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FEDERAL TAXATION OF LIFE INSURANCE COMPANIES: THE EVOLUTION OF A TAX LAW RESPONDING TO CHANGE

by

Keith A. Tucker, J. Dale Dawson,** and Thomas M. Brown****

FOR more than two decades, life insurance companies have been taxed under the provisions of the Life Insurance Company Income Tax Act of 1959 (1959 Act), as amended.¹ This legislation, painstakingly drafted in the 1950s, offered a scheme of taxation that took into account the unique and complex nature of the life insurance business and the delicate competitive balance between stock and mutual life insurance companies. Despite their assiduous efforts, the drafters did not anticipate the spiraling inflation, volatile interest rates, and competitive financial service industry of the 1970s and 1980s. Assailed by such environmental changes, the comprehensive and balanced taxing formula embodied in the 1959 Act has become distorted, biased, and inadequate.

A 1981 Government Accounting Office (GAO) Report to Congress discussed the scheme of taxation of the life insurance industry.² This report prompted vigorous response by the Treasury, Congress, and the life insurance industry. In August 1982 Congress enacted the Tax Equity and Fiscal Responsibility Act (TEFRA),³ which included several permanent and some stopgap provisions designed to correct perceived abuses and distortions.

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Editor's Note: Unless otherwise indicated all statutory references are to the Internal Revenue Code of 1954, as amended, which is codified in title 26 of the United States Code. Internal Revenue Code sections are cited to the 1976 permanent edition and/or current supplement of the United States Code, if therein. Otherwise, code sections are cited to the main edition and/or current supplement of the United States Code Annotated published by West Publishing Company. All Treasury Regulations are cited by section number and may be found in 26 C.F.R. (1983) unless otherwise indicated.

1. I.R.C. §§ 801-820 (1976 & Supp. V 1981) (subchapter L, part I).

2. U.S. COMPTROLLER GEN., REPORT TO THE CONGRESS OF THE UNITED STATES, BILLIONS OF DOLLARS ARE INVOLVED IN TAXATION OF THE LIFE INSURANCE INDUSTRY—SOME CORRECTIONS IN THE LAW ARE NEEDED (1981) [hereinafter cited as REPORT TO CONGRESS].

3. Pub. L. No. 97-428, 96 Stat. 324 (codified in scattered sections of I.R.C.).

tions in the taxation of life insurance companies and raise additional revenue from the life insurance industry. Currently Congress is debating new comprehensive legislation that will overhaul the taxation of the life insurance industry. This Article discusses the unique characteristics of the life insurance industry that must be addressed by new tax legislation, and examines the current tax structure and proposed alternatives in light of these factors.

I. BACKGROUND

Although life insurance companies are similar to banks and other thrift institutions, the life insurance industry is an industry different from any other. A life insurance policy is a contract that provides that the company will receive a premium in exchange for its obligation to pay benefits on the occurrence of an event in the future.⁴ Although the timing of the future event is unpredictable for any particular contract, the time can be estimated with some degree of accuracy for a large number or block of contracts. Accordingly, life insurance companies typically set aside an amount for future liabilities, known as reserves, based on the predictability of the occurrence of such events for a large block of contracts.⁵ Life insurance companies attempt to fund the reserve amount so that the initial reserve amount plus investment growth is sufficient to cover predicted liabilities as they mature.⁶

The fundamental concept underlying the taxation of corporations, which generally holds that gross income minus expenses equals taxable income, does not produce suitable results when applied without modification to life insurance companies.⁷ The life insurance industry is unique in many ways. First, life insurance contracts are long term in nature. An insurance company may write an insurance policy that commits it to pay benefits several years in the future. A life insurance company's true economic income for any twelve-month period is therefore difficult to determine because of the numerous assumptions and estimates required.

4. J. GREIDER & W. BEADLES, *PRINCIPLES OF LIFE INSURANCE* 73 (rev. ed. 1975).

5. Guadiana, *Federal Income Taxation of Life Insurance Companies: The Life Insurance Reserve*, 30 *TAX L. REV.* 173 (1975).

6. J. GREIDER & W. BEADLES, *supra* note 4, at 68.

7. One enlightened congressman observed:

There are three basic and fundamental reasons for the difficulty in taxing life insurance companies. The first reason is that the companies write contracts which commit them to make payments as far into the future as 100 years. . . .

A second special aspect of life insurance is that so far as its long-run operations are concerned, a life insurance company is similar to a bank The problem is that this banking operation is so intertwined with the pure insurance operation that it is difficult to determine what investment income does go to the policyholders and what part goes to the company and in the case of a stock company, to the shareholder.

The third reason why the taxation of life insurance companies has been difficult over the years is that in this one industry . . . the overwhelming bulk of the business is done by cooperative organizations.

105 *CONG. REC.* 2566 (1959) (statement of Rep. Mills).

Second, Congress has recognized the social benefits of insurance. Specifically, insurance companies directly support the health and stability of a society's basic unit, the family, by providing the family with financial security in a time of great need. Insurance also provides liquidity in estate planning, security for creditors, and funds for college education and old age retirement. Fundamentally, life insurance protects against possible economic loss because of the death of an individual, whether the decedent is a key executive or a family member.

Finally, life insurance companies have significant influence on the savings patterns of both individuals and businesses. Savings may take the form of a savings account at a local financial institution or an insurance policy issued by an insurance company. These savings are accumulated by the financial institutions and injected back into the economic bloodstream of the nation in the form of investments that aid economic expansion. The insurance industry is a major source of investment funds for corporate bonds and mortgages, government bonds, real estate, and other investments. As investors, insurance companies have a considerable influence on the stability of the nation's economy. Over the years Congress has attempted to design a taxation scheme that recognizes both the social and economic benefits provided by life insurance companies.

II. THE HISTORY OF LIFE INSURANCE COMPANY TAXATION

A. The Pre-1959 Scheme of Taxation

Historically, Congress has recognized, at least in part, the unique nature of the life insurance industry. During the period from 1909 to the present, Congress devised several tax schemes for the insurance industry. The 1909 and 1913 Tax Acts subjected life insurance companies to the general tax imposed on all corporations, but the companies could take a deduction for reserve increases required by state law.⁸ In 1921 Congress adopted a fundamentally different method of taxation for life insurance companies, which abandoned the total income approach inherent in the 1909 and 1913 Acts and adopted an investment income approach.

Under the 1921 Act life insurance companies were taxed on their "free investment income," defined as the investment income remaining after deducting from total investment income the increase in the company's reserves.⁹ This increase was calculated in several different ways during the period from 1921 to 1951. For example, the Revenue Act of 1942 required each company to report actual reserve requirements to the Secretary of the Treasury.¹⁰ Based upon data collected, the Treasury Department published annually a ratio, known as the "Secretary's ratio," of the reserve requirements to total investment income. Companies then multiplied their

8. Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 113.

9. Revenue Act of 1921, ch. 136, § 245, 42 Stat. 227, 261.

10. Revenue Act of 1942, Pub. L. No. 753, § 201(c)(2), 56 Stat. 798, 868.

investment income by this ratio to determine what amount of income was excludable from taxable income.

In later years Congress determined that this method of taxation did not produce sufficient tax revenues from the insurance industry¹¹ and enacted a series of stopgap measures effective for the years 1949 to 1957. During this period various industry groups conducted studies regarding life insurance company taxation.¹² Finally, in 1954 Congress began the process of writing permanent legislation concerning taxation of life insurance companies, which resulted in the 1959 Act.¹³

B. The Life Insurance Company Income Tax Act of 1959

The 1959 Act abandoned the investment income approach and replaced it with a total income approach that taxed both investment income and underwriting income.¹⁴ The total income approach of the 1959 Act embodied a three-phase taxing scheme. Further, Congress sought to define life insurance companies for federal income tax purposes.¹⁵ The 1959 Act added section 801,¹⁶ which defines a life insurance company as follows:

[T]he term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

- (1) its life insurance reserves . . . , plus
- (2) unearned premiums, and unpaid losses (whether or not ascer-

11. For instance, in 1947 and 1948, the industry-wide averages produced an exclusion in excess of 100%, resulting in no appreciable tax from life insurance companies.

12. These studies indicated, among other things, a significant shift from whole life to term insurance. At that time the largest single component of term business was group insurance. The congressional reports point out that this business involves very little investment income and thus a "tax based exclusively on investment activity can produce fantastic results in relation to the operations of the whole company." 105 CONG. REC. 2567 (1959) (statement of Rep. Mills).

13. Pub. L. No. 86-69, 73 Stat. 112. The 1959 Act is actually a misnomer in that it applied to tax years 1958 and following. I.R.C. § 802(a)(1) (Supp. V 1981).

14. The 1959 Act required life insurance companies to use the accrual method of accounting for tax purposes. *Id.* § 818(a)(1) (1976); see S. REP. NO. 291, 86th Cong., 1st Sess. 775 (1959), reprinted in 1959-2 C.B. 770, 793. Furthermore, I.R.C. § 818(a)(2) (1976) and Treas. Reg. § 1.818-2(a)(2) allow life insurance companies to combine the accrual method with other special accounting practices provided elsewhere in the Code, including depreciation, I.R.C. § 167 (West 1978 & Supp. 1983); research and experimental, *id.* § 174; organizational expenses, *id.* § 248 (1976); and income from installment sales, *id.* § 453B (West Supp. 1983). Except for these basic provisions, however, all tax computations must be made in a manner consistent with that required for purposes of the annual statement approved by the National Association of Insurance Commissioners (NAIC). I.R.C. § 818(a) (1976). The relationship between statutory accounting practices and determination of taxable income has frequently been litigated. See, e.g., *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977) (portion of unpaid premiums required by state law to be added to reserve, but not portion used to pay commissions, state taxes, and overhead, are included in assets and gross premium income).

15. The following discussion relates to the 1959 Act, as amended, prior to TEFRA.

16. I.R.C. § 801 (1976 & Supp. V 1981).

tained), on noncancellable life, health or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves¹⁷

This definition contains a three-part test. First, the company must meet the definition of an insurance company.¹⁸ Second, the company must engage in the business of issuing life insurance and annuity contracts or noncancellable contracts, including guaranteed renewable contracts, of health and accident insurance.¹⁹ Third, the company's life insurance reserves²⁰ must comprise more than fifty percent of its total reserves.²¹

While Congress sought to tax life insurance companies on their total income, the lawmakers still recognized the problem of designing a scheme of taxation "that would take into account the difficulty of measuring profit on long-run business and the difficulty created by the predominant position of the large mutual companies."²² To account for these difficulties, Congress devised a three-phase tax structure. Phase I involves the determination of "free investment income" or taxable investment income.²³ Unlike prior law, the portion of investment income excludable for federal taxation purposes is determined on a company-by-company basis rather than on the basis of an industry-wide average. Phase II involves underwriting income or gain from operations.²⁴ If underwriting income is less than taxable investment income, underwriting income becomes the tax base. If underwriting income exceeds taxable investment income, then one-half of such excess is added to taxable investment income to determine

17. *Id.* § 801(a) (1976).

18. *Id.*; Treas. Reg. § 1.801-3(a)(1). Insurance must be the primary and predominant business of the company. The existence of a state license and charter to do business as an insurance company is not determinative. *Id.*

19. I.R.C. § 801(a) (1976); Treas. Reg. § 1.801-3(b). In defining a contract of insurance the courts and the IRS have focused on the fundamental concept of insurance, shifting the risk of loss. An insurance contract must shift or spread the loss to be qualified as such. In *Helvering v. Le Gierse*, 312 U.S. 531 (1941), the Supreme Court held that the "elements of risk-shifting and risk-distributing are essential to a life insurance contract" *Id.* at 539.

20. Life insurance reserves are defined as amounts

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health or accident contingencies.

I.R.C. § 801(b)(1) (1976); *see* Treas. Reg. § 1.801-4(a)(1)-(2). Life insurance reserves must also be required by law except for certain cases not relevant here. I.R.C. § 801(b)(2) (1976); Treas. Reg. § 1.801-4(a)(3). This definition originated with Justice Clark's opinion in *Maryland Casualty Co. v. United States*, 251 U.S. 342, 350-51 (1920). Since then the definition of life insurance reserves has been litigated on numerous occasions. For a detailed discussion of life insurance reserves, *see* K. TUCKER & D. VAN MIEGHEM, *FEDERAL TAXATION OF INSURANCE COMPANIES* (1983).

21. I.R.C. § 801(a) (1976); Treas. Reg. § 1.801-3(b).

22. 105 CONG. REC. 2567 (1959) (statement of Rep. Mills).

23. I.R.C. § 804(a)(2) (1976).

24. *Id.* § 809(b)(1).

the tax base.²⁵ In Phase III the other half of the excess of underwriting income over taxable investment income is added to the policyholder surplus account, a special accumulation account for income on which taxes have been deferred. The tax on this accumulated or Phase III income is imposed if the policyholder surplus account is distributed or exceeds certain limitations.²⁶

Phase I: Taxable Investment Income. Recognizing the potential social benefit to policyholders, Congress allowed insurance companies to exclude from the taxable base that portion of investment income on reserves that is necessary to meet current and future claims of policyholders and beneficiaries.²⁷ The Phase I tax is therefore designed to be imposed exclusively on investment income that is not allocated via reserves to policyholders.²⁸ Although the principle of Phase I income or taxable investment income is very similar to that of "free investment income" as determined prior to the 1959 Act, the computation of the two amounts differs substantially.

Taxable investment income is an amount, not less than zero, equal to the excess, if any, of net long-term capital gain over net short-term capital loss, plus the sum of the life insurance company's share of every item of investment yield, reduced by (1) the life insurance company's share of tax-empt interest, (2) the deduction for dividends received computed with respect to the life insurance company's share of the dividends received, and (3) the small business deduction.²⁹ In order to determine taxable investment income, the first step is to compute gross investment income. Gross investment income includes interest, dividends, rents, royalties, net short-term capital gains, and trade or business income.³⁰ Trade or business income is defined as gross income from any trade or business, other than an insurance business, carried on by the life insurance company or by a partnership in which the life insurance company is a partner.³¹ A life insurance company can deduct from gross investment income certain investment expenses and other related expenses.³² This net amount is referred to as investment yield. Once determined, investment yield must be divided into (1) the policyholders' share, or "policy and other contract liability requirements," and (2) the company's share, which constitutes the taxable portion of the investment yield.³³

Section 805(a) defines policy and other contract liability requirements as

25. *Id.* § 802(b).

26. *Id.* Life insurance company taxable income is defined as the sum of "(1) the taxable investment income . . . or, if smaller, the gain from operations . . . , (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus (3) the amount subtracted from the policyholders surplus account for the taxable year . . ." *Id.*

27. H.R. REP. NO. 34, 86th Cong., 1st Sess. 738 (1959).

28. H. AARON, A REPORT: TAXATION OF LIFE INSURANCE COMPANIES 14 (1979).

29. I.R.C. § 804(a)(2) (1976).

30. *Id.* § 804(b).

31. *Id.* § 804(b)(3).

32. *Id.* § 804(c).

33. *Id.* § 805(a).

the sum of: (1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate, (2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earning rate, and (3) the interest paid.³⁴

These components of policy and contract liability requirements may be referred to as (1) the reserve interest deduction, (2) the pension reserve deduction, and (3) interest paid, respectively.

