers. However, the Chief Counsel's office did not recommend revocation of the organization's tax-exempt status because it felt that no useful purpose would be served unless the revocation enabled commercial insurers to compete with the organization, which the office concluded was doubtful.

[54] Rev. Rul. 78-41, 1978-1 CB 148.

[55] See, e.g., GCM 39122, CC:EE-36-82 (January 25, 1984), GCM 39003, CC:EE-37-82 (June 24, 1983).

members on a fee-for-service basis was tax-exempt because the class of members was broad enough so that the risk spreading provided by the organization could be considered to benefit the entire community, not private interests. (*Sound Health Association* v. *Comm'r,* 71 TC 158 (1978).)

Social welfare organizations

An organization is entitled to tax exemption if it is operated exclusively for the promotion of social welfare.[56] At least one major health insurance provider has been treated as a tax-exempt social welfare organization. Other organizations providing insurance have been denied tax-exempt status as social welfare organizations. For example, an insurance trust set up to provide group life insurance for members is not tax-exempt because the trust was organized only for the benefit of its members, which was a limited class.[57] Further, if the benefit from an organization is limited to that organization's members, except for some minor and incidental benefit to the community as a whole, the organization is not operated exclusively for the promotion of social welfare.[58]

Labor and agricultural organizations

A labor, horticultural, or agricultural organization is entitled to tax-exempt status provided the organization has no net earnings inuring to the benefit of any member and has as its object the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.[59] Tax-exempt status was originally granted to labor organizations because they provided death, sickness, or accident benefits to its members and such activity was considered to better the conditions of the members. Whether such an organization may provide property insurance to members is unclear.

An agricultural organization may not provide property insurance to its members because the exempt purposes of such an organization contemplate benefiting members of the organization generally, rather than each member individually.[60]

Fraternal beneficiary societies

A fraternal beneficiary society, order, or association that is operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents is entitled to tax exemption.[61]

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[56] Sec. 501(c)(4).

[57] *N.Y. State Association of Real Estate Boards Insurance Fund* v. *Comm'r*, 54 TC 1325 (1970).

[58] Rev. Rul. 75-199, 1975-1 CB 160.

[59] Sec. 501(c)(5). Treas. Reg. sec. 1.501(c)(5)-1(a).

[60] GCM 38743, CC:EE-145-79 (June 9, 1981). At least one court has held, however, that the income received by an agricultural organization from an insurance company as rebates on premiums paid for group insurance (health, accident, and life) by members of the organization was substantially related to the exempt purposes of the organization. *Oklahoma Cattlemen's Association, Inc.* v. *U.S.*, 320 F. Supp. 310 (1969). The IRS does not follow the holding in *Oklahoma Cattlemen's Association.*

[61] Sec. 501(c)(8).

Voluntary employees' beneficiary associations

Voluntary employees' beneficiary associations (VEBAs) are organized to provide life, sick, accident, or other benefits to their members or dependents.[62] VEBAs may be funded solely by employer contributions on behalf of employees, by employee contributions, or by a combination of employer and employee contributions. The Deficit Reduction Act of 1984 made significant changes relating to the extent to which the amounts held by a VEBA supplemental unemployment compensation trust (sec. 501(c)(17)) or group legal services organization (sec. 501(c)(20)) are exempt from taxation.

Supplemental unemployment compensation trusts

Supplemental unemployment compensation trusts (sec. 501(c)(17)) are permitted to provide life, sick, accident, and other benefits to its members.

War veterans organizations

War veterans organizations (sec. 501(c)(19)) may be operated for the purposes of providing insurance benefits to its members or dependents.

Black lung benefit trusts

Black lung benefit trusts (sec. 501(c)(21)) are permitted to pay claims for compensation under Black Lung Acts or to pay premiums for insurance to cover such claims.

Certain veterans' organizations

Veterans' organizations organized before 1880 (sec. 501(c)(23)) in which more than 75 percent of the members are past or present members of the Armed Forces are permitted to provide insurance benefits to veterans or their dependents.

