

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue cap at the top. The globe in the top bulb is dark blue, while the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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Taxation of Life Insurance Companies

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Updated December 24, 2003

Abstract. This report provides an overview of the most significant tax provisions that apply only to life insurance companies. In addition, it examines Internal Revenue Code Sections 809 and 815, which have attracted legislative attention in recent years.

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Taxation of Life Insurance Companies

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Taxation of Life Insurance Companies

Summary

Life insurance companies determine their federal income tax liability using a set of Internal Revenue Code provisions that apply only to those companies. This report provides an overview of these tax provisions.

Life insurance companies sell financial contracts that contain two common features. First, these contracts generally provide protection against uncertain financial risks that relate to the timing of the death of insured individuals. Second, they incorporate a broad variety of financial investment arrangements. Most of the difficult issues that arise concerning the taxation of life insurance companies relate to these two economic components of life insurance arrangements. This report contains a very brief overview of these business activities of life insurance companies.

The report then provides a brief history of the federal income tax treatment of life insurance companies. Prior to 1984, when Congress enacted the current tax provisions, life insurance companies were taxed in a manner that reflected two major policy decisions. First, a significant component of life insurance company profits was untaxed. Second, Congress sought to achieve an “acceptable” balance between the tax burden borne by life insurance companies owned by their shareholders and the mutual life insurance companies that were owned by their policyholders. These provisions of prior law led Congress to enact Internal Revenue Code Sections 809 and 815, which have attracted legislative attention in recent years, which are discussed in this report.

Next, the current tax provisions applicable to life insurance companies, including an overview of the general approach to taxation, are examined. In general, life insurance companies include all of their receipts in income and may deduct their general business expenses. In addition, specialized provisions that apply to insurance companies make certain that these companies are not overtaxed as compared to other financial intermediaries. These specialized provisions are discussed, specifically:

- (1) the special deductions for “small” life insurance companies that effectively reduce the tax rate applicable to these companies from 35% to 14%;
- (2) the limitation enacted to prevent life insurance companies from deducting inappropriate expenses that are attributable to generating tax-exempt income;
- (3) the complex provisions that govern the deductions allowed with respect to a life insurance company’s reserve liabilities; and
- (4) the limitation on the amount of policyholder dividends that mutual life insurance companies are allowed to deduct.

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Taxation of Life Insurance Companies

Introduction

Life insurance companies are generally taxed at the same rates that apply to other business corporations. Life insurance companies compute their taxable income, however, under a set of Internal Revenue Code (IRC) provisions that apply only to life insurance companies. These provisions reflect several distinct policy and political concerns.

First, life insurance companies sell life insurance, annuity and pension contracts. These arrangements combine two elements not frequently bundled together in other financial instruments. Frequently, life insurance products protect their customers from the risk of financial loss arising from uncertain events. For example, life insurance may provide financial resources to substitute for the earnings following an insured individual's death. Similarly, an annuity may provide financial payments that will continue until the death of an annuitant or a pension plan beneficiary. The contingent obligation to pay benefits is one distinguishing characteristic of life insurance and annuity contracts.

Second, many life insurance products require premium payments that occur years before the life insurance company makes the corresponding payments of benefits to beneficiaries. In these circumstances, special tax rules are needed to calculate the insurance company's income for any taxable year.

Third, for many years the life insurance industry was characterized by the presence of two sizable "camps" within the industry: large customer-owned "mutual" companies and the more numerous investor-owned "stock" companies. Over the years, Congress has enacted special tax provisions that reflect this division. One of these provisions remains in effect even though few large life insurance companies now operate as mutual organizations.

Fourth, Congress has historically designed the tax provisions that affect life insurance companies with the goal of generating predetermined levels of tax revenue. To achieve this goal, it has enacted special tax provisions that affect only life insurance companies.

This paper¹ provides an overview of the most significant tax provisions that apply only to life insurance companies. In addition, it examines Internal Revenue Code Sections 809 and 815, which have attracted legislative attention in recent years.

¹ This report was produced under the supervision of James M. Bickley.

The Business of Life Insurance Companies

Life insurance arrangements typically combine two distinct economic components: a pure insurance component and a savings component. When a policyholder pays a premium to a life insurance company, a portion of the premium pays for pure insurance protection. Another portion of the premium can be viewed as an investment in a financial instrument, similar to a bank deposit or a purchase of mutual fund shares.

Most of the difficult issues that arise concerning the taxation of life insurance companies relate to these two economic components of life insurance arrangements. Before discussing the tax issues, this section presents a brief overview of the risk protection and financial intermediation activities of life insurance companies.

Life Insurance Company Products and Premiums

The life insurance industry sells a range of insurance products that generally involve a contingency that relates to mortality, i.e., the timing of the death of an individual. For example, life insurance companies sell:

- life insurance products, in which payments are made to the beneficiaries of a life insurance contract following the death of the insured; and
- annuity and pension products, in which payments are made to an annuitant (or retiree) for the remainder of his or her life.

Within these broad outlines, the life insurance industry sells a wide variety of specific products.

Life Insurance Products.² One common form of life insurance is term life insurance. As with all forms of life insurance, the insurance company pays the specified death benefit if the insured dies during the period of coverage. If the insured remains alive at the end of the policy term, the owner of the policy (and the designated beneficiaries) has no further economic claims against the life insurance company. A term life insurance arrangement primarily involves pure insurance protection, with little or no savings.