A fairly complex formula is used to determine the reserve interest deduction. In 1959 Congress adopted a method suggested by Walter O. Menge, then president of Lincoln National Life Insurance Company, to adjust the amount of life insurance reserves³⁵ to be used in computing the policyholders' share.³⁶ Known as the "Menge formula" or the "10-for-1 formula," this method of adjusting a company's life insurance reserves was designed in part to account for the difference between the actual earnings rate of a company and the rate it assumed in setting up reserves.³⁷ Under the Menge formula adjusted life insurance reserves are equal to the mean of the life insurance reserves at the beginning and the end of the year multiplied by a percentage equal to 100% plus 10 times the average interest rate assumed in computing reserves, less 10 times the adjusted reserves rate, a rate that reflects the investment return on the insurance company's assets.³⁸ This 10-for-1 formula results in a 10% reduction in life insurance reserves for each percentage point by which the adjusted reserves rate exceeds the average interest rate assumed. The adjusted life reserves are then multiplied by the adjusted reserves rate to determine the amount allocable to policy and contract liability requirements.

The adjusted reserves rate is the lower of the current earnings rate or the average earnings rate.³⁹ The current earnings rate is computed by dividing the current year's investment yield by the mean of the company's assets at the beginning and end of the tax year.⁴⁰ The average earnings rate is the average of the current earnings rate for the current year and for each of the four immediately preceding tax years.⁴¹

The policy and contract liability requirements for the second component, pension plan reserves, are determined by multiplying the mean of the pension plan reserves at the beginning and end of the tax year by the cur-

34. *Id.*

35. These life insurance reserves must also be adjusted to reflect any net level reserve adjustment under *id.* § 818(c). See *infra* notes 60-66 and accompanying text.

36. H. AARON, *supra* note 28, at 15.

37. The House Report indicates a concern on the part of Congress for shifting from an industry-wide basis to an individual company basis in computing policy and contract liability requirements. Because life insurance reserves can differ from company to company based upon whether the company followed a liberal or conservative policy in establishing such reserves, Congress adopted a uniform method of determining these reserves for tax purposes. See H.R. REP. NO. 34, 86th Cong., 1st Sess. 739 (1959).

38. I.R.C. § 805(e)(1) (1976).

39. *Id.* § 805(b)(1).

40. *Id.* § 805(b)(2).

41. *Id.* § 805(b)(3).

rent earnings rate.⁴² Pension plan reserves are defined as the life insurance reserves allocable to certain types of life insurance contracts.⁴³ Pension plan reserves are multiplied by the current earnings rate rather than the adjusted reserves rate,⁴⁴ which generally results in a greater policyholders' share, and less taxable investment income, than would be the case if the 10-for-1 formula and the adjusted reserves rate were applied as with other life reserves. The purpose of this preferential treatment accorded pension plan reserves was to help relieve what Congress perceived as a discriminatory situation for small employers. Because of the greater risk and higher administrative cost associated with the operation of a qualified pension or profit-sharing trust, smaller employers were generally forced to set up insured plans rather than trustee pension plans. By allowing the policyholders' share on pension plan reserves to be computed at the current earnings rate, life insurance companies became more competitive with financial institutions that established tax-exempt pension trusts.⁴⁵

The third component of policy and other contract liability requirements

42. *Id.* § 805(a).

43. *Id.* § 805(d) (1976 & Supp. V 1981). Contracts with respect to which reserves qualify as pension plan reserves include those contracts

(1) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be (A) trusts described in section 401(a) and exempt from tax under section 501(a), or (B) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

(2) purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans described in section 403(a), or plans meeting the requirements of paragraphs (3), (4), (5), and (6) of section 165(a) of the Internal Revenue Code of 1939;

(3) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of paragraphs (3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), (19), (20), and (22) of section 401(a);

(4) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws, or purchased to provide retirement annuities for employees described in section 403(b)(1)(A)(ii) by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing;

(5) purchased under contracts entered into with trusts which (at the time the contracts were entered into) were individual retirement accounts described in section 408(a) or under contracts entered into with individual retirement annuities described in Section 408(b); or

(6) purchased by—(A) a governmental plan (within the meaning of Section 414(d)), or (B) the Government of the United States, the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, for use in satisfying an obligation of such government, political subdivision, or agency or instrumentality to provide a benefit under a plan described in subparagraph (A).

Id.

44. *Id.* § 805(a)(2) (1976).

45. S. REP. NO. 291, 86th Cong., 1st Sess. 8087 (1959), *reprinted in* 1959-2 C.B. 775.

is interest paid.⁴⁶ Interest paid is defined by section 805(e) as the sum of (1) interest on indebtedness, (2) amounts in the nature of interest, (3) discount on prepaid premiums, and (4) interest on certain special contingency reserves.⁴⁷ Interest on debt is comparable to interest expense allowed other taxpayers under section 163.⁴⁸ Amounts in the nature of interest include amounts paid or credited, whether or not guaranteed, on insurance or annuity contracts that do not involve, at the time of accrual, life, health, or accident contingencies. This amount also includes interest on dividends left on deposit with the company and interest on premiums received in advance.⁴⁹

Investment yield is reduced by the policyholders' share determined above to arrive at the company's share, or taxable portion, of investment yield. To arrive at taxable investment income, the company's share of investment yield is increased by any excess of net long-term capital gain over net short-term capital loss and is reduced by (1) the company's share of tax-exempt interest,⁵⁰ (2) the dividends received deduction for the company's share of dividends received,⁵¹ and (3) the small business deduction.⁵² Recognizing that the insurance industry was dominated by relatively few large insurance companies, Congress in 1959 added the small business deduction to aid small and new businesses.⁵³

Phase II: Underwriting Income (Gain from Operations). Gain from operations or underwriting income is the second phase of the taxing scheme adopted in the 1959 Act. Generally underwriting income is the gain or loss that results from a life insurance company's total operations, including both the insurance and investment functions of the company. Underwriting income therefore includes income items such as the life insurance company's share of each item of investment yield and gross premiums received on insurance contracts, and expense items such as death benefits paid and dividends paid to policyholders.⁵⁴

46. I.R.C. § 805(a)(3) (1976).

47. *Id.* § 805(e).

48. *Id.* § 163 (West 1978 & Supp. 1983). Treas. Reg. § 1.805-8(b)(1), which defines interest paid for the purpose of determining the policy and other contract liability requirement, specifically refers to § 163 and the regulations thereunder.

49. I.R.C. § 805(e)(2) (1976); Treas. Reg. § 1.805-8(b)(2).

50. Although Congress apparently intended to exclude tax-exempt income from taxable investment income, the actual result is quite the contrary. Under the 1959 Act only the company's share of tax-exempt income is excluded from taxable investment income. I.R.C. § 804(a)(2)(A) (1976). Although this effectively results in tax on a life insurance company's tax-exempt income, the requirement that tax-exempt interest be allocated between the policyholders' share and the company's share was upheld by the Supreme Court in *Atlas Life Ins. Co. v. United States*, 381 U.S. 233 (1965). For further discussion of the merits of this result, see H. AARON, *supra* note 28, at 29-31.

51. I.R.C. § 804(a)(2)(A)(ii) (1976).

52. *Id.* § 804(a)(2)(B). The small business deduction is an amount equal to 10% of investment yield, but not to exceed \$25,000. *Id.* § 804(a)(3).

53. S. REP. NO. 291, 86th Cong., 1st Sess. (1959), *reprinted in* 1959-2 C.B. 770, 776.

54. I.R.C. § 809 (1976). The following is a breakdown of the elements of income and expense comprising gain from operations:

The company's share of investment yield for determining gain from operations in Phase II is computed differently than the company's share of investment yield for determining taxable investment income in Phase I. The assumed rate rather than the actual earnings rate is used. The portion of investment income that is excluded for Phase II purposes is referred to as required interest and equals the assumed rate of return multiplied by the mean of the amount of policyholder reserves at the beginning and the end of the taxable year.⁵⁵

The 1959 Act allows a deduction in computing gain from operations for the net increase in reserves.⁵⁶ Likewise, any decrease in such reserves is treated as an item of income.⁵⁷ The reserves are adjusted for the net level reserve adjustment, as defined below.⁵⁸ Further, section 810(b) provides that the increase in reserves is reduced by the required interest, which represents the Phase II portion of investment yield allocable to

INCOME ELEMENTS

- The life insurance company's share of each item of investment yield, including tax-exempt interest and dividends received.
- The amount, if any, of the net capital gain.
- Gross premiums and other consideration received on insurance and annuity contracts, less return premiums.
- Decreases in certain reserves.
- All other amounts includible in gross income.

EXPENSE ELEMENTS

- Death benefits paid.
 - Increases in certain reserves.
 - Dividends to policyholders.
 - Operations loss deduction.
 - Special deductions for certain nonparticipating policies, accident and health insurance policies, and group life policies.
 - Consideration incurred for another person's assumption of insurance liabilities.
 - Tax-exempt interest and dividends received deduction.
 - Investment expense not allowed in determining taxable investment income.
 - Small business deduction.
 - Other deductions.
55. *Id.* § 809(a)(2). Section 810(c) (1976) defines these reserves as follows:
- (1) The life insurance reserves
 - (2) The unearned premiums and unpaid losses included in total reserves
 - (3) The amounts . . . necessary to satisfy the obligations under insurance and annuity contracts . . . , but only if such obligations do not involve . . . life, health, or accident contingencies.
 - (4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts
 - (5) Premiums received in advance, and liabilities for premium deposit funds.
 - (6) Special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

Id. § 801(c).

56. *Id.* § 809(d)(2).

57. *Id.* § 809(c)(2).

58. *Id.* § 818(c).

policyholders.⁵⁹

A life insurance company may compute its life insurance reserves using either one of the preliminary term methods or the net level premium method.⁶⁰ The preliminary term methods are generally less beneficial to the company for federal income tax purposes because these methods add a smaller portion of premium to the reserve in the first year than is required under the net level method. The amounts not included in the reserve in the first year are recovered by accumulating larger amounts in later years. The net level premium method, on the other hand, adds a uniform percentage of each year's premium to the reserve.

A company using a preliminary term method generally has smaller policy reserves than one using the net level premium method. Congress enacted section 818(c) to relieve the perceived hardship of companies using a preliminary term method.⁶¹ That provision permits companies using a preliminary term method to elect to recompute their reserves under the net level method for all federal income tax purposes, except to meet the definition of a life insurance company. A life insurance company can recompute under either an exact or an approximate revaluation. An exact revaluation is made by computing the preliminary term reserves on the net level premium basis using the same mortality assumptions and interest rates used for preliminary term.⁶² An approximate revaluation is made by adding to the preliminary term reserves for contracts other than term insurance \$21 per \$1,000 of insurance in force and by subtracting from that 2.1% of the related reserves.⁶³ The factors of \$5 per \$1,000 of insurance in force and 0.5% of reserves are used for term insurance contracts that cover a period of more than 15 years.⁶⁴ Reserves for term insurance with terms of 15 years or less cannot be revalued. Even if the company elects an approximate revaluation, it must use exact revaluation for noncancellable and guaranteed renewable accident and health insurance contracts for which additional reserves are computed on a preliminary term basis. Whichever recomputation method is elected, all preliminary term reserves must be revalued, and the election is binding unless the Internal Revenue Service grants permission to terminate.⁶⁵

The most significant advantage in making a section 818(c)⁶⁶ election is that the deduction for reserve increases is accelerated. Additionally, as

59. *Id.* § 810(b).

60. *Id.* § 818(c).

61. *Id.*

62. *Id.* § 818(c)(1).

63. The \$21 per \$1000 of insurance in force adjustment represents the rates established in the 1959 Act. *Id.* § 818(c)(2)(A). This rate was changed to \$19 per \$1000 of insurance in force by TEFRA. *Id.* § 818(c)(2)(A) (West Supp. 1983); see *infra* notes 194-95 and accompanying text.

64. I.R.C. § 818(c)(2)(B) (1976).

65. The Service has ruled that if the reserves revalued on the approximate basis exceed those revalued on an exact basis, the reserves are not limited to the amount computed on the exact basis. Rev. Rul. 77-312, 1977-2 C.B. 235.

66. I.R.C. § 818(c) (1976).

insurance reserves are increased, the Phase I policyholders' share of investment yield is generally increased, thus reducing taxable investment income. This election, however, can be disadvantageous for companies whose total insurance in force, reserved on a preliminary term basis, is not increasing annually.

Life insurance companies may reduce gain from operations by dividends paid to policyholders and by certain special deductions. Although not technically a special deduction, dividends to policyholders are grouped with special deductions because of the limitation applied to all of these deductions. The 1959 Act limits these deductions to \$250,000 plus the excess of gain from operations, before policyholder dividends and special deductions are deducted, over taxable investment income.⁶⁷ Under section 811(a) dividends to policyholders include "dividends and similar distributions to policyholders in their capacity as such."⁶⁸ Amounts properly included as interest paid⁶⁹ or as return premiums⁷⁰ do not constitute dividends to policyholders, however. The regulations further clarify this definition by restricting dividends to amounts paid to policyholders that are not fixed in the contract but depend on the earnings history of the company or the discretion of management.⁷¹

In the 1959 Act Congress, recognizing the unique nature of the insurance business and stock and mutual companies, allowed insurance companies certain special deductions. The special deductions include (1) the nonparticipating deduction and (2) the accident and health and group life deduction. These deductions are called special deductions because they do not require company outlays. The nonparticipating deduction is equal to the greater of 10% of the increase in life insurance reserves for nonparticipating policies or 3% of the premiums on nonparticipating contracts.⁷² The accident and health and group life deduction equals 2% of the premiums on accident and health and group life business.⁷³ This deduction for the current year and all preceding years shall not, however, exceed fifty percent of the premiums for the taxable year attributable to accident and health insurance and group insurance contracts.

In drafting the 1959 Act the lawmakers encountered a controversy between the stock companies and the mutual companies regarding the deductibility of policyholder dividends.⁷⁴ Congress created the nonparticipating deduction to compensate for an advantage mutual companies enjoyed over stock companies. Since a mutual company's business is primarily participating, it can charge a higher premium than a stock

67. *Id.* § 809(f).

68. *Id.* § 811(a).

69. Interest paid is separately deductible under *id.* § 805(e).

70. Treas. Reg. § 1.811-2(a).

71. *Id.*

72. I.R.C. § 809(d)(5) (1976).

73. *Id.* § 809(d)(6). This deduction is, however, subject to certain limitations. *See id.* § 809(f).

74. For a discussion of this controversy, see 105 CONG. REC. 2568 (1959) (statement of Rep. Mills).

company and later return to the policyholder the portion of the premium that is not needed by the company. The portion of the premium not immediately returned to the policyholder provides the mutual company with a cushion of funds until the excess is returned. On the other hand, stock life companies that issue mostly nonparticipating policies must maintain relatively large surplus and capital accounts to provide them with equivalent liquid funds. Congress provided stock companies with the nonparticipating deduction to compensate for this difference in the operation of stock and mutual companies.

Phase III: Surplus Accounts. Under Phases I and II, taxable investment income and 50% of any excess of gain from operations over taxable investment income are subject to tax currently. The life insurance company's taxable income attributable to Phases I and II, net of applicable federal income tax, together with the full dividends received deduction, all tax-exempt interest, net long-term capital gains in excess of taxable income, and the small business deduction are accumulated as a part of the shareholders' surplus account.⁷⁵ Distributions may be made to shareholders out of this account without additional tax to the company.