Tax-exempt organizations sponsoring insurance for members

Tax-exempt organizations that cannot engage in the provision of insurance as part of their exempt activities may, nevertheless, be involved in sponsoring insurance for their members through commercial insurance carriers. Depending on the extent of involvement of the organization in this insurance activity, the income that the organization receives from sponsoring insurance for members may be considered income from an unrelated trade or business that is subject to Federal income tax.

For example, a business league was not entitled to tax-exempt status because a substantial part of the activity of the organization was the administration of insurance programs for members.[63] The insurance activities of the organization constituted engaging in a regular business of a kind ordinarily conducted for profit. Similarly, a business league whose principal activity is to provide its members with group workers' compensation is not tax exempt because the organization renders particular services for individual persons

[62] Sec. 501(c)(9).
[63] *Associated Master Barbers & Beauticians of America, Inc. v. Commr.*, 69 TC 53 (1977).

rather than generally improving business conditions in the contracting business and related industries.[64]

On the other hand, if a business league receives rebates from an insurance company that provides group coverage to participating members of the league and the level of the business league's involvement is not substantial, then the organization will not lose its tax-exempt status. However, the amount of rebates the organization receives constitutes unrelated trade or business income that is subject to tax.[65]

In at least one case, a tax-exempt organization's involvement in insurance programs for members was not considered an unrelated trade or business. The Claims Court recently held that amounts raised by the American Bar Endowment (ABE) were not treated as income from an unrelated trade or business.[66] Working with private insurers, the ABE sells group life insurance to its members on the condition that participants assign their premium refunds to the Endowment for its charitable and educational projects. In 1979, over 55,000 members participated in the program which generated $5.1 million in dividends. In that same year, the ABE expenses from administering the program were only $1.5 million. The business league cases were distinguished under the theory that those associations conducted their activities in a manner that attempted to reduce the cost of insurance for members and, therefore, gave the organization an unfair competitive edge over commercial insurers. The Claims Court concluded that the ABE was actually procompetitive because the insurance sold to members was not significantly below the cost of comparable commercial insurance.

Other Proposal

1984 Treasury report

The 1984 Treasury report recommended repeal of the existing tax exemptions for organizations engaged in insurance activities and would have applied the rules relating to taxable corporations to such organizations. If an organization would otherwise qualify as a life insurance or property or casualty insurance company, it would be taxed under the general principles applicable to such companies.

In addition, the 1984 Treasury report would have continued to recognize as exempt from Federal income tax the insurance activities of an organization that provided insurance at less than cost to a class of charitable recipients.

Analysis

The extent to which tax-exempt organizations should be permitted to engage in insurance or similar activities requires examination of several issues. The first issue is whether insurance activities are so inherently commercial that tax exemption for an entity that engages (other than to an insubstantial extent) in such activities

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[64] Rev. Rul. 74-81, 1974-1 CB 135.

[65] *Carolinas Farm & Power Equipment Dealers Assoc. v. U.S.*, 699 F.2d 167 (4th Cir. 1983).

[66] *American Bar Endowment v. U.S.*, 4 Cl. Ct. 404 (1984) aff'd, No. 84-988 (Fed. Cir.) May 10, 1985.

is inappropriate. The second issue is whether the insurance or similar activities of certain tax-exempt organizations provides an unfair competitive advantage to these organizations. Finally, an issue is raised whether present law encourages self insurance because of the tax exemption provided to certain entities, such as voluntary employees' beneficiary associations (VEBAs).

Inherently commercial activities

Those who support proposals to limit the availability of tax-exempt status in the case of entities engaged in insurance activities believe that the provision of insurance to the general public at a price sufficient to cover the costs of insurance constitutes an activity that is, per se, commercial. They argue that organizations have historically been granted tax exemption only if the organizations engage in functions that can be considered to benefit the public generally or a broad class of individuals, rather than specific individuals (e.g., those who purchase goods or services from the organization).

Those who advance this view suggest that the provision of insurance or insurance-type benefits to members of the organization should always be viewed as benefiting those individuals who receive the insurance. Thus, they argue that, for example, any organization that is primarily engaged in providing insurance to members cannot be viewed as benefiting the public generally or improving the condition of a broad class of individuals, such as all individuals living within a community or the members of a labor organization.