Another form of life insurance is “cash value life insurance.” The distinguishing feature of cash value life insurance is the presence of the contract’s cash value, which is the amount that the policy owner receives if she terminates the policy. The accumulation of cash value reflects the existence of a savings feature in this form of insurance. The savings component is much more significant in cash value life insurance than in term insurance. Variations on the basic cash value life insurance design include “Universal” life insurance, “Variable” life insurance, single premium life insurance and “second-to-die” life insurance. In addition, “Key Person” Life

² A more detailed analysis of life insurance products is contained in CRS Report RL32000, *Taxation of Life Insurance Products: Background and Issues*, by Andrew D. Pike.

Insurance, Corporate Owned Life Insurance (“COLI”) and Split Dollar Life insurance incorporate cash value life insurance into other financial arrangements.

Annuity and Pension Products. Life insurance companies sell a wide variety of savings vehicles that are used to provide post-retirement sources of income. For example, a life insurance company may issue annuity contracts in connection with an employer’s pension plan. In these annuity arrangements, an employer makes a series of premium payments during the working years of its employees. The life insurance company invests these funds and agrees to pay a pension benefit following the employees’ retirement. This type of arrangement is primarily an investment vehicle. However, annuity payments generally continue until the beneficiary’s death. Because the number of payments depends on the timing of the beneficiary’s death, however, there is also an insurance element in these arrangements.

Life insurance companies sell a wide variety of other savings vehicles. Some of these are sold to individuals, including deferred annuities and individual retirement annuities. In these arrangements, individuals pay premiums to the life insurance company. The life insurance company credits a return on the invested funds. Depending on the contractual terms of the annuity, the return may be a fixed rate of interest or a variable return based upon the performance of specified assets. These arrangements are primarily savings vehicles that are quite similar to certificates of deposit issued by banks and mutual fund shares issued by mutual funds. In an annuity arrangement, however, the policyholder has the right (but not the obligation) to receive repayment in the form of a series of payments that continues for the remainder of the beneficiary’s life.

Common Features of Life Insurance and Annuity Arrangements. In these types of contracts, the life insurance company receives one or more premium payments as consideration for its assuming its obligations to make benefit payments. For some insurance products, the life insurance company will receive the premium payment and will pay all benefits under the contract in the same year. More frequently, however, the life insurance company receives the premium payment in one (or more) years, and will pay the benefits under the contracts in subsequent years.

In many instances, the premium charged with respect to a life insurance contract, an annuity or a pension plan exceeds the amount that the insurance company is expected to pay out in benefits with respect to that contract during the current year. Because the life insurance company may become obligated to make benefit payments in future years, the premium charged will reflect the following amounts:

- the amount that the life insurance company estimates that it will pay out in the current year;
- the amount that the life insurance company estimates will be sufficient (in combination with future premium payments and interest) to pay out benefits in connection with the contract in future years; and

- the amount that will be used to pay the life insurance company's operating expenses and a profit.

State Regulation and Reserve Liabilities

Each life insurance company is subject to regulation by the state insurance regulators in the states in which the company conducts business. The primary concern of the state regulators is to ensure that the life insurance company remains solvent (in an actuarial sense). The goal of this solvency requirement is to make certain that the life insurance company will have sufficient assets to pay insurance benefits when they become due. In demonstrating its solvency, the life insurance company files an annual statement reporting its assets and its "reserve liabilities." In general terms, these "reserve liabilities" represent a mathematical estimate of the present value of the company's future liabilities. The life insurance company's actuaries compute the reserve liabilities taking into account the following factors:

- the actuarial likelihood that benefit payments will become payable in any given year;
- the future premium payments specified in the insurance contracts; and
- the interest that the life insurance company will set aside in future years (at an assumed rate).

A more detailed discussion of reserve liabilities, and a simple illustration of the computation of reserve liabilities, are on page 11.

The Life Insurance Company as Financial Intermediary

As previously discussed, many life insurance products incorporate a significant savings component. In these arrangements, the life insurance company receives premium payments, a portion of which is invested to benefit the policyholders (or their beneficiaries). In later years, the company uses the invested amounts, together with interest credited thereto, to pay the insurance benefits to the beneficiaries of the insurance contracts. This investment of the policyholders' funds to provide a future economic benefit for the beneficiaries is a form of financial intermediation. For this reason, a life insurance company operates as a financial intermediary.

Other financial intermediaries, such as banks and mutual funds, also receive funds from their customers. These financial intermediaries invest the funds, and credit an investment return — interest in the case of banks and changes in the asset values of the mutual funds — to the accounts of the customers. In calculating the annual income of these financial intermediaries, the amounts that customers pay to the financial intermediary as an investment is not treated as income. Rather, the bank treats these amounts as non-taxable deposits, and the mutual funds treat these amounts as non-taxable capital contributions. Similarly, the bank (and the mutual fund) may deduct the interest (or other investment return) allocated to its depositors (or the owners of the mutual fund shares).

For purposes of reporting a life insurance company's annual income for state regulatory purposes and for income tax purposes, it is necessary to reflect the company's operations as a financial intermediary. Unfortunately, two factors make this analysis more difficult in the case of the life insurance company. First, the insurance premium may not separate the portion that is to be invested for the benefit of each policyholder. Second, the liabilities owed to the beneficiaries are contingent — the amount and timing of the benefit payments depend upon the occurrence and timing of future events. These issues are discussed below in connection with the tax treatment of the insurance reserve liabilities.