The 50% excess of gain from operations over taxable investment income that is not subject to current taxation, plus the nonparticipating deduction and the accident and health and group life deductions, are accumulated in the policyholders' surplus account.⁷⁶ Phase III income will occur if this account exceeds certain statutory limitations⁷⁷ or if the company makes a distribution to shareholders, either in cash or in kind, in excess of the amount in the shareholders' surplus account.⁷⁸

Reinsurance. Discussion of federal taxation of life insurance companies would not be complete without consideration of the tax effects of reinsurance. Reinsurance is an arrangement whereby an insurance company passes some or all of its policy risks to another insurance company.⁷⁹ There are two basic types of reinsurance, assumption reinsurance and indemnity reinsurance. Indemnity reinsurance can be divided into three general forms, yearly renewable term (YRT), coinsurance, and modified coinsurance. The tax effects of each form of reinsurance vary significantly.

Assumption reinsurance is an arrangement in which the assuming company, the reinsurer, becomes solely liable to the policyholders on the contracts transferred by the ceding company, the reinsured.⁸⁰ In general terms

75. I.R.C. § 815(b) (1976).

76. *Id.* § 815(c).

77. Treas. Reg. § 1.815-6(d).

78. I.R.C. § 815(f) (1976) defines the term "distribution."

79. In order for a reinsurance agreement to be effective for federal income tax purposes, a sufficient business purpose must exist and a shifting of the risk of the loss must take place. See *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 729 (1977); *Carnation Co. v. Commissioner*, 71 T.C. 400, 403 (1978), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981).

80. I.R.C. § 809(d)(7) (1976); Treas. Reg. § 1.809-5(a)(7)(ii).

the reinsured treats the assumption as a decrease in reserves⁸¹ and accounts for the consideration paid to the reinsurer as a deduction from gain from operations.⁸² On the other side of the transaction, the reinsurer is entitled to a deduction for the reserves assumed.⁸³ The reinsurer includes the consideration received for assuming the ceding company's reserves in premium income.⁸⁴ If any additional consideration or bonus is paid by the reinsurer to the ceding company for the business assumed, however, it must be capitalized and amortized as a deferred expense over the reasonably estimated life of the contracts reinsured.⁸⁵

Indemnity reinsurance is an arrangement in which the ceding company passes all or a portion of the insured risk to the reinsurer,⁸⁶ but remains primarily liable to the policyholders. Under a typical coinsurance arrangement the following tax consequences accrue to the ceding company and the reinsurer.

Ceding Company

- Reduces premium income for the premium allocable to the reinsurer.⁸⁷
- Reduces its deductions for expenses to the extent they are reimbursable by the reinsurer.⁸⁸
- Reduces its deduction for death and other policy benefits to the extent they are recoverable from the reinsurer.⁸⁹
- Increases "other income" under section 809(c)(3) for the experience refunds⁹⁰ it receives from the reinsurer.⁹¹
- Reduces its deduction for policyholder dividends to the extent they are reimbursable by the reinsurer.⁹²
- Increases income under section 809(c)(2) for the decrease in its reserves attributable to the reinsurance transaction.⁹³

Reinsurer

- Includes its share of the ceding company's premium in premium income.⁹⁴

81. I.R.C. § 809(c)(2) (1976).

82. *Id.* § 809(d)(7).

83. *Id.* § 809(d)(2).

84. *Id.* § 809(c)(1); Treas. Reg. §§ 1.809-4(a)(1)(i); 1.817-4(d)(2)(ii)(A). Treas. Reg. § 1.809-4(a)(1)(i) was declared invalid to the extent it requires different treatment of unpaid premiums. *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148, 160-63 (1976).

85. I.R.C. § 809(d)(1) (1976); Treas. Reg. § 1.817-4(d)(2)(ii)(B). Prior to the issuance of this regulation in 1976, considerable uncertainty existed as to the deductibility of bonus paid for acquiring a block of insurance contracts.

86. Treas. Reg. § 1.809-4(a)(1)(iii).

87. I.R.C. § 809(c)(1) (1976); Treas. Reg. § 1.809-4(a)(1).

88. I.R.C. § 809(c)(3) (1976).

89. *Id.* § 809(d)(1); Treas. Reg. § 1.809-5(a)(1).

90. Experience refunds are rebates to the ceding company from the reinsurer based on the history of claims on the ceded policies.

91. Treas. Reg. § 1.809-4(a)(3).

92. I.R.C. § 820(c)(5) (1976); Treas. Reg. § 1.820-3(a)(7).

93. I.R.C. § 809(c)(2) (1976).

94. *Id.* § 809(c)(1); Treas. Reg. § 1.809-4(a)(1).

- Deducts its share of policy benefits due the ceding company.⁹⁵
- Deducts any expenses for which it must reimburse the ceding company.⁹⁶
- Treats experience refunds payable to the ceding company as return premiums.⁹⁷
- If the reinsurer reimburses the ceding company for policyholder dividends, it deducts an amount for such dividends under section 809(d)(3).⁹⁸
- Deducts as an increase in reserves the reserves established for the risk assumed under the reinsurance contract.⁹⁹

Modified coinsurance is a form of indemnity reinsurance in which, unlike coinsurance, the ceding company retains ownership of the assets and maintains the reserves for the risks assumed by the reinsurer. The ceding company remains liable to the policyholders just as it does with coinsurance and yearly renewable term reinsurance. The ceding company pays the reinsurer the proportionate share of the policy premiums less the reinsurer's share of expenses. The reinsurer reimburses the ceding company for the reinsurer's share of policy benefits. At year end the reinsurer typically pays the ceding company an amount necessary to maintain the policy reserves. This amount is reduced, however, by the amount of investment income that the reinsurer would have earned if it held the assets.

The tax consequences to the ceding company and the reinsurer of a modified coinsurance arrangement are similar to those attributable to a coinsurance arrangement, with the following exceptions. For the ceding company, the increase in reserve deduction under section 809(d)(2) as to the reinsured policies is retained because no assets or reserves are transferred. Likewise, the reinsurer does not realize a decrease in reserves under section 809(c)(2) since no assets or reserves are transferred. Also, for the ceding company, amounts paid by the reinsurer to maintain the ceding company's policy reserves, net of interest, are treated as premium income.¹⁰⁰ Likewise, the reinsurer decreases premium income for these amounts.¹⁰¹ Since the ceding company maintains the assets and reserves under modified coinsurance, the investment income is taxed to the ceding company, even though the reinsurer has received an economic benefit for the investment earnings through an adjustment to reserves for the amount of the investment earnings. On the other hand, the reserve interest adjustment, which benefits the reinsurer, is includable in the reinsurer's gain from operations.¹⁰² Under this analysis this amount would be doubly taxed, once as investment income to the ceding company and once as gain from operations to the reinsurer.

95. I.R.C. § 809(d)(1) (1976); Treas. Reg. § 1.809-5(a)(1).

96. I.R.C. § 809(d)(1) (1976); Treas. Reg. § 1.809-5(a)(12).

97. Treas. Reg. § 1.809-4(a)(1)(ii).

98. I.R.C. § 820(c)(5) (1976); Treas. Reg. § 1.820-3(a)(7).

99. I.R.C. § 809(d)(2) (1976).

100. *Id.* § 809(c)(1).

101. *Id.*

102. *Id.* § 809(c)(2).

To avoid this result, Congress enacted section 820, which provides that the ceding company and the reinsurer can elect to treat modified coinsurance as if it were conventional coinsurance.¹⁰³ Although assets and reserves are not actually transferred from the ceding company to the reinsurer in a modified coinsurance arrangement, they are treated as transferred for federal income tax purposes if the section 820 election is made.

Summary. The 1959 Act was the culmination of over a decade of efforts by Congress and the life insurance industry to devise a taxing structure that would fairly and equitably tax the income of that industry. The authors of this legislation recognized, at least in part, the unique nature of the life insurance industry and the social and economic benefits provided by the industry. They also considered the competitive balance, as well as the inherent difference, between the stock companies and the mutual companies. The drafters also recognized the plight of the small stock life insurance company in the 1950s. The result was perhaps one of the most complicated pieces of tax legislation ever enacted.

Since that time various groups both within and without the life insurance industry have sharply criticized the 1959 Act. While Congress designed the 1959 Act to support the social benefits of insurance by providing somewhat preferential tax treatment, Congress is now more keenly aware of the need to raise additional revenue in light of current budget deficits. Thus Congress faces two competing objectives, encouraging those who provide financial security to society and collecting additional revenue to narrow widening budget deficits. Further, certain provisions of the 1959 Act do not provide reasonable and predictable results for current economic transactions involving the life insurance industry. Specifically, as pointed out in the recent GAO Report, the Menge formula for determining the reserve deduction for the policyholders' share of reserve increases does not provide reasonable results in a period of high interest rates.¹⁰⁴ Additionally, the \$250,000 limitation on policyholder dividends and special deductions does not adequately reflect the effect of inflation since 1959. The ability of the new investment-oriented products now being introduced by life insurance companies to compete with other investment alternatives depends on a grant of favorable tax treatment by Congress. The framers of the 1959 Act were clearly unable to conceptualize and address the proper taxation of these new products. Taxation of these products must, however, take into account increasing competition among and decreasing differences between members of the financial services industry. Finally, critics of the 1959 Act have urged simplification of taxation of the life insurance industry. Some proponents have called for a single-phase tax structure very similar to that imposed on other corporations.

103. *Id.* § 820(a)(2); Treas. Reg. § 1.820-2(a).

104. REPORT TO CONGRESS, *supra* note 2, at 85-87.

III. THE GOVERNMENT ACCOUNTING OFFICE STUDY AND REPORT

In response to perceived changes in the life insurance industry over the past twenty years, the Government Accounting Office conducted an examination of the 1959 Act and proposed to Congress certain alterations. The GAO Report recommended three specific changes in the 1959 Act and identified six additional issues for study by Congress.¹⁰⁵ Perhaps the most significant result of the study was that it alerted Congress to the need for reform in taxation of life insurance companies and prompted extensive response from various sectors of the industry. The following discussion outlines the study and the findings of the GAO.

A. *The Bases of the GAO Study*

The GAO based its study on literature available on the life insurance industry and surveys and discussions with the staff of the Joint Committee on Taxation and representatives of various industry trade associations.¹⁰⁶ In August 1979 the GAO hosted a conference of industry representatives and tax experts. In addition, the GAO accumulated tax data on a sample of the largest life insurance companies for the period 1974-1978.¹⁰⁷ The GAO Report identified the following as major changes that have occurred in the life insurance industry since 1959. First, while the bulk of the largest life insurance companies are mutual companies, mutual companies no longer dominate the industry in terms of total assets and total number of companies.¹⁰⁸ Second, life insurance sales have largely shifted from whole-life to term policies.¹⁰⁹ Third, life insurance companies have filled

105. *Id.*

106. These included the American Council of Life Insurance (ACLI) and the National Association of Life Companies (NALC).

107. REPORT TO CONGRESS, *supra* note 2, at 4. While the GAO Report examined several key issues affecting the life insurance industry, the following issues were intentionally overlooked in their study:

- the propriety of allowing companies a current deduction for additions to policyholders' reserves rather than postponing the deduction until benefits are paid . . . ;
- the extent to which the omission from the individual income tax base of amounts credited by the company to policyholders' reserves (the "inside buildup") should affect the structure of company-level taxation;
- the possibility of attributing company earnings to policyholders and taxing them at the individual level as a substitute for company-level taxation;
- the question of whether special offsets should be allowed during an inflationary period against taxes imposed on returns to capital, whether the recipients are life insurance companies, other companies or entities, or individuals;
- the propriety of bending tax policy to respect the "competitive balance" . . . between stock companies and mutual companies within the life insurance industry; and
- the relevance today of certain social and economic objectives that were expressed in the 1959 Act.

Id. at 3.

108. *Id.* at 29.

109. *Id.* at 20.

an increased role in the pension business.¹¹⁰

Mutual Versus Stock Companies. Large mutual insurance companies have typically dominated the life insurance industry. When the 1959 Act was written mutual companies held approximately two-thirds of the insurance in force and three-fourths of the assets in the life insurance industry.¹¹¹ In 1980 mutual companies held approximately 50% of the insurance in force and approximately 60% of the assets in the industry.¹¹² Mutual companies represent 7% of the total number of life insurance companies.¹¹³ Thus, while the relative dominance of the mutual companies appears to be declining, they remain a dominant force within the industry.

Whole Life Versus Term Insurance. In recent years term insurance has increased in popularity due to its lower cost in the insured's younger years.¹¹⁴ Whole life insurance has correspondingly experienced a decline in market share. The following table provides a comparison of whole life and term insurance in force for selected years.

*Face Value of Life Insurance in Force
in United States, Selected Years, 1957-77*¹¹⁵
(dollar amounts in billions)

Year	Term Insurance		Permanent Insurance	
	Amount	As Percent of Total	Amount	As Percent of Total
1957	\$ 208	45%	\$ 256	55%
1962	341	51	334	49
1966	549	56	436	44
1974	1,246	63	740	37
1977	1,680	65	903	35

Pensions. As a vehicle for saving, private pension plans, both insured and uninsured, have increased substantially in volume over the last thirty years. For example, total pension assets in 1952 were \$17.5 billion.¹¹⁶ By 1978, this amount had increased to \$317.7 billion.¹¹⁷ Likewise, total pension assets held by life insurers in 1952 were \$7.7 billion,¹¹⁸ while by 1978

110. *Id.* at 24.

111. REPORT TO HOUSE COMM. ON WAYS AND MEANS BY SUBCOMM. ON INTERNAL REVENUE, TAXATION 85TH CONG. 2D SESS., TAXATION OF LIFE INSURANCE COMPANIES 291 (1958).

112. AM. COUNCIL OF LIFE INS., 1981 LIFE INSURANCE FACT BOOK 90 (1981).

113. *Id.*

114. REPORT TO CONGRESS, *supra* note 2, at 20.

115. Data compiled from AM. COUNCIL OF LIFE INS., LIFE INSURANCE FACT BOOK 1979, at 22 (1979), and AM. COUNCIL OF LIFE INS., LIFE INSURANCE FACT BOOK 1968, at 25 (1968).

116. REPORT TO CONGRESS, *supra* note 2, at 25.

117. *Id.*

118. *Id.*

this amount equalled \$119.1 billion.¹¹⁹ The GAO Report noted the growth in pension activity by life insurance companies as a significant change in the industry and attributed this change, at least in part, to the favorable tax treatment accorded insured pension funds.¹²⁰

The Nature of the Life Insurance Industry. The GAO Report identified three basic characteristics of the industry that are important to the development of a fair and equitable taxing scheme.¹²¹ First, the long-term nature of the insurance business makes measurement of income on an annual basis difficult.¹²² The GAO Report pointed out that Congress, recognizing this characteristic, allowed a deduction for reserve additions in the 1959 Act.¹²³ Moreover, the accounting methods used to determine the taxable income of a life insurance company are substantially different from the accounting methods used by other companies, which usually conform to generally accepted accounting principles. The GAO also noted that Congress considered the long-term nature of the insurance business in allowing deferral of one-half of the excess of gain from operations over taxable investment income.¹²⁴ This deferral was essentially designed to provide a cushion for life insurance companies in the event of catastrophic losses.

Second, life insurance companies generally set aside a portion of annual investment income to meet future reserve requirements. The GAO Report noted the inherent difficulty in accurately determining the portion of investment income that should be set aside for policyholders, and therefore not subject to current taxation, versus the portion that should be currently taxed to the company.¹²⁵ Recognizing that a company's actual earnings rate often differs from its assumed rate in computing reserves, Congress in the 1959 Act devised a method of determining the policyholders' share of investment income based on adjusted life reserves, which are computed on the basis of the company's actual earnings rate.

