TRANSACTIONS OF SOCIETY OF ACTUARIES
1981 VOL. 33

FEDERAL INCOME TAXATION OF LIFE INSURANCE COMPANIES IN THE 1980s

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ABSTRACT

In the years since the passage of the Life Insurance Company Income Tax Act of 1959, a number of changes have taken place in the external environment in which life insurance companies operate and in the business methods of these companies. As a result, the 1959 act has a different impact today than it did in 1959. After outlining some of the issues involved in the taxation of life insurance companies, this paper describes the tax consequences of various strategic courses of action by life insurance companies. Finally, it comments on some of the defects in the 1959 act and discusses some possible corrective measures.

1. INTRODUCTION

More than twenty years have passed since the Life Insurance Company Income Tax Act of 1959 was enacted into law. During that time, the industry's external environment has changed substantially, particularly with regard to inflation. Also, many of the methods used by insurance companies in their business operations have been revised. Today, the 1959 act has a different impact on the life insurance industry, its policyholders, and its stockholders than it did when it first became law. As a result, there is increased discussion, both by the government and by the industry, of the need for major changes. Also, there is increased emphasis on tax planning to alleviate the rapidly increasing tax burden faced by the industry.

The purpose of this paper is to examine the federal income taxation of life insurance companies in the 1980s. The paper has three major sections:

1. Section II discusses some of the issues in the taxation of the life insurance industry, to provide a background for the principal concepts embodied in the 1959 act.
2. Section III describes the tax consequences of certain strategic courses of action possible under the 1959 act.
3. In Section IV some of the defects in the 1959 act are discussed, and possible changes are suggested.

II. ISSUES IN THE TAXATION OF LIFE INSURANCE COMPANIES

There are three principal purposes of levying taxes: (1) to raise revenue in as fair and efficient a manner as possible, (2) to influence individual and corporate actions by providing tax incentives or penalties, and (3) to redistribute wealth. The methods of assessing taxes and the resulting allocation of the tax burden among different types of taxpayers have evolved over many years. They can be viewed as representing a series of political compromises, each of which reflects the power held by various special interest groups when the compromise was made and represents an attempt to implement public policy as it was perceived at the time.

The system of taxation has a very significant effect on the economy, and on how people invest their money. With respect to life insurance, it has an important impact on the types of life insurance products that are sold, as well as on the financial results of the companies.

For life insurance companies, seven categories of tax bases are used today: (1) net income (profits), (2) gross investment income, (3) net investment income, (4) premium income, (5) payroll (e.g., FICA and workers' compensation), (6) property, and (7) miscellaneous (license fees and the like). Nearly all states tax premium income and levy some type of license fees. A few states have taxed all or certain portions of gross investment income. Some states have taxed net income.

At the federal level, except for the usual payroll taxes, the tax base generally has been restricted to net income or net investment income, the problem being to define these amounts so as to raise an appropriate amount of revenue in a manner that is fair to all concerned. The 1959 act, with its use of a combination of net income and net investment income as a basis for taxation, was the result of a long struggle to develop a reasonable basis for the federal taxation of life insurance companies. This struggle developed because of a unique combination of issues that required consideration. These issues included the following.

A. *Public Purpose*

Life insurance serves a number of purposes considered to be desirable for the economy and for the public. These include the following:

1. Providing security for persons so that they will not become public charges in the event of the premature death of a breadwinner. Although the social security system replaces lost income in some circumstances, it does not cover all situations and is not intended to be sufficient by itself. Private life and disability insurance must make up the difference. In the absence of adequate insurance, many persons would

live in poverty or near-poverty and would require tax-supported aid to survive.
2. Promoting savings and capital formation. Life insurance companies offer products that promote personal savings and that channel such savings into capital investment. The tax system should encourage such savings by making it attractive for the public to save.
3. Helping our economy function more efficiently by making certain types of business transactions work better. Large loans to businesses that depend on the performance of particular people can be made more secure by the purchase of keyman life insurance. Life and disability insurance also can be used to fund buy-sell agreements.
4. Funding retirement benefits. Life insurance companies have helped develop the entire concept of funded retirement programs. Funded retirement benefits are an essential part of financial security. Furthermore, pay-as-you-go programs create an excessive financial burden in certain demographic situations, as will occur when those born during the post–World War II baby boom reach retirement.

Over the years, the public purpose served by the life insurance industry has been a major argument against heavy taxation of life insurance and pension products, either at the company level or at the policyholder level.

B. *The "Inside Buildup"*

A major issue in life insurance company taxation has been the treatment of the "inside buildup," that is, the investment income earned by the life insurance company on the funds it holds for its policyholders. A savings account is taxed to the depositor as the interest is credited to the account, whether or not the depositor withdraws his funds. However, this is not the case for a life insurance or annuity policy. Although the company may be taxed to the extent that the deduction allowed for interest on policy or contract funds is not adequate, the policyholder is not taxed unless he surrenders the policy for an amount in excess of the tax basis of the policy. Several reasons have been put forth for this approach:

1. Because life insurance and annuity products serve an important public purpose, purchase of such products should be encouraged through deferral of tax on the investment earnings attributable to policy reserves.
2. Taxing investment earnings, which are available to the policyholder only through an interest-bearing policy loan, is inherently unfair and could create a significant hardship for some policyholders.
3. The savings element of a permanent plan life insurance policy is an integral part of the whole policy, and it is not possible to separate it from the mortality and expense elements. In contrast to deposits in a bank or other savings institution, part of the earnings of a life insurance policy is needed to pay death claims. Also, the cash value is not directly related to the gross premium, whereas the balance

of a deposit in a savings bank depends directly on the amount deposited plus the interest earned on the deposit.