Brief History of Taxation of Life Insurance Companies

Taxation Prior to the Life Insurance Company Tax Act of 1959

At the outset of the federal corporate income tax, life insurance companies were taxed according to the same statutory provisions as other corporations. Beginning with the Revenue Act of 1921, however, Congress has taxed life insurance companies under of rules that differ from those applicable to normal business corporations.

From 1921 through 1957, life insurance companies were taxed utilizing the “free investment income” approach. Under this method, a life insurance company was taxed only on the portion of its profit attributable to its investment activities. Cash value life insurance, annuities and pension plan contributions represent, in whole or in part, a financial investment. The premiums paid with respect to these types of contracts include an amount that is invested for the benefit of the policyholder or pension plan beneficiary. The life insurance company invests these funds and, in effect, credits an investment return to the policyholders.

In calculating its free investment income, a life insurance company started with its net income from its investment activities. From this amount, the life insurance company subtracted the portion of this net investment income that was deemed to be allocable to the company's obligations to its policyholders. The remainder of the company's net investment income was “free” of any obligation towards the company's policyholders and was, therefore, subject to income taxation. During the period from 1921 through 1957, Congress used a number of different formulas to determine the amount of investment income that was deemed to be allocable to the company's policyholders and, thus, deductible in computing the life insurance company's taxable income.

In enacting this method of taxation, Congress avoided some of the difficult issues inherent in taxing life insurance companies. Specifically, taxing life insurance companies on their free investment income made it unnecessary to decide the extent to which premiums received represented taxable income and whether life insurance companies should be allowed an offsetting deduction for the life insurance company's reserve liabilities.

Moreover, a life insurance company may earn “underwriting profits.” Underwriting profit results if the amounts that a company charges policyholders for protection against insurance risks exceed the corresponding benefits paid to the beneficiaries. For example, a life insurance company that sells term insurance may collect \$5 million in premiums for these contracts. If the company pays \$3 million as benefits and expenses with respect to these contracts, the life insurance company has a \$2 million underwriting profit. During the period in which life insurance companies were taxed on their free investment income, underwriting profits were not taxed.

Taxation Under the Life Insurance Company Income Tax Act of 1959

In the years prior to the enactment of the Life Insurance Company Income Tax Act of 1959 (the “1959 Act”)³, developments in the life insurance industry made it necessary to abandon the free investment income approach to taxing life insurance companies. These changes included:

- the growth of the stock life insurance companies relative to the mutual life insurance companies; and
- the substantial increases in the amounts of term life insurance and credit life insurance sold. These life insurance products generated substantial underwriting profits, but relatively small amounts of premium and investment income.

The 1959 Act sought to respond to these developments by enacting the so-called three-phase system of taxation.⁴ Under this extraordinarily complex system, each life insurance company had to determine its “taxable investment income” (which roughly corresponded to the “free investment income” tax base used prior to 1958) and its “gain from operations” (which roughly corresponded to the life insurance company’s total profits).

Although the details of this three-phase system are beyond the scope of this paper, the following significant features are worth noting:

³ P.L. 86-69, 73 Stat. 112. Although enacted in 1959, the statutory provisions enacted in the Life Insurance Company Income Tax Act of 1959 were made retroactive to the beginning of 1958.

⁴ The extraordinarily complex statutory rules enacted in the 1959 Act will not be discussed in detail in this paper. In analyzing a tax dispute arising under the 1959 Act, Judge Fletcher of the Court of Claims wrote that “[t]hese complex and obscure provisions bear all of the earmarks of a conspiracy in restraint of understanding.” *Lincoln National Life Insurance Company v. U.S.*, 582 F.2d 579, 583 (Ct. Cl. 1978).

- Congress sought to collect a predetermined level of income tax revenue from the life insurance industry.
- An “appropriate” portion of this tax revenue would be collected from each of the two segments of the life insurance industry — the stock segment and the mutual segment.
- Most mutual life insurance companies would continue to be taxed on their share of the company’s investment income, with an appropriate limit on the amount of policyholder dividends that a mutual company could deduct. In technical terms, they were taxed on their Phase I income.
- The tax liability of most stock life insurance companies would be based upon their “gain from operations.” This was the Phase II tax base. These companies were allowed to deduct certain non-economic “special deductions” and were allowed to defer the taxation of 50% of the remaining underwriting income.
- If a life insurance company deducted any special deductions, or had underwriting income that was not taxed in full, these amounts were added to the company’s “policyholders surplus account.” These deductions were designed to provide a financial cushion to be used in the event that the company experienced significant underwriting losses in future years. If, however, the company distributed these funds to its shareholders, or if it ceased to be a life insurance company, the previously untaxed amounts were included in the life insurance company’s taxable income. When these amounts were included in income, they were referred to as the Phase III amounts.

Overview of Current Taxation

In 1984, Congress overhauled the federal income tax treatment of life insurance companies. The fundamental goal of this overhaul was to establish a single scheme for taxing all life insurance companies and to eliminate the three-phase method of taxation. Although life insurance companies continue to compute their taxable income under a set of Internal Revenue Code provisions that apply only to life insurance companies, they are taxed in a manner comparable to other businesses operating in corporate form. Certain differences tend to reduce the effective tax burden imposed on life insurance companies as compared to other corporations.