Third, the insurance industry's composition of both mutual and stock companies defies development of one scheme of taxation that will equitably tax each group.¹²⁶ The GAO Report discussed the problems Congress faced in fashioning the 1959 Act in a manner that fairly and equitably apportioned the tax burdens between stock and mutual companies.¹²⁷ The main object of controversy was the treatment accorded policyholder dividends. The report recognized that mutual companies are viewed as cooperative organizations, wherein the policyholders serve the multiple roles of creditors, customers, and owners.¹²⁸ Under current law dividends paid by

119. *Id.*

120. *Id.* at 24-27.

121. *Id.* at 30-31.

122. *Id.* at 30.

123. *Id.* at 36-37.

124. *Id.* at 37.

125. *Id.* at 37-38.

126. *Id.* at 39-40.

127. *Id.*

128. *Id.* at 39.

mutual companies are treated as premium rebates for tax purposes. In stock companies, on the other hand, the owners are the stockholders, who may or may not also be policyholders, and dividends are deemed to be a distribution of income. The report emphasized the need "to recognize the different organizational structures and devise a formula that taxes mutual and stock companies in a fair and equitable way."¹²⁹ In drafting the 1959 Act Congress developed a compromise formula that limited the deduction for policyholder dividends to the excess of gain from operations over taxable investment income, plus \$250,000. The GAO Report states that this compromise formula resulted in the mutual companies paying 69% of the tax burden in 1958.¹³⁰ The 69% ratio was presumably determined by averaging the mutual companies' share of all life insurance in force, 63%, with its share of industry assets, 75%.¹³¹

*B. The Examination of Specific Provisions of the 1959 Act*¹³²

The GAO Report examined certain specific provisions of the 1959 Act and formulated various alternatives to these provisions. The areas examined included (1) the effect of the 1959 Act on a life insurance company's investment decisions, (2) policy and other contract liability requirements, (3) the interplay of the three-phase tax structure, and (4) net level adjustment to life insurance reserves.

Life Insurance Company Investments. Any tax policy that affects the taxation of a company's investment income will affect a company's investment decisions. Two areas affected by the 1959 Act are tax-exempt securities and discount bonds. Under the 1959 Act tax-exempt interest earned by a life insurance company is not fully tax-exempt. This interest, along with taxable interest and other investment income, is prorated between the policyholders and the company.¹³³ Only the portion prorated to the company is excludable as tax-exempt interest. This tax policy discourages investment in tax-exempt issues since a life insurance company does not benefit from a 100% exclusion of the income earned on tax-exempt securities.

The 1959 Act, as amended, further provides that life insurance companies can elect not to amortize market discount on bonds as ordinary in-

129. *Id.*

130. *Id.* at 40.

131. Clark, *The Federal Taxation of Financial Intermediaries*, 84 *YALE L.J.* 1603, 1649 (1975).

132. This section is a summary of the GAO's findings with regard to specific provisions of the 1959 Act. See REPORT TO CONGRESS, *supra* note 2, at 50-71. Opinions expressed in this section do not necessarily reflect those of the authors.

133. See *supra* notes 27-28 and accompanying text.

come.¹³⁴ As a result, bond discount can be treated as capital gain income when the bonds are sold or retired. In the late 1970s and early 1980s many corporate bonds were significantly discounted because of spiraling interest rates.¹³⁵ These bonds have therefore been particularly attractive to life insurance companies because of this advantageous tax treatment.

Although the GAO Report described in detail the effect of the 1959 Act on investment decisions regarding tax-exempt securities and discount bonds,¹³⁶ the report did not suggest any alternatives for Congress to consider, nor did it request Congress to perform additional studies of these issues.

Policy and Other Contract Liability Requirements. Life insurance companies may deduct from investment income an amount for policy and other contract liability requirements in order to arrive at taxable investment income.¹³⁷ Policy and other contract liability requirements consist of (1) the reserve interest deduction, (2) the pension reserve deduction, and (3) interest paid. As previously discussed, the reserve interest deduction is based on the 10-for-1 or Menge formula. The GAO Report recognized that the Menge formula is "one of the most controversial provisions of the 1959 Act."¹³⁸ The 10-for-1 formula was intended to result in a reasonable approximation of the company's reserves based on its actual earnings rate, and is apparently a fairly accurate indicator of a company's reserve needs when the difference between the adjusted reserves rate and the average rate of interest is small. As the difference increases, however, the 10-for-1 formula results in more unrealistic adjusted life insurance reserves and marginal tax rates on additional investment income that can exceed the maximum corporate rate of 46%. Given today's high interest rates, coupled with an assumed rate of 3% or 4%, the difference between these rates can be significant.¹³⁹ The GAO Report recommended that Congress

134. I.R.C. § 818(b) (1976).

135. These bonds were commonly referred to as "deep discount" bonds.

136. REPORT TO CONGRESS, *supra* note 2, at 50-51.

137. See *supra* notes 34-49 and accompanying text.

138. REPORT TO CONGRESS, *supra* note 2, at 53.

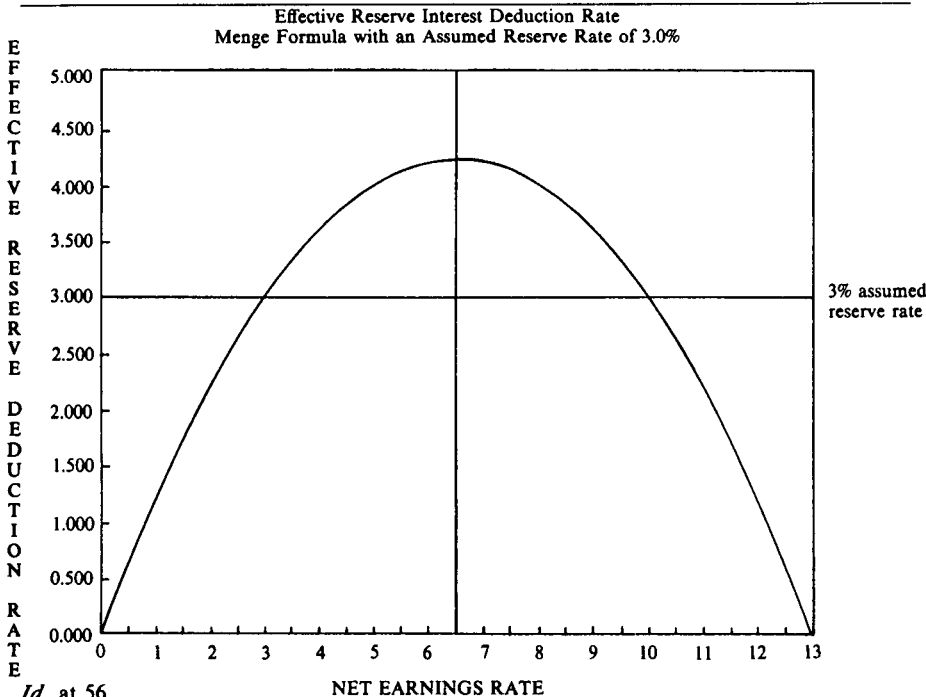
139. The GAO study describes this result as follows:

The relationship between the reserve deduction that is allowed under the 10-to-1 approximation and the interest deduction based on the assumed rate is a portion of a parabolic curve, starting from 100 percent when the two rates are equal and increasing to a maximum (halfway between the assumed rate and 10 percent) and then decreasing to 100 percent again when the adjusted earnings rate equals 10 percent. However, the curve does not stop there. For adjusted earnings rates in excess of 10 percent, the reserve deduction allowed by the Menge formula actually becomes less than 100 percent of the required interest until it disappears entirely, if and when the adjusted earnings rate exceeds the assumed rate by 10 percent or more

Id. at 55. The result described by the study can be depicted as follows:

adopt one of three alternatives to the 10-for-1 or Menge formula.¹⁴⁰ First, Congress could substitute the actual required interest based on assumed rates for the 10-for-1 adjustment. This is known as the “free interest” method. Second, a reserve deduction based on a geometric approximation could replace the 10-for-1 rule. Third, Congress could substitute a 4.5% maximum for the average earnings rate with either the 10-for-1 reserve adjustment or with the geometric reserve adjustment.

Under the free interest method, a life insurance company substitutes its required interest, determined by multiplying the assumed rate by the mean life reserves, for its reserve interest deduction.¹⁴¹ Since companies set premiums based upon expected earnings rates rather than the lower assumed rates mandated by states to determine reserves, industry observers believe that this method results in a perceived inequity. The geometric approximation method assumes that for a difference of “n” percent between the actual and assumed earnings rates, the level of reserves decreases by 0.9 to the nth power.¹⁴² Because geometric approximation provides a larger reserve interest deduction under current economic conditions, this method has gained the widest industry support. The 4.5% maximum method assumes a maximum adjusted reserves rate of 4.5% and can be used in con-



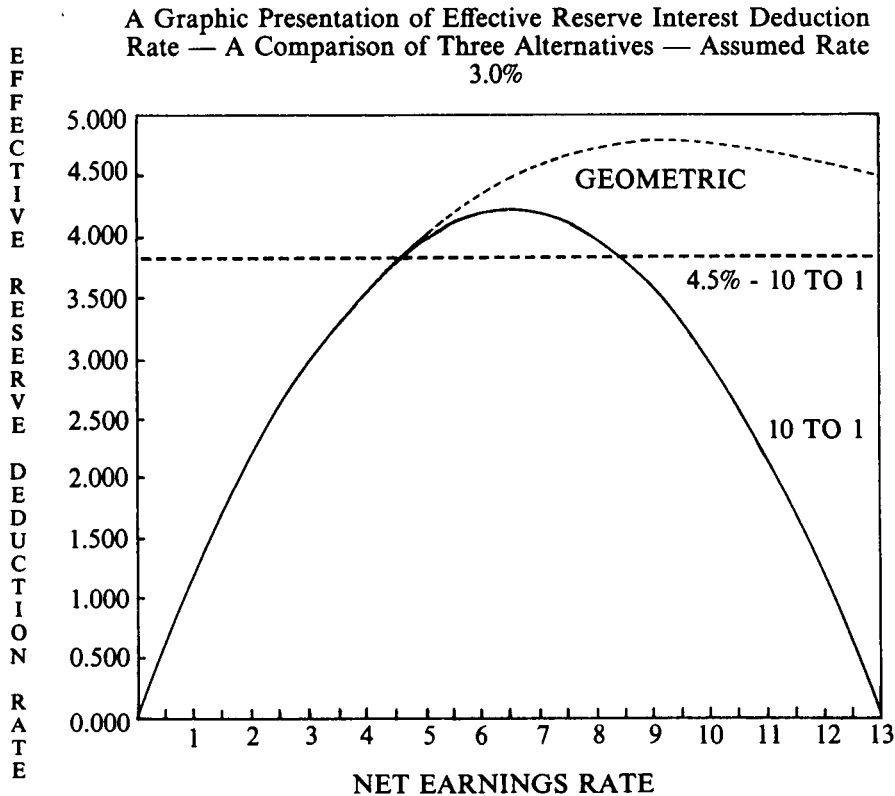
Id. at 56.

140. *Id.* at 87.

141. *Id.* at 89.

142. *Id.* “For example, an earned rate 2.0 percent higher than the assumed rate adjusts reserves to 81 percent (.09 squared multiplied by 100 percent) of actual reserves. These adjusted reserves are then multiplied by the actual earnings rate to obtain the reserve interest deduction.” *Id.*

junction with either the 10-for-1 formula or the geometric approximation.¹⁴³ The 4.5% maximum method, therefore, places an upper limitation on the reserve interest deduction. The following chart included in the GAO Report shows the relationship between these three methods.¹⁴⁴



Interplay of the Three-Phase Tax Structure. As previously discussed, a life insurance company is taxed on the lesser of taxable investment income or gain from operations, plus 50% of the excess, if any, of gain from operations over taxable investment income. The GAO Report noted two specific concerns regarding this taxing scheme. First, the report discussed the use of modified coinsurance arrangements.¹⁴⁵ Under a modified coinsurance arrangement, a company taxed on Phase I income transfers a block of insurance business reserved on a preliminary term basis to a reinsuring company taxed on Phase II income. Assuming a section 820 election is made, the ceding company reduces its investment income, and thus its tax base, by an amount equal to the earnings on the assets transferred. The reinsurer, on the other hand, assumes assets equal to the statutory reserves and therefore recognizes premium income equal to its deduction for the increase in statutory reserves. Further, if the reinsurer has elected to re-

143. *Id.* at 91.

144. *Id.* at 93.

145. *Id.* at 62.

value its reserves under section 818(c), it will also receive a deduction for the revalued amount on the reserves assumed, resulting in a net reduction in its underwriting income and thus its tax base.¹⁴⁶ The GAO Report notes that the multi-phase taxing scheme made such arrangements advantageous for certain taxpayers. The report did not recommend that section 820 be repealed, however, but stated that Congress would probably do so.¹⁴⁷

Second, the GAO questioned the necessity of the 50% deferral of any excess of gain from operations over taxable investment income.¹⁴⁸ This provision was provided to protect an insurance company in the case of unpredictable catastrophic losses. The GAO contended that losses are actually highly predictable and that no deferral is necessary. The GAO also argued that the deferral favors stock companies rather than mutual companies. Consequently, the GAO recommended that the deferral of one-half of gain from operations over taxable investment income be phased out.¹⁴⁹

Net Level Election. As previously discussed, the 1959 Act provided two methods of revaluing preliminary term reserves for the purpose of computing the Phase II deduction for the net increase in reserves, exact revaluation and approximate revaluation.¹⁵⁰ Under the approximate revaluation method preliminary term whole life reserves were increased by \$21 per \$1,000 of insurance in force, less 2.1% of the reserves. The GAO contended that this approximate revaluation resulted in a reserve greater than that computed by an exact revaluation. As a result, the GAO recommended that the approximate revaluation be reduced from \$21 to \$15 per \$1,000 of insurance in force.¹⁵¹

Additional Areas of Study. In addition to specific recommendations, the GAO recommended that Congress study six additional provisions:¹⁵²

- (1) deferred annuities;
- (2) the definition of a life insurance company;
- (3) the definition of life insurance reserves;
- (4) the deduction for investment expenses;
- (5) the definition of assets; and
- (6) the use of modified coinsurance for tax avoidance.

146. See I.R.C. § 820 (1976); *supra* notes 100-03 and accompanying text.

147. REPORT TO CONGRESS, *supra* note 2, at 63. Section 820 was, in fact, repealed by TEFRA. See *infra* notes 154-56 and accompanying text.

148. REPORT TO CONGRESS, *supra* note 2, at 63; see *supra* notes 76-78 and accompanying text.

149. *Id.* at 104.

150. See *supra* notes 62-65 and accompanying text.

151. REPORT TO CONGRESS, *supra* note 2, at 105.

152. *Id.*

IV. THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA)

On September 3, 1982, President Reagan signed into law the Tax Equity and Fiscal Responsibility Act of 1982.¹⁵³ The life insurance and annuity provisions of TEFRA significantly affect not only the federal income tax treatment of life insurers and their products, but also the taxation of the consumers of such products. These provisions reflect a compromise among the life insurance industry, the Treasury Department, and various congressional committees. TEFRA contains a number of stopgap provisions effective only for taxable years beginning after December 31, 1981, and before January 1, 1984. The aim of these provisions is not only to increase tax revenues from the insurance industry, but also to provide rules regarding the tax treatment of various new life insurance products.