On the other hand, others contend that the provision of insurance to members of a nonprofit organization is not inconsistent with the purposes for tax exemption. For example, some suggest that any organization that provides health insurance benefits to members of a broad-based community generally could be considered, if the organization operates on a nonprofit basis, to benefit the community as a whole, rather than the particular individuals who receive the benefits. They point out that some health maintenance organizations have been granted tax-exempt status because they make health care available to the general public. This, they argue, is not the same as the activity of a commercial insurance company, which may selectively extend the availability of its coverage.

Competition with commercial insurance companies

Whether tax-exempt organizations engaging in insurance activities compete directly with commercial insurance companies raises two questions: (1) whether the eligibility for tax-exempt status provides an organization with an unfair advantage in bidding for business, and (2) whether the unrelated business income tax rules are adequate to deal with the question of competition between tax-exempt organizations and commercial businesses.

Some argue that the availability of tax-exempt status under present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in sections 501(c)(3) or (4).[67] These organizations now constitute the largest health care insurer in the United States. For example, in 1978, Blue Cross insured more than 83 million individuals, or 37.6 percent of the population, for hospital services.[68]

Further, some believe that the conditions on which the original tax-exempt status for organizations such as Blue Cross/Blue Shield was based have changed considerably over the years, while taxable companies have grown to provide comparable levels of coverage. They argue that these tax-exempt organizations, such as Blue Cross, have abandoned many of the practices (such as open enrollment and community rating) that marked them as unique, socially conscious organizations and, therefore, distinguishable from commercial insurance enterprises. They point out that the favorable tax status granted to certain health care providers and other insurance entities has been a major cause of dissatisfaction among insurance companies, which view tax exemption as a distinct competitive advantage.

Those who support proposals to clarify or limit the availability of tax-exempt status for organizations providing insurance and other similar organizations argue that providing tax-exempt status to an organization engaged primarily in an activity that would otherwise be taxable permits the members of the organization to benefit from the tax exemption on investment earnings of the organization.

For example, a commercial insurance company that provides health insurance to its policyholders is required to pay tax currently on its taxable investment income even if the investment income is used, in part, to pay claims on policies. On the other hand, the investment income of a tax-exempt health care provider is not subject to tax. Thus, the tax-exempt organization can provide the same insurance benefit at a lower cost to its members because the premiums charged to its members do not have to reflect taxes payable on investment income.

Further, those who support the proposal to eliminate tax-exempt status for organizations involved primarily in providing insurance argue that such proposals are consistent with the Administration proposal to eliminate the tax exemption for credit unions.

On the other hand, those who oppose proposals to eliminate the the tax-exempt status of organizations similar to commercial health insurers argue that such a change should not be made without a careful evaluation of its potential effect on the availability of adequate health care in the United States. They point out that the IRS generally has required that, in order to qualify for tax-exempt status, a HMO must offer its services to the general public on a fee-for-service basis. They suggest that elimination of the tax exemption for such organizations could have the effect of eliminating or restricting the availability of health care on at least a fee-for-service basis. Furthermore, they point out that generally commercial insurance companies are not taxed on investment income to the extent the income is attributable to tax-exempt obligations.

[67] Most health maintenance organizations (HMOs) have also historically been treated as exempt from Federal income taxation.

[68] Health Insurance Association of America, *Source Book of Health Insurance Data,* 1979–80.

An additional issue is whether the present-law unrelated business income tax rules adequately address the issues raised when tax-exempt organizations engage in insurance activities. The unrelated business income tax provisions are directed, in part, at the issue of unfair competition by tax-exempt organizations. The legislative history of these provisions make clear the Congress' intent to make certain that an exempt organization does not commercially exploit its exempt status for the purpose of unfairly competing with tax-paying organizations.