As with other business corporations, a life insurance company includes all of its receipts in its income, including all premiums received and all of its investment income. In computing its taxable income, the company is allowed to deduct its general business deductions, which include the range of ordinary and necessary business expenses that all business corporations may deduct. Consequently, a life insurance company may deduct such routine expenses as salaries, rents, utilities, advertising costs and other normal operating expenses. The company may also

deduct all benefits accrued with respect to its insurance contracts during the taxable year.

Special provisions of the tax law are designed so that the tax burden of life insurance is not excessive compared to the taxation of other financial intermediaries. Specifically, amounts that customers pay to a life insurance company as an investment are not taxed. This is accomplished in a two-step manner that is unique to the taxation of insurance companies. First, a company must include in income the full amount of premiums that the policyholder pays. Second, a company is allowed to deduct any net additions to its life insurance reserves. The reserve liabilities generally reflect the investment component of the contractual arrangements. Similarly, the increase in reserves also reflects the amount of interest that the life insurance credits with respect to the policyholders' investments.

Analysis of Current Law: Major Structural Issues in Taxation of Life Insurance Companies

Although life insurance companies generally are taxed in a manner comparable to other business corporations, the taxation of life insurance companies deviates from the general corporate tax principles in four significant respects. When Congress created the current system for taxing life insurance companies in 1984, it made the following major policy decisions:

- The taxable income of life insurance companies would be based upon their total economic profit. Congress decided, however, to adjust the industry's tax burdens by effectively reducing the tax rate applicable to life insurance companies. (IRC Section 806). Following the general reduction in corporate tax rates enacted in 1986, however, the lower tax rates now apply only to "small" life insurance companies.
- Limitations were enacted to prevent life insurance companies from deducting costs that are attributable to tax-exempt income, and thereby generate inappropriate double tax benefits.
- Every life insurance company was allowed to deduct increases in the level of its reserve liabilities. For tax purposes, Congress established "objective" standards for calculating the reserve liabilities for all life insurance companies. (IRC Section 807).
- Congress was concerned that mutual life insurance companies may have enjoyed inappropriate tax advantages arising from the mutual form of doing business. In response to this concern, and to achieve what Congress viewed as an appropriate allocation of the tax burdens between the stock and mutual life insurance companies, Congress created an explicit limitation on the amount of

policyholder dividends that a mutual life insurance company could deduct. (IRC Section 809).

Each of these matters is discussed below.

Effective Tax Rate Reduction for Small Life Insurance Companies

In designing the life insurance company provisions of the Tax Reform Act of 1984, one of the legislative goals was to raise a predetermined level of federal income tax revenue from the life insurance industry. To produce this level of tax revenue, Congress first estimated the level of revenue generated under the structural provisions that taxed life insurance companies on their total economic profit. Because the estimated revenue exceeded the predetermined targets, Congress enacted two extraordinary deductions that reduced the effective tax rates of life insurance companies to levels that would have generated the desired level of tax revenues.

The first extraordinary deduction was called the “special deduction.” It equaled 20% of a life insurance company’s taxable income. This effectively reduced a large life insurance company’s rate of tax from the 46% statutory corporate tax rate then applicable to a 36.8% rate. In 1986, Congress reduced corporate tax rate to 34% for corporations with taxable income of more than \$335,000. In light of this general reduction in corporate tax rates, Congress eliminated this 20% special deduction in 1986.

The second extraordinary deduction is the so-called “small life insurance company deduction.” Under Internal Revenue Code Section 806, a “small” life insurance company may deduct 60% of its otherwise taxable income, subject to several limitations. First, the small life insurance company deduction cannot exceed \$1,800,000. Second, if a life insurance company’s otherwise taxable income exceeds \$3 million, the deduction is phased out, so that no deduction is allowed for life insurance companies with taxable income in excess of \$15 million. Third, no deduction is allowed for a life insurance company that has assets in excess of \$500 million.

To illustrate the operation of the small life insurance company deduction, consider the following example. Assume that a company has taxable income of \$2 million before taking the small life insurance company deduction. The small life insurance company deduction equals \$1.2 million (i.e., 60% of its otherwise taxable income). The company’s taxable income of \$800,000 is taxed at the generally applicable corporate tax rate. Although technically a deduction, this provision has the effect of reducing a small life insurance company’s effective rate of taxation to 40% of the normal rate applicable to corporations. Thus, a small life insurance company with income of up to \$3 million will be subject to a maximum effective tax rate of 14%, rather than the 34% statutory rate.

In enacting this provision, Congress recognized that this deduction did not reflect an expense that constituted a cost of doing business. Rather, it recognized that small life insurance companies had “enjoyed a tax-favored status for some time [prior

to the enactment of the Tax Reform Act of 1984] and [Congress] believe[d] that it would not be appropriate to dramatically increase their tax burden at this time.”⁵ The legislative history does not address reason why small life insurance companies should be taxed at lower rates than other business corporations with the same level of income.

Costs Incurred to Produce Tax-Preferred Forms of Income

Certain forms of income are taxed in a preferential fashion under the income tax. For example, interest paid to owners of certain state and local bonds is exempt from taxation. (IRC Section 103). Similarly, a corporation that receives intercorporate dividends is permitted a deduction equal to between 70 and 100% of the dividend (IRC Section 243).