A. Reinsurance Provisions

Repeal of Modified Coinsurance Provisions (Section 820). Although section 820 was originally intended to avoid possible double taxation of investment income to both the ceding company and the reinsurer, the Treasury and others sensed that life insurance companies were using modified coinsurance arrangements to substantially reduce or eliminate their federal income tax liabilities.¹⁵⁴ In response to the Treasury's concerns, Congress repealed section 820 effective for taxable years beginning after December 31, 1981.¹⁵⁵ The repeal applies to modified coinsurance contracts entered into prior to 1982 as well as those entered into after 1981.¹⁵⁶

TEFRA does, however, "grandfather" the pre-1982 federal income tax treatment of modified coinsurance agreements.¹⁵⁷ The eligibility of prior years for the section 820 treatment is determined "solely by reference to the terms of the contract."¹⁵⁸ Accordingly, the pre-1982 federal income tax savings attributable to modified coinsurance should be free from IRS scrutiny. The sole exception to this special treatment is in the case of fraud.¹⁵⁹

Special Termination Accounting. Congress prescribed a series of special termination accounting rules for modified coinsurance arrangements, one of which concerned the treatment of assets and reserves as of January 1, 1982. Assets and reserves as of the beginning of 1982 are treated as assets and reserves of the reinsurer and not of the ceding company, while assets and reserves as of the end of 1982 are treated as having been returned to

153. Pub. L. No. 97-248, 96 Stat. 324 [hereinafter cited as TEFRA].

154. S. REP. NO. 494, 97th Cong., 2d Sess. 90 (1982).

155. TEFRA § 255(a), 96 Stat. at 533.

156. *Id.* § 256(f), 96 Stat. at 536. Section 256(f) of TEFRA contains a special election that allows a ceding company to revoke retroactively a § 820 election for contracts entered into in 1980 or 1981 with an unrelated reinsurer. The company must have either had loss from operations or been taxed on gain from operations in the year the contract took effect.

157. *Id.* § 255(c)(2), 96 Stat. at 534.

158. *Id.*

159. *Id.*

the ceding company.¹⁶⁰ This procedure effectively increases the 1982 taxable investment income of the ceding company and also reduces the Phase II tax-exempt interest and dividends received deductions of the reinsurer. Further, Congress specifically disallows any increase in reserves attributable to the restoration of reserves to a ceding company to qualify for the special deduction for nonparticipating contracts.¹⁶¹

The net level reserve adjustment also received special treatment. This special rule affects both the ceding company and the reinsurer. Under the general rules a ceding company that recaptures reserves that are subject to the net level election is entitled to a deduction in the year of recapture equal to the reserves assumed, including the net level reserve adjustment. The deduction for the increase in the net level reserve adjustment is not, however, allowed to the ceding company under the special termination rules.¹⁶² On the other hand, the reinsurer is required to include in taxable income the decrease in its net level reserve adjustment caused by the repeal of section 820.¹⁶³ Congress recognized the additional tax burden resulting from the special termination rules and thus provided a transitional rule that allows the reinsurer to pay the increased federal income tax caused by the release of the net level election reserves over a three-year period.¹⁶⁴

Reimbursed Policyholder Dividends—Conventional Coinsurance. Prior to TEFRA policyholder dividends reimbursed by a reinsurer under the terms of a reinsurance contract were considered paid by the reinsurer rather than by the ceding company. In *Lincoln National Life Insurance Co. v. United States*¹⁶⁵ the Court of Claims construed this requirement to mean that a reinsurer's dividend deduction is limited to amounts actually paid by the reinsurer.¹⁶⁶ In effect this decision places reinsurers, which are required to be accrual method taxpayers, on the cash basis method for purposes of deducting reimbursed dividends. Under TEFRA reimbursed policyholder dividends under conventional coinsurance are treated as policyholder dividends of the ceding company,¹⁶⁷ and the reimbursed dividends are included in premium income of the ceding company. The reinsurer, on the other hand, is entitled to a full deduction for reimbursed policyholder dividends determined on an accrual basis.¹⁶⁸ Congress's apparent rationale for this procedure was that the deductibility of dividends should be determined by the ceding company.

160. *Id.* § 256(b), 96 Stat. at 535.

161. *Id.* § 256(d)(4), 96 Stat. at 535-36.

162. *Id.* § 256(d)(2), 96 Stat. at 535 (amending I.R.C. §§ 810(a)-(b)). The new law is silent as to whether the tax benefit rule will apply to exclude from income the decrease in the net level reserve adjustment when the underlying insurance contracts lapse or terminate.

163. TEFRA § 256(d)(1), 96 Stat. at 535.

164. *Id.* § 256(e), 96 Stat. at 536.

165. 582 F.2d 579 (Ct. Cl. 1978).

166. *Id.* at 603-04.

167. TEFRA § 255(b), 96 Stat. at 533 (adding I.R.C. § 811(c) (West Supp. 1983)).

168. I.R.C. §§ 809(d)(12), 811(c) (West Supp. 1983).

Other Reinsurance Agreements. A number of life insurers enter into reinsurance agreements whereby the reinsurer records the reserves assumed on its annual statement even though the related assets are not transferred to the reinsurer. Instead, the ceding company transfers a note to the assuming company with a stated rate of interest. This interest is treated as interest paid by the ceding company and reduces taxable investment income. The new law removes the incentive for this arrangement by disallowing the interest deduction for any interest paid or accrued after December 31, 1981 by a ceding company to any person in connection with a reinsurance agreement.¹⁶⁹ This provision does not apply, however, with respect to interest paid on account of delay in making periodic settlements of income and expense items under the terms of the contract.

TEFRA does not specifically address other reinsurance arrangements.¹⁷⁰ Nonetheless, both the Senate Finance Report and the Conference Committee Report state that in appropriate circumstances the Internal Revenue Service may properly challenge other reinsurance tax planning arrangements on a number of grounds, including lack of economic substance, lack of business purpose, or principal purpose of tax evasion.¹⁷¹

Related Party Reinsurance. TEFRA added a new provision concerning reinsurance transactions between related parties.¹⁷² Related parties include those in an affiliated group as well as related foreign entities or casualty insurance companies.¹⁷³ The new provision provides that the IRS may allocate or recharacterize any item, such as investment income, premiums, deductions, assets, reserves, or credits, if allocation or recharacterization is necessary to reflect the proper source and character of taxable income.

B. Policyholder Dividend and Special Deductions Limitation

As part of its stopgap provisions, TEFRA increases the limitations on the deductibility of policyholder dividends and special deductions and incorporates an elective alternative approach that no longer associates the maximum permitted deduction with the relationship of the tentative gain from operations to the taxable investment income. The purpose of this change is to reflect the effect of inflation since 1959, when the existing amount was established.¹⁷⁴ Under the new limitation a life insurance

169. *Id.* § 805(e) (West 1982 & Supp. 1983).

170. Reinsurance agreements involving asset transfers are, however, covered by proposed regulations issued by the Treasury. Prop. Treas. Reg. § 1.809-4(a)(1)(ii), 47 Fed. Reg. 11,882 (Mar. 19, 1982). These regulations treat all or a part of a reinsurance experience refund as investment income to the ceding company and as a reduction of investment income by the assuming company.

171. S. REP. NO. 494, 97th Cong., 2d Sess. 336, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 1074; H.R. REP. NO. 760, 97th Cong., 2d Sess. 641, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 1190, 1412.

172. I.R.C. § 818(g) (West Supp. 1983) (as amended by TEFRA § 258(a)).

173. S. REP. NO. 494, 97th Cong., 2d Sess. 337, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 1074.

174. *Id.* at 338, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 1075-76.

company's total deduction for policyholder dividends and special deductions equals the greater of (1) \$1,000,000 plus the excess, if any, of gains from operations, before policyholder dividends and special deductions, over taxable investment income, or (2) the alternative limitation, which is the sum of (a) the policyholder dividends allocable to section 805(d) qualified pension contracts, (b) the base amount, which consists of policyholder dividends under nonqualified contracts and the deduction for nonparticipating contracts, up to \$1,000,000, and (c) for a mutual company, 77.5% of the base amount; for a stock company, 85% of the base amount.¹⁷⁵

As indicated above, the statutory amount for policyholder dividends and special deductions is increased to \$1,000,000, both under the original formula limitation and in the new elective alternative limitation. The \$1,000,000 amount begins to decrease when the total available policyholder dividends and special deductions exceed \$4,000,000, and it continues to decline substantially until the sum of such deductions reaches \$8,000,000, after which it no longer applies.¹⁷⁶ Further, the gradual decrease of the \$1,000,000 statutory limitation amount is based on the full amount of policyholder dividends and special deductions, not just on the base amount. Thus, policyholder dividends on qualified pension contracts and the potential deduction for certain accident and health and group life contracts affect computation of the alternative limitation.

At this large company level, the deduction for nonqualified business would be determined solely under the percentage limitation provision. This new alternative election can enable unaffiliated stock companies whose base amount is \$5,000,000 or less to realize a tax benefit for 100% of the policyholder dividends on nonqualified contracts and 100% of the nonparticipating contract deduction. For a mutual company, the equivalent point would be \$4,210,000 of nonqualified policyholder dividends. According to the Senate Finance Committee report, the difference in treatment "is intended to reflect that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (deriving from their ownership interest in the company), and accordingly, should not be deductible."¹⁷⁷

Under prior law no specific authority existed in the Code or regulations stipulating the treatment of the statutory limitation for members of a controlled group.¹⁷⁸ The new law allows a controlled group a single \$1,000,000 statutory limitation that may be divided among the component members of the group on December 31 of each tax year.¹⁷⁹ The \$1,000,000 amount is divided equally unless regulations permit an unequal allocation. Before allocation the \$1,000,000 statutory limitation must be reduced if the total policyholder dividends and special deductions of the controlled group

175. I.R.C. § 809(f) (West Supp. 1983) (as amended by TEFRA § 259(a)).

176. I.R.C. § 809(f)(3) (West Supp. 1983).

177. S. REP. NO. 494, 97th Cong., 2d Sess. 339, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 1076.

178. Controlled groups are defined in I.R.C. § 1563(a) (1976).

179. *Id.* § 1561(a) (West 1982 & Supp. 1983) (as amended by TEFRA § 259(b)).

exceed \$4,000,000.¹⁸⁰

Election of the alternative limitation allows a guaranteed 100% deduction for all policyholder dividends paid with respect to qualified pension business.¹⁸¹ Congress hoped this provision would not only provide parity between the tax treatment of insured pension plans and trustee pension plans, but also effectuate its intent that investment income attributable to insured pension plans be tax free, thereby allowing the insurance industry to compete effectively for qualified pension plans.¹⁸²

C. Excess Interest on Deferred Annuities

Many life insurance companies issue deferred annuity contracts, or more specifically, fixed annuities. This type of annuity allows interest to be credited during the deferral period at a rate in excess of the relatively low rate currently guaranteed upon issue of the contract. The proper characterization of this excess interest on deferred annuity contracts has been an area of long-standing controversy between the insurance industry and the IRS. The controversy centers around whether the excess interest credited under annuity contracts should be characterized as policyholder dividends, effectively nondeductible prior to TEFRA by a life insurance company taxed strictly on gain from operations, or whether it is fully deductible in determining gain from operations as reserve increases to provide for benefits guaranteed under the contract.

The IRS attempted to resolve a portion of this controversy in June 1982 by issuing a revenue ruling that held that amounts credited to policyholder accounts in excess of the assumed rate of interest in the contracts are distributions similar to policyholder dividends that are deemed to be immediately paid back in the form of premiums to the life insurance company.¹⁸³ As a result, the insurers' deductions for excess interest credits¹⁸⁴ were substantially reduced or eliminated. This position was heavily criticized by the insurance industry as to both timing and correctness. The ruling was widely perceived to threaten not only the continued viability of new annuity insurance products, but also, to some extent, the issuing companies themselves as competitors in the broadening financial services industry.

In order to resolve the legal uncertainty surrounding the tax treatment of excess interest in the aftermath of the IRS ruling and to provide stability in the annuity marketplace, Congress effectively reversed the IRS position in the case of nonqualified annuity contracts.¹⁸⁵ TEFRA allows a full deduction for excess interest credited under nonqualified annuity contracts, provided certain requirements are met.¹⁸⁶ Under the new rules all interest

180. I.R.C. § 1561(a)(4) (West Supp. 1983).

181. Qualified pension business is defined in *id.* § 805(d) (1976 & Supp. V 1981).

182. TEFRA § 260(a) (amending I.R.C. § 818(h)); TEFRA § 260(b) (amending I.R.C. § 805(g)).

183. Rev. Rul. 82-133, 1982-2 C.B. 119, 121.

184. I.R.C. § 809(f) (West Supp. 1983) (as amended by TEFRA § 259(a)).

185. TEFRA § 264 (adding I.R.C. § 805(f)(3)(a) (West Supp. 1983)).

186. *Id.*

credited under a fixed annuity contract is included in full as interest paid in determining taxable investment income in Phase I and as required interest for the purpose of determining gain from operations in Phase II if such interest is "qualified guaranteed interest."¹⁸⁷ Qualified guaranteed interest must be determined (1) under a rate guaranteed in advance for a period not less than twelve months or for a period ending not earlier than the close of the taxable year in which the contract was issued, or (2) under any formula or rate declaration, including an external index, guaranteed in advance, where the terms of the formula or rate may not be changed by the company during the period under (1) above and are independent of the company's investment experience.¹⁸⁸ In order to be a contractual guarantee, the rate or formula need not be stated in the individual contract so long as the company issuing the contract has made a commitment to pay a rate of interest that is legally binding under state law and is enforceable by the policyholder. In addition, the annuity contract must be a "qualified contract." A qualified contract must (1) be nonparticipating, (2) involve life contingencies at the time the qualified interest is credited under the contract, (3) provide that excess interest may be credited thereunder, and (4) not be a qualified pension contract.¹⁸⁹ TEFRA further provides that the twelve-month guarantee rule is deemed satisfied, even though the guarantee is for less than twelve months, if the period does not end earlier than the close of the taxable year in which the contract was issued.¹⁹⁰ This rule permits contracts to be issued with interest guarantees that coincide with the calendar year.

A special elective provision allows a partial deduction for excess interest credited under a participating annuity contract, assuming the requirements for qualified guaranteed interest treatment are met. For participating contracts, the amount included as interest paid and as required interest equals the sum of (1) all interest credited at the minimum guaranteed rate and (2) 92.5% of any interest credited in excess of the minimum guaranteed rate.¹⁹¹ Without this rule the excess interest credited to a participating deferred annuity contract, which is not a section 805(d) qualifying pension contract, might be eligible only for the 77.5% policyholder dividend deduction limitation allowed to mutual companies or 85% dividend deduction limitation applicable to stock companies. No deduction is allowed for the remaining 7.5% of the excess interest.