Some argue that the present-law provisions are adequate to deal with the problems of unfair competition. They contend that it is inappropriate to repeal the tax-exempt status for organizations that provide some insurance, even if it can be shown that such activity is essentially commercial and is not substantially related to the organization's exempt purpose or function. Rather, they argue, such insurance business activity should be treated as subject to tax as an unrelated business (secs. 511-514). If so taxed, insurance activities of tax-exempt organizations would not have an unfair competitive advantage over taxable commercial insurance businesses. They believe that the more significant issue is the extent to which tax exemption is granted to organizations that are primarily engaged in inherently competitive activities.

Others contend that, in many cases, tax-exempt organizations providing insurance do so as a major part of their activities or as their only purpose or function. The unrelated business income provisions are consequently inadequate to address the situation in which the insurance activity is not unrelated to the organization's exempt purpose. They further argue that, if an organization's unrelated business is so substantial, and if insurance activities are inherently commercial, then tax-exempt status is inappropriate.

Tax exemption for self insurance

Some believe that it is appropriate to reevaluate the extent to which present law encourages the use of tax-exempt organizations as self-insurance vehicles. For example, an employer who sets aside funds for the purpose of providing future benefits (such as health insurance or disability compensation) to employees would not generally be permitted a deduction for the amounts set aside. The income earned on such funds generally would be taxed to the employer. Nevertheless, subject to certain limitations, employers are able to deduct currently contributions to certain tax-exempt organizations, such VEBAs, SUB trusts, and black lung trusts that fund future employee benefits, and investment income earned by these associations and trusts is exempt from tax.

Those who support restricting the use of tax-exempt organizations as self-insurance vehicles argue that the present-law treatment encourages employers and others to self-insure benefits, which may reduce the protection against loss because the risk of loss may not be adequately spread in the case of self-insurance. Further, they argue that allowing tax exemption for self-insurance vehicles effectively shifts a portion of the cost of self insurance to the general public, by necessitating higher marginal tax rates on taxable income to recoup the revenue loss.

Further, some believe that, if the Administration proposal relating to loss reserve deductions for property and casualty companies is adopted, it is appropriate to consider whether the rules for VEBAs and similar tax-exempt entities should be reevaluated to guarantee that such organizations are not provided with an even greater competitive advantage over insurance companies. This would result because the present-law rules for employer deductions for contributions to VEBAs generally do not require them to use a cash method of accounting. However, the qualified reserve account method proposed by the Administration for property and casualty companies is essentially equivalent to putting such companies on a cash method of accounting with respect to their loss reserves.

On the other hand, some believe that the proposal to repeal the tax exemption for certain self-insured arrangements may, in fact, have a disproportionately heavier tax burden on these arrangements than would be imposed on casualty insurance companies under the Administration proposal to limit property and casualty company loss reserve deductions. This would result, they argue, because limits would still be imposed on an employer's deduction for contributions to a welfare benefit fund, whereas the payment of insurance premiums to a commercial insurer would generally be deductible. They also suggest that, in the case of an entity that pools the risks of many individuals or groups, characterization of the arrangement as self-insured may be misleading.

They argue that there is no empirical evidence that the effective tax rate on these tax-exempt arrangements would be comparable to the effective rate on property and casualty insurance companies. Moreover, they point out that the repeal of tax exemption would require higher employer contributions to fund the current level of benefits promised under such an arrangement.

In addition, some argue that, even if it is demonstrated that the tax burden after the repeal of the tax exemption of certain self-insured arrangements is comparable to the tax burden on casualty insurance companies, there are social policy reasons why the tax exemption should be continued. They point out that, to the extent that the entity provides benefits to employees of participating employers, the assets of these entities may be treated as plan assets under the Employee Retirement Income Security Act of 1974 and, therefore, subject to significant restrictions on investments. Premiums paid to an insurance company are not treated as plan assets. This, they argue, means that the fiduciaries of the self-insured arrangement are not competing with insurance companies for investment returns under the same set of requirements. Those who oppose the repeal of tax-exempt status for certain employer-maintained self-insurance arrangements argue that, due to such economic distinctions between commercial insurance and self-insurance, tax law distinctions between them are appropriate and should be retained.

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