A taxpayer who incurs deductible expenses to earn tax-preferred income may engage in what tax analysts call “tax arbitrage.”⁶ A simple illustration demonstrates the tax benefits that arise in tax arbitrage transactions. Consider a taxpayer who borrows \$100,000 which is used to purchase a tax-exempt bond. Assume that the taxpayer pays interest on the borrowed funds at a 6% rate and that the tax-exempt bond pays interest at a 5% rate.

In this example, were there no restraints on “tax arbitrage,” the taxpayer receives \$5,000 of interest income and pays \$6,000 of interest expense. On a pre-tax basis, the taxpayer loses \$1,000 per year as a result of engaging in these transactions. On an after-tax basis, however, this transaction is profitable. Assuming that the taxpayer’s income is taxed at a 35% marginal tax rate, the tax-deductible interest payment of \$6,000 generates tax savings of \$2,100 ($0.35 \times \$6,000$). This tax savings convert the pre-tax loss of \$1,000 into an after-tax profit of \$1,100.

The Internal Revenue Code contains several provisions that reduce the tax benefits that otherwise would arise in tax arbitrage transactions. For example, Internal Revenue Code Section 265 limits the deduction for interest deemed to be allocable to investments in tax-exempt bonds. The tax provisions governing life insurance companies contain the most comprehensive limitation on deductions arising from tax arbitrage (IRC Sections 805(a)(4) and 807(a)(2)). These provisions apply to all tax-exempt interest and most intercorporate dividends. Under these provisions, the tax-preferred investment income is “prorated” between the company and the policyholders. This proration is based upon the portion of the life insurance company’s investment income that is allocable to the policyholders.

For example, if 90% of the company’s investment income is used to satisfy the company’s obligations to its policyholders, only 10% of the tax-preferred income is deemed to be allocable to the company’s own investment. As result, the company is allowed a deduction with respect to only 10% of the intercorporate dividends

⁵ U.S. Congress, House of Representatives, H.Rept. 432 (pt 2), 98th Cong., 2nd sess. 1410 (1984).

⁶ Generally, individuals cannot (but businesses can) deduct the interest on borrowed funds used to purchase securities paying interest which is taxable.

received. Similarly, the proration rules effectively disallow the deduction for interest allocable to the policyholders' share of the company's tax-exempt interest income.

Treatment of Life Insurance Reserve Liabilities

As previously discussed, life insurance companies operate as financial intermediaries. To measure a life insurance company's income and net worth, it is necessary to take into account its reserve liabilities.⁷ Under both the 1959 Act and the 1984 Act provisions, life insurance companies were allowed to take their reserve liabilities into account in measuring their taxable income. Specifically, life insurance companies were allowed to deduct any increase in the level of the company's life insurance reserves and they were required to include in income any decrease in their life insurance reserves.⁸ The methodology utilized in calculating the reserve liabilities, however, differed in the two Acts.

To determine the level of life insurance reserves, actuaries undertake complex calculations that take into account numerous factors. The most important factors utilized in making these calculations are: (1) the actuarial likelihood that benefit payments will become payable in any given year; (2) an assumed rate of interest; (3) the future premium payments specified in the insurance contracts; and (4) the technical actuarial method utilized in the computation. Each of these factors can influence the calculated level of reserves.

To illustrate, assume that a life insurance company will become obligated to make a payment of \$10,000 ten years from today. Because the liability is for a known sum of \$10,000 and there is certainty concerning the date of payment, the only variable factor is the rate of interest that the life insurance company will credit to satisfy this obligation. If the company calculates its reserve with respect to this contract utilizing a 3% assumed rate of interest, the reserve will be \$7,441 (i.e., the present value of \$10,000 payable in 10 years using a 3% discount rate). If, however, the reserve is computed utilizing a 5% interest rate, the reserve will be only \$6,139.

The difference in the level of the computed reserves affects both the annual income and the net worth of a life insurance company. Assume that a life insurance company receives a premium payment of \$7,500 to create the obligation to pay

⁷ The Joint Committee on Taxation characterizes the deduction of life insurance reserves as a tax expenditure, and it estimates that this deduction reduces tax collections by \$6.8 billion for the years 2003-2007. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007* (JCS-5-02), Dec. 19, 2002.

⁸ A life insurance company establishes reserves for periods before all benefits are paid with respect to an insurance contract. Although the life insurance company may deduct the amount paid as a benefit under an insurance contract, this deduction is offset by the amount of reserves established with respect to that contract. For example, consider a life insurance company that paid \$100,000 to the beneficiaries of a life insurance contract following the death of the insured. If the company had established a reserve of \$90,000 with respect to this contract, the company is entitled to a net deduction of \$10,000 — which equals the \$100,000 payment reduced by the \$90,000 reserve which is no longer needed to fund future benefit payments.

\$10,000 in 10 years. If it can use a 3% interest rate in calculating its reserves, the deduction for the increase in its reserves equals \$7,441. In this case, the life insurance company's income in connection with this contract is \$59 (i.e., the \$7,500 premium - the \$7,441 reserve increase). In contrast, the life insurance company will have income of \$1,361 if it uses a 5% assumed interest rate for reserve calculation purposes (the \$7,500 premium - the \$6,139 reserve increase). It should be noted, however, that in this latter case the life insurance company will have larger increases in its reserves in subsequent years, with the consequence that its income will be smaller in those years.