For the purpose of computing taxable investment income, qualified guaranteed interest is taken into account separately as interest paid in determining the policy and other contract liability requirements. To prevent a double deduction in Phase I, the contractual policy interest and related reserves are excluded from the computation of the reserve interest deduc-

187. TEFRA § 264 (adding I.R.C. § 805(f)(1) (West Supp. 1983)).

188. *Id.*

189. TEFRA § 264(b) (adding I.R.C. § 805(f)(2) (West Supp. 1983)).

190. TEFRA § 264(b) (adding I.R.C. § 805(f)(1)(A)(ii) (West Supp. 1983)).

191. TEFRA § 264(b) (adding I.R.C. § 805(f)(3)(A) (West Supp. 1983)).

tion.¹⁹² Additionally, for the purpose of computing gain or loss from operations in Phase II, a similar treatment is prescribed whereby actual amounts of qualified guaranteed interest are treated as required interest. This treatment of qualified guaranteed interest will have a negative effect on the computation of the company's share of tax-exempt interest and the dividends received deduction in Phase II. To avoid a double exclusion under Phase II, reserves on these contracts are excluded from the reserves that are multiplied by the assumed rate to arrive at the required interest amount.¹⁹³ TEFRA's changes to the tax treatment of deferred annuities were clearly designed to alleviate the results of the 1982 revenue ruling. This revised tax treatment also affords the life insurance industry a more competitive stance within the financial services industry.

D. Changes in Revaluation Procedure

Partially in response to GAO recommendations, Congress reduced the amount by which preliminary term reserves on whole life business may be increased under the approximate revaluation method to \$19 per \$1,000 of insurance in force less 1.9% of reserves under such contracts.¹⁹⁴ This rule applies to qualifying reserves established under contracts entered into after March 31, 1982.¹⁹⁵ A company may therefore have reserve layers revalued at both \$21 and \$19 per \$1,000 of net amount at risk. Congress also provided a transitional rule that allowed a life insurance company that revalued its reserves using the approximate revaluation method to elect the exact revaluation method without obtaining prior consent from the IRS.¹⁹⁶ This provision, however, applied only to a life insurance company's first taxable year beginning after 1981.

Definition of Whole Life Versus Term Insurance. Although not a part of the new law, the Senate Finance Committee report questioned the treatment of "disguised term policies" as whole life policies for reserve revaluation purposes. The committee recognized that certain renewable term policies eligible for, at most, revaluation at \$5 per \$1,000 were often being called whole life policies so that the issuing company could claim the higher revaluation adjustment for insurance other than term insurance.¹⁹⁷ The committee specifically mentioned certain graded premium policies that do not provide for a cash surrender value until the contract has been in force for sixteen years or longer, but do provide for the payment of premiums commensurate with a whole life policy only when the insured reaches age eighty. While recognizing that some graded premium policies may appro-

192. I.R.C. §§ 805(c)(1), 809(a), 809(e) (West 1982 & Supp. 1983) (as amended by TEFRA § 264(c)(1)).

193. *Id.*

194. I.R.C. § 818(c)(2)(A) (West Supp. 1983) (as amended by TEFRA § 267(a)).

195. TEFRA § 267(b), 96 Stat. at 551.

196. I.R.C. § 818(c) (West Supp. 1983).

197. S. REP. NO. 494, 97th Cong., 2d Sess. 341, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1078.

priately be treated as whole life policies for purposes of approximate adjustment, the report cited two criteria for distinguishing true whole life policies. The policies should "either have a substantial cash surrender value within several years after the policy is issued or level premiums should be charged within the relatively short period of time after the policy is issued."¹⁹⁸ In lieu of specifically responding to this problem, the Senate Finance Committee report encouraged the Treasury Department to issue regulations addressing the graded premium policy issue.¹⁹⁹ On November 7, 1983, the Treasury released proposed regulations regarding the graded premium policy issue. The regulations provide that in order for a policy to be treated as a whole life policy for revaluation purposes, it must provide for a constant level of death benefits and endow, at the end of a specified period or upon maturity, an amount equal to the level death benefit. In addition, the gross premiums charged under the contract must be level during the premium paying period unless certain requirements are met: (1) the policy provides for a cash value which at all times is at least 75% of the minimum required by state law for comparable policies; (2) the reserves for the policy with respect to the endowment amount are at all times at least equal to the minimum reserve required by state law for comparable policies; and (3) the gross premiums charged are level from the end of the fifth year throughout the remainder of the premium paying period.²⁰⁰

E. Additional Interest Reserves

Additional interest reserves usually arise under deferred annuity contracts when interest rates are guaranteed beyond the end of the year at a rate in excess of the maximum valuation rate allowed by state insurance departments. TEFRA provides that no deduction will be allowed for these additional reserves during the two-year stopgap period to the extent they relate to interest guarantees made after July 1, 1982, and before January 1, 1984.²⁰¹ The purpose of this provision is to prevent companies from accelerating the deduction for interest pertaining to periods after the close of a taxable year.²⁰²

F. Adjustment of the Menge Formula

In response to recommendations by the GAO and industry groups, Congress changed the 10-for-1 Menge formula for determining adjusted life reserves to a geometric approximation method. As previously discussed, the geometric approximation method assumes that for a difference of "n"

198. *Id.*, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1079.

199. *Id.*

200. Prop. Treas. Reg. § 1.818-4(h)(2). This provision will be effective for contracts issued 30 days after the Treasury Decision based on these proposed regulations is published in the Federal Register.

201. TEFRA § 263(a)(3)(A), 96 Stat. at 541.

202. S. REP. NO. 494, 97th Cong., 2d Sess. 341, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1078.

percent between the actual and assumed earnings rates, the level of reserves decreases by 0.9 to the n th power.²⁰³ The Senate Finance Committee stated that this "geometric ten-for-one" rule would better fit the economics of the insurance industry in the current interest climate and result in a better approximation of reserves at the prevailing higher earnings rates.²⁰⁴

G. Consolidated Returns

A provision of the Tax Reform Act of 1976 states that the parent of an affiliated group that includes one or more domestic life insurance or mutual casualty companies can elect to treat all such companies as includible corporations eligible to file a consolidated return.²⁰⁵ Consent to treat these related companies as includible members was previously denied because of the fundamental differences between methods of taxation applied to life insurance and mutual casualty companies and the method of taxation applied to other corporations. Separate returns were therefore warranted for related insurance companies. This reasoning had considerable merit before 1958 when life insurance companies were taxed essentially only on investment income. The 1959 Act, however, by adopting a total income approach, brought life insurance company taxation more in line with the taxation of other corporations.

A basic question in computing consolidated life insurance company taxable income is whether consolidation should be approached on a bottom line or a phase-by-phase basis. In June 1982 the Treasury Department released proposed regulations on certain issues related to life-nonlife consolidations. These proposed regulations embraced an approach, generally resisted by the insurance industry, known as a "modified phase-by-phase" consolidation method. Under this method each company's separate taxable investment income and gain or loss from operations were aggregated. Consolidated taxable income was then computed based on consolidated taxable investment income and consolidated gain from operations.

Before hearings could be held on the proposed regulations, Congress enacted TEFRA, which provides a "bottom line" consolidation method for determining life insurance company taxable income for taxable years 1982 and 1983.²⁰⁶ Under the bottom line method each company computes its separate life insurance company taxable income. The separate company taxable income amounts are then combined to arrive at the consolidated taxable income of the affiliated group. TEFRA did not affect the treatment of items that are not unique to life insurance companies, such as capital gains and losses and the deductions for charitable contributions

203. See *supra* note 142 and accompanying text.

204. S. REP. NO. 494, 97th Cong., 2d Sess. 343, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1080.

205. I.R.C. § 1504(c)(2)(A) (Supp. V 1981).

206. TEFRA § 262, 96 Stat. at 540 (amending I.R.C. § 818(f)).

and dividends received. Those items are subject to the general consolidation rules applicable to all taxpayers.

On March 14, 1983, the Treasury issued final regulations for life-nonlife affiliated groups electing to file a consolidated federal income tax return. Despite industry criticism of many of the provisions, the Treasury Department adopted and finalized the proposed regulations with few revisions. The final regulations retain the "subgroup method" of consolidation initially introduced by the proposed regulations.²⁰⁷ This method of computing life-nonlife consolidated taxable income assumes the existence of two subgroups within one consolidated tax return, a "nonlife subgroup" comprised of nonlife companies, including mutual casualty companies, and a "life subgroup" comprised of life insurance companies.²⁰⁸ Subject to certain limitations on losses, consolidated taxable income for the entire group is determined by combining the "bottom line" consolidated taxable income or loss of the two subgroups. The final regulations do not, however, specifically address the precise manner in which the consolidated taxable income of the life subgroup should be computed. Clearly, many questions remain unanswered, and the application of the final regulations to specific taxpayer situations continues to be very complex.

H. Policyholder Tax Treatment

The tax treatment of new investment-oriented products greatly influences their success or failure in the financial marketplace. In this area Congress faces two objectives. First, Congress has committed itself to protect the social and economic benefits provided by these products and to encourage savings and capital accumulation on the part of the average individual. Second, Congress must consider the effect of its decisions on competition between the various members of the financial services industry. Similar products offered by both banks and insurance companies should be taxed equally at the policyholder/investor level.

Deferred Annuities. In recent years the life insurance industry has developed deferred annuity products that provide investment yields competitive with short-term money market investments. Marketing of these annuities has focused more on their effectiveness as short-term tax shelters and less upon long-term funding. Prior law tended to assist this short-term marketing strategy for deferred annuity contracts by providing that annuity income was not currently taxed to the policyholder. Amounts paid out under an annuity contract prior to the starting date of the annuity were treated first as a return of the policyholder's capital and were taxable as ordinary income only after the policyholder had recovered his investment in the contract.²⁰⁹

Congress believed that the use of deferred annuity contracts to meet

207. Treas. Reg. § 1.1502-47(a)(2).

208. *Id.*

209. I.R.C. § 72(e) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

long-term investment goals, such as providing income security, should receive favorable tax treatment, but that the use of deferred annuities for short-term investment and income tax deferral should be discouraged.²¹⁰ Because Congress enacted the prior tax rules before the advent of investment-oriented deferred annuities, a change in the law was warranted. The new law makes two changes to the tax treatment of fixed or variable deferred annuities.²¹¹ First, a withdrawal before the annuity starting date will be treated as income to the extent the cash value of the contract exceeds the investment in the contract.²¹² Second, policyholders incur a penalty tax for certain premature distributions from annuity contracts.²¹³

Amounts Not Received as an Annuity. A withdrawal before the annuity starting date, termed "an amount not received as an annuity," is treated as income on the contract to the extent the cash value of the contract exceeds the investment in the contract immediately before distribution.²¹⁴ The policyholder must include the amount withdrawn in taxable income to the extent allocable to income on the contract.²¹⁵ The investment in the contract is defined as the aggregate amount of premiums or other consideration paid for the contract minus the aggregate amount previously received under the contract to the extent such amount was excludable from gross income.²¹⁶ Any amount received that is not allocable to income on the contract is treated as allocable to the investment in the contract and is not included in gross income.²¹⁷

The new law does not provide for any netting of withdrawals and premiums. A withdrawal may therefore result in taxable income even though the withdrawal is later offset by additional premium payments. A policyholder dividend distributed prior to the annuity starting date is not, however, included in gross income to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.²¹⁸ Such amounts will, however, increase the policyholder's investment in the contract.²¹⁹ The new law also provides that any direct or indirect loan under the contract, or any assignment or pledge of any portion of the value of the

210. S. REP. NO. 494, 97th Cong., 2d Sess. 347, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 1082.

211. The legislative provisions, however, failed to address the "wraparound" issues pertaining to such contracts, leaving various unanswered questions in this area.

212. I.R.C. § 72(e) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

213. I.R.C. § 72(q) (West Pam. Supp. 1983) (as amended by TEFRA § 265(b)(1)).

214. I.R.C. § 72(e) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

215. I.R.C. § 72(e)(2)(B)(i) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)). An amount is treated as allocable to income on the contract to the extent it does not exceed the excess of the cash value of the contract, without regard to any surrender charge, over the investment in the contract immediately before the amount is received. I.R.C. § 72(e)(3)(A) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

216. I.R.C. § 72(e)(6) (as amended by TEFRA § 265(a)).

217. I.R.C. § 72(e)(2)(B)(ii) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

218. I.R.C. § 72(e)(4)(B) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

219. The policyholder's investment in the contract is defined by I.R.C. § 72(e)(6) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)) as "premiums or other consideration paid for the contract."

contract, is treated as a cash withdrawal rather than a true loan.²²⁰ In consequence, a policyholder will receive income to the extent the amount of the loan, assignment, or pledge is allocable to income on the contract. Presumably, repayments on any policy loans will correspondingly be reclassified as additional policy premiums, thereby increasing the policyholder's investment in the contract.

The existing rules are retained in certain cases. Most importantly, the new rules do not apply to contracts entered into before August 14, 1982.²²¹ Nonetheless, any amount allocable to the investment in the contract after August 13, 1982, is treated as derived from a contract entered into after such date.²²² The amount allocable to the investment in the contract after August 13, 1982, is apparently intended to be computed first with respect to the most recent investments under the contract, although TEFRA does not explicitly provide for this treatment.

Penalty Tax. Congressional intent to discourage the use of deferred annuities for short-term investment and income tax deferral is apparent in a new rule that provides for a 5% penalty for certain premature distributions from annuity contracts.²²³ The penalty tax equals 5% of the amount of the distribution includible in the policyholder's gross income that is properly allocable to any investment in the annuity contract made during the ten-year period ending on the date of the distribution.²²⁴ For purposes of determining whether an amount is allocable to an investment in the annuity contract made during the prior ten years, the amount includible in gross income is allocated to the earliest investment in the contract.²²⁵

The penalty tax is expressly inapplicable to certain distributions. The penalty tax will not apply to any distribution made on or after the date on which the policyholder attains age 59½, or to a distribution that is one of a series of substantially equal periodic payments made for life or for a period of at least sixty months after the annuity starting date.²²⁶ Further, the penalty will not apply if the withdrawal follows the death of the policyholder or is attributable to the policyholder's becoming disabled.²²⁷ Finally, the penalty does not apply to any distribution from a qualified plan.²²⁸

The penalty tax provisions do not apply to contracts entered into before August 14, 1982.²²⁹ Any amount allocable to premiums paid for annuities

220. I.R.C. § 72(e)(4) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

221. TEFRA § 265(c)(1), 96 Stat. at 547.

222. I.R.C. § 72(e)(5)(B) (West Pam. Supp. 1983) (as amended by TEFRA § 265(a)).

223. I.R.C. § 72(q) (as amended by TEFRA § 265(b)(1)).

224. The penalty was 10% under the original Senate bill, but was reduced to 5% in conference. H.R. REP. NO. 760, 97th Cong., 2d Sess. 647, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1416.

225. TEFRA § 265(b)(1) (adding I.R.C. § 72(q)(1)(B) (West Pam. Supp. 1983)).

226. TEFRA § 265(b)(1) (adding I.R.C. §§ 72(q)(2)(A)-(B) (West Pam. Supp. 1983)).

227. TEFRA § 265(b)(1) (adding I.R.C. §§ 72(q)(2)(B)-(C) (West Pam. Supp. 1983)).

228. TEFRA § 265(b)(1) (adding I.R.C. § 72(q)(2)(E) (West Pam. Supp. 1983)).

229. TEFRA § 265(b)(1) (adding I.R.C. § 72(q)(2)(F) (West Pam. Supp. 1983)).

after August 13, 1982, is treated for this purpose as received from a contract entered into after that date. The penalty tax provisions do not, however, apply to distributions made before January 1, 1983.

I. Flexible Premium Life Insurance Contracts

In recent years many life insurance companies have begun marketing flexible premium life insurance contracts known as "universal life" or "adjustable life" contracts. These policies permit the policyholder to change the amount and timing of the premiums and the amount of the death benefits. Under these contracts the death benefit may or may not bear any relation to the cash value of the policy.

A 1981 private letter ruling to E.F. Hutton Life Insurance Company held that the death benefit under its universal life insurance product, a flexible premium life insurance contract, would be excluded from taxable income as proceeds of a life insurance contract.²³⁰ The ruling allows the earnings on the investment portion of the contract to accumulate tax-free unless the contract is surrendered before the death of the insured. A policyholder could therefore enjoy an unlimited amount of tax deferred savings. The IRS later announced that it was reconsidering its position on the treatment of flexible premium life insurance contracts.²³¹

Because the uncertain tax treatment of flexible premium contracts caused significant confusion among both consumers and life insurance companies, Congress believed the tax treatment of these contracts should be resolved by legislation.²³² In TEFRA Congress provided specific guidelines that a flexible premium life insurance contract must meet in order to be treated as a traditional life insurance policy for tax purposes.²³³ If these guidelines are violated at any time during the life of the contract, the death benefit will be taxable income to the beneficiary to the extent the amount received exceeds the investment in the contract.

The new law defines a flexible premium life insurance contract as one that provides for the payment of one or more premiums that are not fixed by the insurer as to both timing and amount.²³⁴ The term also includes contracts with riders for so-called qualified additional benefits, which include guaranteed insurability, accidental death, family term coverage, and waiver of premium.²³⁵ A contract providing any annuity benefits other than settlement options, or any single premium life insurance contract, is not considered a flexible premium life insurance contract. In order to qualify for tax-free receipt by the beneficiary of death benefits, a flexible premium life contract must at all times meet one of two separate tests, the guideline premium limitation test or the cash value test.

230. Ltr. Rul. 8116073 (Jan. 23, 1981).

231. Ltr. Rul. 8236069 (June 11, 1982).

232. S. REP. NO. 494, 97th Cong., 2d Sess. 352, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781.

233. I.R.C. § 101(f) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

234. I.R.C. § 101(f)(3)(A) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

235. *Id.*

Guideline Premium Limitation. Under this test two conditions must be satisfied. First, the sum of the premiums paid under the contract must not at any time exceed the guideline premium limitation.²³⁶ Briefly, the guideline premium limitation is the guideline single premium or the sum of the guideline level premiums. The guideline single premium is the single premium necessary at issue to fund the future benefits provided under the contract, based on the mortality and other charges fixed in the contract, plus interest at the greater of an annual effective rate of 6% or the minimum rate or rates guaranteed on issue of the contract.²³⁷ The guideline level premium is the annual amount payable over the longest period permitted under the contract, which may not be less than 20 years from the date of issue or, if earlier, until age 95. The amount is computed on the same basis as the guideline single premium except that the interest rate used is the greater of an annual effective rate of 4% or the minimum rate or rates guaranteed under the contract at issue.²³⁸

The second condition requires that the death benefit not at any time be less than the applicable percentage of the cash value of the contract.²³⁹ The applicable percentage is defined as 140% of the cash value when the insured, at the beginning of the contract year, is age 40 or less. When the insured is over 40 at the beginning of the contract year, the applicable percentage is 140% reduced, but not below 105%, by 1% for each year in excess of age 40.²⁴⁰

Cash Value Test. The second test is the cash value test.²⁴¹ Under this test the cash value of a contract cannot at any time exceed the net single premium for the death benefit at such time. The net single premium must be computed using the most current mortality table, an interest rate equal to the greater of 4% or the minimum guaranteed interest rate, and a maturity date not earlier than age 95.²⁴²

The provisions on flexible premium life insurance contracts apply to contracts entered into before January 1, 1984.²⁴³ For any contract entered into before January 1, 1983, there is a one-year grace period from the date of enactment to bring the contract into compliance with the new law. During the grace period any death benefit paid under a flexible premium life insurance contract is excluded from taxable income.

J. Summary

Although TEFRA was designed to be only a temporary solution to the problem of insurance company taxation, it did permanently address some

236. I.R.C. § 101(f)(1)(A)(i) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

237. I.R.C. § 101(f)(2)(B) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

238. I.R.C. § 101(f)(2)(C) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

239. I.R.C. § 101(f)(1)(A)(ii) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

240. I.R.C. § 101(f)(3)(C) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

241. I.R.C. § 101(f)(1)(B) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

242. I.R.C. § 101(f)(3)(G) (West Pam. Supp. 1983) (as amended by TEFRA § 266(a)).

243. TEFRA § 266(c)(1), 96 Stat. at 550.

of the problems inherent in the 1959 Act. For example, the TEFRA adjustments to the Menge formula and to the limitation on policyholder dividends and special deductions reflect Congress's awareness of changes in the economic climate. In addition, TEFRA at least initially addressed the tax treatment of new investment-oriented products and the vanishing distinctions between members of the financial services industry. The TEFRA legislation also evidenced Congress's desire to raise additional revenue and indicated that the life insurance industry, among others, was viewed by legislators as a prime source of that additional tax revenue.

V. PROPOSED ALTERNATIVES TO THE 1959 ACT

Because the stopgap legislation included as part of TEFRA expires at the end of 1983, Congress must replace it with either some form of permanent legislation or additional stopgap legislation. Several industry groups, the Treasury, and Congress have been examining life insurance company taxation and have promulgated several alternative tax proposals. Due to the apparent divergence of opinion within the industry and the complexity of many of the issues, an eventual compromise on permanent tax legislation will not come easily or expeditiously. Because of current budgetary problems, however, Congress will almost certainly not allow existing stopgap legislation to be extended without a "toll charge."²⁴⁴ This toll charge could take the form of a decreased limitation on special deductions, a decrease in the approximate revaluation figures for computing net level reserves, or some other tax increase measure.

With the stopgap measures enacted as part of TEFRA expiring at the end of the year, the House Ways and Means Subcommittee on Select Revenue Measures began working on permanent legislation. The subcommittee, chaired by the Honorable Fortney H. (Pete) Stark (D-California), held hearings on May 10 and 11, 1983, on the tax treatment of life insurance companies and their products. Although the subcommittee had not yet formulated a specific proposal, it did identify the major issues. The hearings also indicated that a significant split still existed within the industry. Notably, this split between mutual and stock companies closely resembled the split that occurred at the time of the 1959 Act.

The split within the industry was already very apparent prior to the enactment of the TEFRA stopgap legislation. Prominent industry groups such as the ACLI, which Congress and the Treasury typically look to for industry input into the legislative process, failed to reach a consensus on any proposed legislation because of the split between stock and mutual companies. Out of these groups several informal organizations were formed. Among these were the Stock Information Group, an association

244. House Ways and Means Committee Chairman Dan Rostenkowski (D-Illinois), speaking at a life insurance meeting in Washington, D.C., on July 27, 1983, indicated that a "toll charge" may be imposed if another set of temporary rules has to be enacted. He indicated that any new stopgap proposals would be harsher than the present stopgap provisions due to the budgetary situation.

of 120 stock companies, and the Mutual Company Executive Committee, a group of executives from certain large mutual companies. These informal groups developed several alternative proposals regarding the future taxation of insurance companies. Subsequently, Representative Stark and Representative Henson Moore (R-Louisiana) made public a specific proposal. Known as the Stark-Moore proposal, this measure was designed to simplify the present tax structure applicable to life insurance companies by replacing the three-phase tax system with a single-phase system. While the subcommittee acknowledged that the proposal needed considerable refinement, it represented a starting point for debate by Congress, the Treasury, and the industry. On July 28, 1983, the subcommittee held additional hearings to elicit public testimony on the Stark-Moore proposal. Again the controversy between mutual and stock companies was evident. Ultimately, on October 3, 1983, Representative Stark introduced to the House Ways and Means Committee the Life Insurance Tax Act of 1983 (LITA),²⁴⁵ which, with a few exceptions, parallels the Stark-Moore proposal. This legislation, which was unanimously approved by the subcommittee and approved with minor changes by the full House Ways and Means Committee on October 5, 1983, represents an insurance industry compromise that is somewhat tentative but, at least through the Ways and Means Committee, is supported by all segments of the industry. At the time of the writing of this article, LITA is being considered by the full House of Representatives as a part of an overall comprehensive tax reform package.²⁴⁶ The following discussion considers some of the major issues currently being examined by the Congress, the Treasury, and the industry.

A. Mutual Versus Stock Companies

As in 1959, the primary concern among both mutual and stock companies is maintenance of a competitive balance between the two. This concern raises the issue of the tax treatment of policyholder dividends under participating policies. Stock companies generally contend that some differential in the tax treatment of stock and mutual companies is essential to secure this competitive balance.²⁴⁷ The stock companies argue that some portion of mutual company earnings actually represents a return on equity that should be taxed similar to stock company return on equity.

Mutual companies contend that the tax treatment of policyholder dividends should be the same for both mutual and stock companies. The mutual companies believe that any difference in treatment would impose a penalty on the mutual form of organization and grant special tax incentives for the stock form of organization.²⁴⁸ The mutual companies also

245. H.R. 4065, 98th Cong., 1st Sess. (1983).

246. H.R. 4071, 98th Cong., 1st Sess. (1983).

247. This differential is often referred to as the "ownership differential." Absent any pertinent legislation, mutual companies could "dividend" out their profits to their policyholder-owners on a deductible basis and thus escape corporate tax on the profits.

248. A memorandum entitled "The Case Against a Mutual/Stock Organization" stated that any differential between mutual and stock companies is negligible because (1) any re-

point out that the decision in 1959 to limit deductions for policyholder dividends and to create special deductions for stock companies was made at a time when mutual companies clearly dominated the life insurance industry in terms of assets and in force amounts. Since 1959 the dominance of mutual companies has declined and thus the social, economic, and political pressures to maintain a competitive balance within the industry through differential tax treatment have disappeared.

Industry groups, Treasury officials, and others generally recognize two basic methods of limiting the deductibility of policyholder dividends by mutual companies. The first method imposes a limitation on the deductibility of dividends for all companies. This method resembles the TEFRA stopgap legislation that provides generally that dividends are deductible at a rate of 77.5% for mutual companies and 85% for stock companies.²⁴⁹ Perhaps not surprisingly, stock companies argue that the 7.5% difference is too small, while the mutual companies argue that the differential is much too large. While the use of any such percentages is a simple means of achieving a balance between the two industry segments, industry observers have criticized this approach because it provides Congress or the Treasury a convenient rheostat that can easily be adjusted in order to obtain more revenue from the life insurance industry as a whole.²⁵⁰ In addition, any limitation on the deductibility of policyholder dividends necessitates definition of precisely what items constitute policyholder dividends. Questionable items include excess interest, premium refunds and adjustments, indeterminate premiums, experience refunds, retrospective rate credits, and additional benefits as a result of a policy change.

The second recognized method, and the method proposed in LITA, is the imputation of some form of mutual company adjustment to reflect the ownership differential. Under this method, notwithstanding any such mutual company adjustment, policyholder dividends would be fully deductible. The mutual company adjustment would be equal to earnings imputed on an average equity base and would approximate the equity element of any policyholder dividend. The equity base is a difficult term to define, however. Some proponents argue that it should equal statutory surplus, plus certain adjustments; others contend that it should approximate some form of tax surplus. Under LITA, the equity base of a mutual insurance company is equal to its capital and surplus, plus adjustments for items such as nonadmitted financial assets and the excess of statutory reserves

turn on equity in a mutual company is relatively small, (2) any current tax structure that retains gain from operations as part of its tax base contains a built-in differential tax on mutual companies because a portion of the premiums received by mutual companies represents contributions to equity and is included in income, and (3) any tax imposed on mutual company policyholders for equity dividends would be de minimus due in part to the \$200 exclusion for dividends received by individuals. T. Groom & M. Zinn, *The Case Against a Mutual/Stock Organization 2* (Jan. 12, 1983).

249. These rates are a part of the alternative limitation on policyholder dividends and special deductions. See I.R.C. § 809(f)(2)(B) (West Supp. 1983).

250. These views are reflected in certain reports prepared for the ACLI Steering Committee.

over tax reserves. The average equity base on which the differential earnings amount is computed is the average of the equity bases determined as of the close of the current year and the preceding year. In addition, the determination of an appropriate earnings rate causes concern in many segments of the industry. Among the alternatives suggested are the statutory investment earnings rate,²⁵¹ an industry rate equal to the average rate of stock company shareholder dividends increased by the average taxes paid by the stockholders, or some other industry-wide rate determined by the IRS. Many industry leaders feel that this approach is weak because it requires a determination of earnings that is both arbitrary and difficult. Moreover, under LITA the earnings rate used in computing the policyholder dividend limitation is the excess of an imputed earnings rate over an average earnings rate for a specified year. In 1984 the imputed earnings rate is 16.5%. After 1984, however, the rate is based on a formula that takes into account the earnings of the fifty largest stock life insurance companies.²⁵²

The members of the subcommittee perceive another problem regarding the stock versus mutual form of organization. Specifically, the subcommittee contends that mutual companies could derive an undue benefit by operating through one or more stock subsidiaries. The Assistant Secretary of the Treasury for Tax Policy, John E. Chapoton, voiced the general concern with respect to the potential for tax avoidance where mutual companies form stock company subsidiaries.

If stock subsidiaries of mutual companies were permitted to pay and deduct policyholder dividends without regard to any minimum tax base, these stock subsidiaries could gain an unfair competitive advantage over their publicly-owned stock company competitors since they would be allowed to make tax deductible distributions of a portion of their profits to policyholders, in their capacity as equity owners. Unlike true stock companies, there would be no corporate tax except to the extent the stock subsidiary retained its earnings rather than distributing them to its policyholders in their capacity as equity owners.²⁵³

Under the original Stark-Moore proposal a mutual company's eighty percent owned stock subsidiaries were treated as mutual companies. Mutual

251. The statutory earnings rate is published annually in Exhibit II of the NAIC Annual Statements.

252. LITA is designed to raise an estimated \$2.8 billion in tax revenues from the life insurance industry in 1984 with the industry tax burden split approximately 55%-45% between the mutual and stock life insurance companies. In order to assure that the segment shares of the industry's tax burden are appropriate, the Treasury Department is directed to conduct a study during 1984, 1985, and 1986 on the operation of the provisions of LITA. This study is intended to look at the portion of the industry's taxes actually paid by the mutual and stock companies and will also analyze the amount of items, such as life insurance reserves, pension business, equity, total assets, and gross receipts, among others, that are held by each segment. The Treasury Department must complete the study and report its findings to Congress no later than Jan. 1, 1989.

253. Statement of The Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (July 28, 1983).

companies argue that the policyholders of a stock subsidiary are not its owners, and therefore no ownership differential should be applied to a stock subsidiary. Apparently in order to win the support of the mutual segment of the industry, Representative Stark's subcommittee later reversed its initial position on stock subsidiaries. The provision eventually incorporated into LITA treats stock subsidiaries as stock companies for tax purposes. However, the mutual company parent must include the stock subsidiary in the determination of its average equity base. Thus, the taxable status of the subsidiary (as a stock company) is preserved, but the potential benefits for policyholder dividends at the mutual company parent's level may be diminished due to the inclusion of its capital and surplus and other items in the mutual company parent's average equity base.

B. Deferral Mechanisms Within the Three-Phase System

The GAO Report and Treasury officials have called for an end to the deferral of 50% of the excess of gain from operations over taxable investment income. In addition, certain proposed alternatives to the present tax structure eliminate special deductions for nonparticipating contracts and accident and health and group life contracts that also create a deferral of tax for stock companies. Proponents of these changes note that the framers of the 1959 Act created these deferral mechanisms to provide a cushion against future catastrophic losses that, based upon industry experience, has not been necessary. Opponents of the proposal to eliminate these deferral mechanisms argue that such a cushion for future contingencies is in fact needed and that the elimination of these items could pose a stock/mutual balance problem. The elimination of the deferral mechanisms also raises the issue of how the current deferral amounts accumulated in policyholder surplus accounts should be taxed. Proposed solutions range from total forgiveness to immediate taxation.