The tax law has used two different approaches with respect to the actuarial assumptions used to compute life insurance reserve liabilities. Under the 1959 Act, life insurance companies used, for tax purposes, the same actuarial assumptions that the companies chose to use for reporting their reserve liabilities on their Annual Statements for state regulatory purposes. The principal concern of the state insurance regulators is to assure solvency — that is, to make certain that life insurance companies set aside sufficient assets to meet their future liabilities to their policyholders. To accomplish this goal, the insurance regulators want to prevent life insurance companies from understating their liabilities. Consequently, the regulators specify “minimum” actuarial assumptions but permit the use of more conservative assumptions. Thus, the state insurance regulators may prevent life insurance companies from using an interest rate assumption in excess of 5%, but a life insurance company could choose to use an interest rate assumption of 3% or 4%.

While drafting the life insurance company tax provisions of the 1984 Act, Congress recognized that some life insurance companies used reserve actuarial assumptions that were exceedingly conservative, thereby reducing the amount of income subject to taxation. For this reason, it enacted Internal Revenue Code Section 807, which contains new limits on the actuarial assumptions that may be used for computing reserves for tax purposes.

As a general rule, the life insurance reserve used for tax purposes for any contract is the greater of: (1) the net surrender value of the contract; and (2) the reserve computed in compliance with the requirements of IRC Section 807. In general, this provision precludes the use of actuarial assumptions that would produce unduly large reserves. Consequently, the reserve levels tend to be the minimum level of reserves that the states mandate. Specifically, IRC Section 807 mandates that the most significant actuarial assumptions be determined as follows:

- (1) **the actuarial likelihood that benefit payments will become payable will be based upon minimum state regulatory standards.** The reserves computed with respect to contracts issued in a given year are determined utilizing the “prevailing commissioners’ standard table for mortality and morbidity.” The National Association of Insurance Commissioners (the “NAIC”) publishes Commissioners’ Standard Tables when sufficient new actuarial data becomes available. When life insurance companies are allowed to use the new table for computing reserves for state regulatory purposes in at least 26 states, the table becomes the prevailing table.

- (2) **the assumed rate of interest will be the greater of two rates.** The first rate is the “prevailing State assumed interest rate.” This term is defined as the highest assumed interest rate that life insurance companies may use in at least 26 states to compute reserves with respect to the particular type of insurance contract. The second rate is the “applicable federal rate.” This is a rate published by the Internal Revenue Service that reflects the average of mid-term interest rates during the 60-month period preceding the year for which the rate is calculated.
- (3) **the technical actuarial computation method will be based upon methods approved by the state regulatory authorities.** Actuaries employ different mathematical techniques in calculating reserves. The state regulatory authorities specify which technical methods may be used for purposes of calculating the reserves reported on the Annual Statement. Some of these methods utilize a “preliminary term” approach, which tends to produce relatively small reserves in the initial years of an insurance contract. Other techniques produce larger reserves in those years. Internal Revenue Code Section 807, which specifies which of these techniques may be used for tax purposes, generally mandates the use of a preliminary term approach.

Deduction of Policyholder Dividends and the Special Treatment of Mutual Companies

In general, corporations cannot deduct amounts paid as dividends to their shareholders. In addition, the shareholders are required to include in income the amount of dividends that they receive. This treatment applies to distributions that life insurance companies make to their shareholders in the same manner as it applies to general business corporations.

Life insurance companies make distributions to their policyholders that, in the parlance of the insurance industry, are also called dividends. These are policyholder dividends, which are defined as any distribution not fixed by the terms of the insurance contract. For example:

- an insurance contract may specify that interest will be credited at a rate that will never be less than 3%. The contract may also provide that interest may be paid at higher rates determined at the discretion of the insurance company. Any interest paid in excess of the 3% guaranteed rate of interest is treated as a policyholder dividend.
- a life insurance company may agree to provide term life insurance protection to the employees of a business. The life insurance contract states that the life insurance company may rebate a portion of the premium paid for this protection if the company, in its discretion, determines that the profits for its term insurance business exceeded the company’s targets. Any rebate paid in connection with this term insurance arrangement is characterized as a policyholder dividend.

The interest payments that a financial intermediary makes to its depositors are generally treated as deductible business expenses. Rebates that a business pays to its customers are also deductible. In general, life insurance companies are also allowed to deduct these amounts when payments are made to their policyholders.

The conceptual problem arises when a mutual company pays policyholder dividends to its policyholders. Historically, many of the largest life insurance companies were organized as mutual organizations. Unlike a general business corporation, mutual organizations do not have a separate class of owners. Rather, the mutual company's policyholders are also the owners of the organization. The difficult question is whether the mutual life insurance company pays dividends to its policyholders in their capacity as customers or in their capacity as owners of the enterprise.