LITA calls for a single-phase tax scheme, thus eliminating the 50% deferral of excess gain from operations over taxable investment income, and also calls for elimination of the special deductions for nonparticipating policies and accident and health and group policies. Under LITA, the amounts in the policyholders' surplus accounts are still subject to tax in the future. These amounts are included in income under circumstances similar to those under the 1959 Act.²⁵⁴

254. In order to determine whether a Phase III tax is incurred in the future, LITA requires that each life insurance company continue to maintain both its shareholders' surplus account (SSA) and its policyholders' surplus account (PSA). Similar to present law, subsequent additions will be made to the SSA and distributions to shareholders will be treated as made first from the SSA.

The yearly addition to the SSA will be the excess of the sum of the following items over the taxes paid for the year:

- (1) Life Insurance Company taxable income (determined without regard to any distributions from the PSA);
- (2) the taxable income adjustment;
- (3) the small company deduction;
- (4) the deduction for intercorporate dividends received; and

C. Reserves

Another area of concern on the part of Congress and the Treasury involves the issue of reserves. In a letter to the ACLI president in early 1983 Senate Finance Committee Chairman Robert J. Dole (R-Kansas) raised three issues regarding reserve accounting for tax purposes: (1) the appropriate method of accounting for current liabilities; (2) the propriety of statutory accounting pursuant to the National Association of Insurance Commissioners' (NAIC's) promulgations; and (3) the continuing justification for revaluation of reserves.²⁵⁵

With regard to revaluation of reserves to a net level basis, the GAO Report recommends merely that the approximate revaluation formula be adjusted from \$21 to \$15 per \$1,000 of insurance in force to reflect more realistic net level reserves. The Treasury Department contends that the approximate revaluation method should be abandoned altogether.²⁵⁶ The Treasury Department later stated that it believes that both preliminary term and net level reserves as reported on NAIC annual statements were overstated and that an alternative method of computing reserves should be adopted.²⁵⁷ The insurance industry has rejected this proposal on the grounds that federal tax law has historically recognized reserves required by state regulations and that any other method of computing reserves would ignore this prior treatment. Certain industry spokesmen further contend that elimination of the net level adjustment would allow large, well-financed companies to gain a competitive advantage over smaller companies.

One of the major changes that would be made by LITA involves the computation of life insurance reserves. As under present law, a life insurance company continues to deduct reserve increases from income and continues to include reserve decreases in income. However, unlike present law, LITA mandates a new method to be used in computing or measuring the reserve. In general, the applicable reserve would be the higher of the net surrender value of the contract or the reserve determined by means of a formula. However, in no event would the reserve exceed the amount taken into account in determining statutory reserves. The term "net surrender value" is defined as the cash surrender value of the policy reduced by any surrender penalty. The formula approach would consist of the following:

(5) excluded tax-exempt interest.

For the PSA, no additions would be made to this account for taxable years that begin after December 31, 1983. Therefore, in most cases, the PSA will be frozen at its December 31, 1983, balance and will be subject to reduction if distributions exceed the SSA balance or another triggering event occurs.

255. Senator Dole's statements are published in *BEST'S INSURANCE MANAGEMENT REPORTS*, Release No. 6 (Mar. 21, 1983).

256. Statement of The Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (May 10, 1983).

257. Statement of The Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy (July 28, 1983).

- (1) The tax reserve method applicable to the contract—generally this would be the Commissioners' Reserve Valuation Method for life insurance contracts, the Commissioners' Annuities Reserve Valuation Method for annuity contracts, or a two-year full preliminary term method for noncancellable accident and health contracts;
- (2) the highest assumed interest rate permitted by twenty-six states for computing reserves for a life insurance or an annuity contract at the time the contract is issued; and
- (3) the most recent commissioner's standard tables permitted under the insurance laws of twenty-six states at the time the contract is issued.

The proposed reserving method is applicable to taxable years beginning after December 31, 1983. In making the change to the new reserving method, all life insurance reserves as of the beginning of the first taxable year covered by the proposed new method would be revalued. For example, for a calendar year life insurance company, the life insurance reserves as of January 1, 1984, would have to be revalued to the new reserving method.²⁵⁸ In the vast majority of instances, the reserve revaluation required by LITA will result in life insurance reserves as of the beginning of the first year covered by LITA lower than the closing reserves as of the end of the preceding year. This will be particularly true for life insurance companies that have made an election under section 818(c). The difference between the old and the new reserves does not, however, have to be included in income. LITA takes a fresh start approach so that life insurance companies will not have to recapture these previously deducted reserve increases into income, regardless of amount. Thus, the entire difference is forgiven.

In anticipation that some insurance companies may attempt to abuse the fresh start approach, LITA, in effect, places a moratorium on certain reinsurance agreements. The fresh start concept does not apply to any life insurance reserves transferred pursuant to a reinsurance agreement entered into, modified, or terminated after September 27, 1983. Insurance companies are not, therefore, able to benefit from the fresh start approach for reserve increases attributable to reinsurance agreements after September 27, 1983. In this situation, an assuming company must include the reserve difference in income ratably over a ten-year period beginning in 1984. It is important to note that this inclusion in income may not be taken into account for purposes of computing the two new special life insurance company deductions discussed below. The effect of this rule is that this income will be taxed at the full corporate tax rate of 46%.

D. The Definition of Life Insurance

Another issue involved in considerable debate concerns the definition of

258. This regulation will result in a significant administrative burden for life insurance companies due to the fact that they will have to isolate for the year of issue the various factors, such as the prevailing interest rate and commissioners' standard table, considered in the computation of the reserve.

life insurance. While government and industry officials agree that new permanent legislation should contain provisions defining life insurance, uncertainty exists with regard to how the term should be defined. LITA provides alternative tests for determining whether an insurance product constitutes life insurance. One alternative deals with a cash value accumulation test, while the second alternative involves a guideline premium limitation test and a cash value corridor test. The cash value accumulation test is intended to allow traditional whole life policies with cash values that accumulate based on reasonable interest rates to continue to qualify as life insurance contracts. This test can, therefore, be satisfied if the cash surrender value of the contract does not exceed the net single premium that would be paid to fund future benefits. In general, in making this test, the single net premium will be computed using the greater of a 4% annual effective rate of interest or the rate guaranteed when the contract is issued.

The second alternative test has two requirements, a guideline premium test and a cash value test. The guideline premium test distinguishes between contracts that are funded on a traditional level premium payment basis and those that involve greater investments by the policyholder. The cash value test disqualifies any contract that builds up excessive amounts of cash value in relation to the life insurance risk. In combination, these requirements tend to limit the definition of life insurance to contracts that require modest investment and yield a modest investment return. A contract can satisfy the guideline premium test if the sum of the premiums does not exceed the guideline premium limitation. Basically, the premium limitation is the greater of the guideline single premium or the sum of the guideline level premiums. The cash value test can be satisfied if the death benefit at any time is equal to a percentage, supplied in a table contained in LITA, of the cash surrender value. In general, the applicable percentages begin at 250% for an insured who is less than 40 years of age and decreases to 100% for an insured who is 95 years of age.

If a contract fails to meet the definition of life insurance at any time, the pure insurance portion of the contract, the difference between the face amount and the cash surrender value, will be treated as term life insurance. The cash surrender value will be treated as a deposit fund and income earned on the fund would be taxable currently. In addition, all income previously deferred will be included in the insured's income in the year the contract fails to qualify as a life insurance contract. The new definition applies only to contracts issued or exchanged after December 31, 1983.

E. The Small Life Insurance Company Deduction

Since enactment of the 1959 Act legislators have recognized the plight of the small insurance company in an industry traditionally dominated by large companies. As previously discussed, the 1959 Act specifically provided a deduction to benefit small companies. Under LITA small companies can deduct 60% of their first \$3,000,000 of tentative life insurance

company taxable income (LICTI).²⁵⁹ The deduction is gradually phased out as tentative LICIT reaches \$15,000,000. No deduction is allowed to companies whose assets, generally determined on a fair market value basis, exceed \$500,000,000. The asset limitations are determined on a controlled group basis, including both insurance and noninsurance members. The tentative LICIT test is also made on a controlled group basis, such that all the life insurance companies in the group are treated as one company.²⁶⁰

F. The Special Life Insurance Company Deduction

When the original version of the Stark-Moore proposal was being developed, the potential existed for the insurance industry to bear a disproportionately large tax burden when compared to other financial intermediaries. In order to reduce or eliminate this disparity, the concept of a taxable income adjustment (TIA) was developed in the original Stark-Moore proposal and has been carried over into LITA. The special life insurance company deduction (still commonly referred to as the TIA) is an adjustment equal to 25% of tentative LICIT. Similar to the small company deduction, tentative LICIT for purposes of the TIA is computed on a controlled group basis and excludes noninsurance trade or business income, except when the income is from a noninsurance trade or business that is typically carried on by a life insurance company. The TIA is made after the small company deduction. Therefore, a life insurance company cannot qualify for a small company deduction by reducing its tentative LICIT by the TIA first. However, the TIA is not limited or phased out like the small company deduction.

Industry spokesmen and others have argued that the novel concept of the TIA is indicative of flaws within the new tax legislation. Additionally, the TIA has been criticized as being a convenient target in future years if additional tax revenues are needed from the industry.

G. Method of Accounting

As under present law, the federal income tax accrual method of accounting generally is required to be used by life insurance companies under

259. Tentative LICIT is determined without regard to the taxable income adjustment or the small company deduction. In addition, tentative LICIT is reduced by the amount of the net capital gain.

260. The tentative LICIT test also is made on a controlled group basis so all life insurance companies in the group are treated as one company. Tentative LICIT, however, is determined without regard to the income from noninsurance trade or business activities unless the trade or business is of the type typically carried on by an insurance company for investment purposes. Thus, if a life insurance company is also engaged in a manufacturing activity, the income from such a trade or business is some type of activity normally conducted by an insurance company for investment purposes, income from the trade or business would be included in tentative LICIT. Examples of businesses typically carried on by a life insurance company would include the ownership and rental of real estate or the development and sale of real estate. It should be noted that, while the manufacturing activity mentioned above would not be included in the tentative LICIT test, the assets of that activity would be included in the assets test for the small company deduction.

LITA. However, LITA attempts to resolve any doubt that federal income tax accrual accounting rules have primacy over state statutory accounting rules. If state rules are inconsistent with federal rules, the federal accrual accounting rules must be followed.²⁶¹

H. Life Insurance Company Defined

The definition of a life insurance company in LITA generally parallels that contained in present law. Therefore, a life insurance company would be an insurance company that has life insurance reserves, or unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves, that comprise more than 50% of its total reserves.

LITA, however, makes two changes to present law. First, the company must satisfy a new statutory definition of an "insurance company." An "insurance company" is defined as a company that has more than half of its business activity during the year in the issuing of insurance or annuity contracts or the reinsuring of risk underwritten by insurance companies. The "more than half" requirement is a facts and circumstances test that will take into account factors such as the employees, the space allocation, and the net income of the business activities being conducted. Second, amounts set aside to satisfy obligations under contracts that do not contain permanent guarantees with respect to life, accident, or health contingencies are not included in life insurance reserves or total reserves. Thus, amounts set aside for such contracts cannot be included in determining whether the company is a life insurance company.

I. Policyholder Loans

LITA limits the amount of interest that may be deducted by policyholders on policyholder loans. Specifically, the interest deduction is disallowed if the rate at which interest is paid or accrued exceeds the rate charged by the IRS on income tax deficiencies.²⁶² Additionally, the deduction is disallowed if it exceeds \$250,000 for an individual return (\$500,000 for a joint return) and \$500,000 times the number of qualified lives for a corporation. These interest limitations apply only to policies issued after September 27, 1983.

261. In an explanation of the Stark-Moore proposal that was drafted by the subcommittee staff, it was indicated that this federal accrual accounting primacy rule was intended to reverse the Supreme Court's decision in *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977). According to the subcommittee's explanation, the effect of this rule as it relates to the *Standard Life* case is to disallow as a deduction a reserve for any item unless the gross amount of the premiums and other consideration attributable to such item are required to be included in income. Thus, because deferred and uncollected premiums for a contract do not accrue as income under the accrual method of accounting, the reserves related to these items may not be recognized until the premiums are taken into income, i.e., when they are received in cash.

262. I.R.C. § 6621 (1976).

VI. CONCLUSION

In formulating a new system of taxation for insurance companies, Congress should consider the complex and changing environment of the new financial services industry. The life insurance industry is only one player in the new financial services game. Changing consumer demands, regulations, technology, market conditions, and competition are forcing life insurance companies to compete not only with other life insurers, but also with other providers of financial services. The various members of the financial services industry are becoming more integrated and distinctions among them are fading. One-step financial shopping and full integration of financial services are already available to consumers. Congress must recognize that any change in the taxation of the life insurance industry must leave it on an equal competitive level with other competitors in the financial services industry.

Any new tax legislation must have the flexibility to provide predictable and reasonable results despite changes in the economy. Specifically, any new scheme of taxation should not discourage growth, expansion, or writing of new business in a period of great economic growth. Insurance companies are regulated by state insurance commissions and therefore must follow conservative statutory accounting principles in preparing annual statements that are filed with the state insurance commissioner. These conservative statutory accounting principles are designed to insure the solvency of the insurance company and its ability to pay claims to policyholders. Any proposed tax reform should not result in a tax burden that would make an insurance company insolvent for statutory accounting purposes nor should it encourage insurance companies to adopt reserve or accounting methods that will impair its financial viability. Additionally, Congress has traditionally recognized the inherent differences in the stock versus mutual form of organization. Because of the competition between stock and mutual insurance companies, any tax scheme should recognize the differences in these forms of organization and should not upset the competitive balance between the two.

Finally, Congress should design a tax scheme that can be properly administered. The current tax structure for all taxpayers is based on self-assessment. Congress must design an insurance tax scheme that can be followed by even small and unsophisticated insurance companies. If the tax structure is too complicated for insurers to understand, the degree of compliance will be adversely affected.

To summarize, the framers of any new tax law must consider the following:

- (1) the unique long-term nature of the life insurance business;
- (2) the social and economic benefits provided by life insurance;
- (3) the most fair and equitable means of obtaining additional revenue, not only from various other industries but also from the life insurance industry itself;
- (4) the need for tax legislation that provides for predictable and rea-

sonable results in response to changes within the national and international economy;

- (5) the maintenance of a competitive balance within the life insurance industry, specifically between the stock and mutual companies;
- (6) the maintenance of a competitive balance between the members of the financial services industry; and
- (7) the ease with which the taxing scheme can be administered in a self-assessment taxing system.

Congress should examine the history of life insurance taxation to determine how prior legislation either met or failed to meet these established objectives.

The method of taxing life insurance companies in the future remains in doubt. Certain barriers, specifically the stock versus mutual controversy, must be overcome. Nevertheless, the success or failure, and in turn the longevity, of any permanent reform in the taxation of life insurance companies depends on the ability of Congress, the Treasury, and industry groups to reach a satisfactory compromise that recognizes the unique nature of the life insurance industry and its role within the larger financial services industry, the economy, and society as a whole.