IRC Section 809 was enacted with the goal of creating tax parity between mutual life insurance companies and stock-owned life insurance companies. In enacting IRC Section 809, Congress indicated that it believed that mutual life insurance companies effectively distribute a portion of their corporate earnings to their policyholders in their capacities as owners of the enterprise.⁹

A key conceptual difficulty is that a mutual life insurance company's policyholders also are customers and creditors of the insurance company. Consequently, it is impossible to determine whether amounts that a mutual life insurance company allocates to its policyholders represent rebates of premiums, interest or corporate earnings.¹⁰ For this reason, the drafters of IRC Section 809 attempted to derive an indirect method of measuring the amounts distributed to the policyholders in their capacity as owners of the enterprise. Specifically, they made the following assumptions:

- (1) a mutual life insurance company's distributed earnings would be proportionate to the company's equity;
- (2) in the aggregate, stock life insurance companies and mutual companies will earn comparable rates of return; and

⁹ The policyholders generally did not include these amounts in income because the amounts were treated as nontaxable pension or life insurance benefits. In general, an owner of a life insurance contract includes benefits in income only if: (1) the policy is surrendered prior to the death of the insured; and (2) the amount received upon the surrender exceeds the premiums paid with respect to the contract. Amounts credited with respect to a pension plan are not taxed currently. Rather, taxation occurs only when the plan participant receives her pension.

¹⁰ A life insurance company can allocate amounts to policyholders using several different techniques. First, the life insurance company could credit the "policyholder dividends" to the cash values of life insurance or annuity contracts, or it could increase the accumulation value of pension contracts. Second, the life insurance company could increase the rate of interest that it commits itself to pay with respect to its life insurance, annuity or pension contracts. Third, the life insurance company could reduce the premiums that it charges.

- (3) any difference between the observed pre-tax profit of mutual life insurance companies (as a group) and the pretax profit of investor-owned life insurance companies (as a group) would be attributable to a distribution of corporate earnings to the policyholders in their capacity as owners of the mutual enterprise.

IRC Section 809 implemented these assumptions in a complicated manner. In simplified terms, IRC Section 809 utilizes the following steps:

- (1) Each mutual life insurance company and each of the 50 largest investor-owned life insurance companies must compute its “equity base” (as that phrase is defined in IRC Section 809(b)).
- (2) Each mutual company and each of the 50 largest investor-owned life insurance companies must compute its pretax profit by computing its “statement gains from operations” (as that term is defined in IRC Section 809(g)(1)).
- (3) The Treasury Department computes the average earnings rate for the mutual companies (as an aggregate entity) and the average rate of the 50 largest stock life insurance companies.
- (4) After the Treasury Department adjusts these averages (as mandated in IRC Section 809(d)), it calculates the “imputed earnings rate” for a given taxable year. The imputed earnings rate is the pretax rate of return that IRC Section 809 deems to be the pretax rate of return that mutual life insurance companies (as a group) should have earned — given the pretax rate of return of the mutual life insurance companies.
- (5) For each year, the Treasury Department compares the imputed earnings rate and the average earnings rate for the mutual companies.

To the extent that the imputed earnings rate is higher than the average earnings rate for the mutual companies, Congress assumed that the difference resulted from a distribution of corporate earnings to the policyholders of the mutual life insurance companies. In these circumstances, IRC Section 809(a) disallows any deduction for the “differential earnings amount” which equals the difference between these two rates of return multiplied by each mutual company’s “equity base.”

Significant Current Issues

Repeal IRC Section 809

From its enactment, IRC Section 809 has been heavily criticized on both conceptual and pragmatic grounds. In addition, President Bush's fiscal 2004 budget proposal included a provision to repeal IRC Section 809.

The conceptual criticisms of Section 809 have focused on two arguments. First, some tax analysts have argued that the theoretical underpinnings of Section 809 are not sound. These arguments are based on the following three lines of analysis.

- Some argue that a “prepayment” analysis demonstrates that tax equity is achieved only if mutual companies are allowed to deduct all amounts distributed to their policyholders. This analysis is based on the fact that an investor-owned corporation is not taxed when it receives contributions to capital from its shareholders. If a mutual life insurance company's policyholders pay amounts to acquire an ownership interest, these amounts are taxed as premium income to the company. Commentators argue that this difference demonstrates that IRC Section 809 has no theoretical justification.¹¹
- Others argue that the implicit assumptions underlying IRC Section 809 are deeply flawed. Specifically, they argue that it does not make sense to assume that stock and mutual life insurance companies will necessarily earn comparable rates of return. In addition, they argue that IRC Section 809 does not adequately reflect variations in the operations of different mutual companies.
- Others argue that there is no empirical evidence that mutual life insurance companies provide greater benefits to their policyholders than do stock life insurance companies. As a result, they argue that there are no distributions to the mutual policyholders in their capacity as owners of the mutual enterprise. Consequently, they conclude that no special tax provision is needed to equalize the tax treatment of stock and mutual life insurance companies.

Pragmatic criticisms of IRC Section 809 also exist. The first pragmatic argument focuses on the ineffectiveness of IRC Section 809. For the years 2001, 2002 and 2003, Congress established a temporary differential earnings rate of zero. (IRC Section 809(j)). The House of Representatives has approved H.R. 3521, which contains an extension of this provision to 2004. For most of the preceding years, the actual differential earnings rate was also zero. It is unclear what led to this result. Three possibilities are:

¹¹ M. Graetz, “Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential” in *Life Insurance Company Taxation — The Mutual vs. Stock Differential*, Larchmont, New York (Rosenfeld, Emanuel, 1986).

- (1) mutual companies do not allocate any earnings to their policyholders in their capacity as owners of the enterprise;
- (2) mutual life insurance companies were able to increase their apparent pretax profit rate by realizing their capital gains to a greater extent than stock life insurance companies; and
- (3) some other flaws exist in the structure of Section 809.

A second pragmatic argument focuses on changes in the life insurance industry following the enactment of Section 809. In the intervening years, a number of mutual life insurance companies (including the largest mutual companies) have “demutualized” to become investor-owned companies. Consequently, of the 25 mutual companies that were the largest mutual life insurance companies in 1984, at least 21 no longer operate as mutual companies. As a result, the perceived need to “balance” the relative tax burdens of the stock and mutual segments of the life insurance industry that led Congress to enact Section 809 may be greatly lessened.

Forgive Deferred Section 815 Amounts

Deferred Section 815 Amounts Under the 1959 Act. As discussed above, from 1958 through 1983, life insurance companies were taxed under the so-called three-phase method of taxation. Under this system of taxation, each life insurance company had to determine its “taxable investment income” and its “gain from operations.”

In rough terms,¹² a company’s taxable investment income represented the company’s profits from its actions as a financial intermediary. Cash value life insurance, annuities and pension plan contributions represent, in whole or in part, a financial investment. The premium payments made with respect to these types of contracts include an amount that is invested for the benefit of the policyholder or pension plan beneficiary. The life insurance company invests these funds and credits amounts to the policyholders’ cash values.

In calculating its taxable investment income, a life insurance company started with its net income from its investment activities. From this amount, the life insurance company subtracted the portion of this net investment income that was deemed to be allocable to the company’s obligations to its policyholders. Under the provisions of the tax law in effect from 1958 through 1983, the company’s taxable investment income was taxed at the full corporate tax rate.

¹² The Life Insurance Company Tax Act of 1959 included numerous technical provisions and non-economic “special deductions” that are not discussed in this paper. Many of these provisions had the effect of reducing a life insurance company’s taxable investment income to levels significantly below the company’s profits from its operation as a financial intermediary. Similarly, certain of these provisions reduced a company’s gain from operations to levels below the company’s total economic profit.

Again in rough terms, a company's "gain from operations" represented the life insurance company's total profit as computed for tax purposes. In addition to its profits from its actions as a financial intermediary, the company's gain from operations included the company's profits from its underwriting activities. Unlike the company's profit attributable to its financial intermediary function, only a portion of a life insurance company's underwriting profit was taxed in the taxable year in which it was earned.

Technically, if a life insurance company's gain from operations exceeded its taxable investment income, the company was subject to tax on the sum of: (1) its taxable investment income and (2) 50% of the excess of its gain from operations over its taxable investment income. The untaxed 50% of a life insurance company's underwriting profits was tax-deferred. A life insurance company was required to maintain, for tax purposes, an account called the policyholders' surplus account. In any year in which the company had untaxed underwriting income, it was required to increase its policyholders' surplus account by the untaxed amount. In addition, life insurance companies were allowed to deduct amounts under provisions that authorized non-economic "special deductions." The amounts deducted under these provisions were also added to the policyholders' surplus account. If the company distributed these amounts to its shareholders or if the corporation was dissolved, the previously untaxed amounts were included in the life insurance company's income.¹³

The legislative history to the 1959 Act indicates that Congress permitted life insurance companies to defer the taxation of one-half of a company's underwriting profits because of the claim that it is difficult to establish with certainty the annual income of life insurance companies.¹⁴ Concern was expressed that, given the long-term nature of contracts, computation of income on an annual basis will characterize certain amounts as profit which, as a result of subsequent events, will be needed to fulfill obligations arising under these contracts. If the untaxed profits are distributed to shareholders, however, it was recognized that the life insurance company no longer needed those funds to meet its obligations to its policyholders.

1984 Act Treatment of Previous Additions to Policyholders Surplus Account. The 1984 Act eliminated the three-phase system for taxing life insurance companies. As a result, no further deferral of underwriting profits was allowed. In addition, the 1984 Act retained the requirement that a life insurance company must include in income any amount deemed to be distributed out of a company's existing policyholders surplus account.

President Clinton's 2000 budget proposals contained a proposal to require life insurance companies to include in income any remaining balance in their policyholders surplus accounts. This proposal focused on the fact that the original

¹³ Under IRC Section 815, a distribution triggered income recognition only if the amount of the distribution exceeded the previously taxed retained earnings of the corporation. Income recognition was also triggered if the company ceased to be an insurance company or if it ceased to be taxed as a life insurance company for two successive years.

¹⁴ Report of the Committee on Ways and Means to accompany H.R. 4245, H.Rept. 34, 86th Cong., 1st sess. 13 (1959).

rationale for the deferral — that the long-term nature of the life insurance and annuity contracts made it difficult to determine profits on an annual basis — no longer existed. Because the deferrals took place between 20 and 40 years ago, it is unlikely that unanticipated losses will occur with respect to the insurance contracts issued during those earlier years. Congress took no action with respect to this proposal.

On the other hand, the Senate Finance Committee approved an amendment to the proposed National Employee Savings and Trust Equity Guarantee Act on September 17, 2003 that would suspend the application of the rules imposing income tax on distributions to shareholders from the policyholders' surplus account for the years 2004-2009. The provision also would have modified the order in which distributions reduced the various accounts, so that distributions would have been treated as first made out of the policyholders' surplus account. The apparent primary rationale for this proposal is that little, if any, tax revenue will be generated under the existing provisions governing the policyholders' surplus account. Under current law, life insurance companies have the ability to decide whether to undertake discretionary distributions to their stockholders that “trigger” the tax. Consequently, life insurance companies may avoid this trigger by limiting the distributions that they make to their shareholders.

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