4. Taxing the interest credited each year on individual policies would require millions of policyholders to report as taxable income amounts that would be very small in many cases. It would be difficult to achieve a high level of compliance, because many policyholders would be unable to understand the reason for paying taxes on money not available to them. Thus, the administrative and compliance problems might outweigh the revenue gains.

C. *Equity among Different Types of Life Insurance Companies*

It is important that the tax laws provide reasonable equity among competing life insurance companies. For the life insurance industry, this has meant equity between stock and mutual companies, between large and small companies, and among different types of companies, such as credit, debit, and ordinary.

However, providing such equity has raised a number of issues, the most significant of which have been (1) the extent to which policyholder dividends should be deductible in establishing the tax base, (2) the degree to which a portion of each year's profits should be exempted from current taxation because of the need to build up contingency funds for the protection of policyholders, and (3) the type and size of small-business adjustments that should be built into the law. All of these issues were considered in the development of the 1959 act. The complicated nature of that act, with its three "phases," is a direct result of attempts to develop a solution that was reasonably equitable for all types of companies.

D. *Investment Income Required for Maintenance of Policyholder Funds*

A major issue, which existed long before the development of the 1959 act, has been how to determine the portion of investment income of a life insurance company to be exempted from tax because it is needed for the maintenance of life insurance or annuity reserves, or for other required interest payments. Prior to 1959, this amount was determined on an industry-wide basis, using a formula that provided for only very rough equity and frequently for relatively little tax. However, with the passage of the 1959 act, the deduction for interest needed for this purpose was determined individually for each company, in part on the basis of the familiar 10-for-1 rule. This formula gave reasonable results in the early years of the act. However, with the increasing spread between the earned and valuation interest rates in recent years, it has produced very serious inequities and levels of taxation that are becoming unduly high for many companies.

E. *Equity between Life Insurance Companies and Other Savings Institutions*

A major source of difficulty in developing a tax system for the life insurance industry has been the fact that life insurance and annuity products involve a combination of insurance protection and investment earnings. At various times, certain states (e.g., Connecticut and Pennsylvania) have considered levying a sales tax on insurance premiums. The fact that no similar tax would have been levied on savings deposits indicated that these states believed that an insurance premium was quite different from a savings deposit. With today's high interest rates, the problem of competition between insurance companies and other savings institutions is becoming increasingly important. Annuity products are increasingly being marketed for their investment features, with emphasis on the tax deferral available because of the inside buildup.

F. *Tax-exempt Interest*

Interest on securities issued by state or local governments is exempt from federal taxation. Congress has felt, quite logically, that if this interest is to be tax-exempt, the expenses associated with such income should not be tax-deductible. Accordingly, section 265 of the Internal Revenue Code prevents taxpayers from deducting interest on money borrowed to purchase or carry tax-exempt securities.

Applying this concept to the taxation of life insurance companies presented a special problem. The solution was the provision in the 1959 act prorating tax-exempt interest between the "policyholder's share" and the "company's share." Only the company's share was to be deducted from gross investment income (which included tax-exempt interest). The legality of this concept was questioned by the life insurance industry in the *Atlas Life Insurance Company* case some years ago.[1] Particularly after the *Atlas* case was decided in favor of the government, the industry stayed almost entirely out of the tax-exempt securities market, thereby depriving state and local governments of an important source of funds.

G. *Need for Contingency Funds*

Nearly all businesses have a need for contingency funds to allow for unexpected or fluctuating expenses, and to provide additional operating funds during adverse periods. They are expected to provide these funds either through paid-in capital or surplus, or by retained after-tax earnings.

[1] United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965).

The life insurance contract guarantees payment of benefits many years in the future, regardless of events that may occur in the interim. Although those who purchase bonds or debentures do so at their peril, and may lose their money if the issuing company goes bankrupt, public policy has dictated that the purchaser of life insurance should be protected as much as possible from such an occurrence. For this reason, life insurance companies are highly regulated at the state level. Also for this reason, it has been considered in the public interest to provide for the buildup of contingency funds on a pre-tax basis, particularly for certain types of life insurance products.

H. *Other Issues*

In addition to the above, there have been a number of other, less significant issues that have required special consideration for the life insurance industry. These include loss carry-over provisions, taxation of foreign life insurance companies, and the appropriateness of consolidating taxable income of one life insurance company with that of another life insurance company or nonlife insurance company.

III. STRATEGIC COURSES OF ACTION POSSIBLE UNDER THE 1959 ACT

Under the 1959 act, a life insurance company is taxed on different bases depending on its tax situation. The act defines life insurance company taxable income (*LICTI*) as the sum of

a) The lesser of "taxable investment income" and "gain from operations," plus
b) 50 percent of any excess of "gain from operations" over "taxable investment income," plus
c) In the case of stock companies, the amount, if any, subtracted during the year from the "policyholders surplus account," as defined in the law.

John Fraser, in the paper titled "Mathematical Analysis of Phase 1 and Phase 2 of 'The Life Insurance Company Income Tax Act of 1959' " (*TSA*, XIV, 51), analyzed the 1959 act to quantify the factors producing increases or decreases in tax. He defined four basic tax situations, as shown in the accompanying table, where I is taxable investment income, D represents

Situation	Definition	Life Insurance Company Taxable Income
A	$G - I < 0$	G − \$250,000*
B	$0 < G - I < D$ − \$250,000	I − \$250,000
C	D − \$250,000 $< G - I < D$	$G - D$
D	$D < G - I$	$\frac{1}{2}(I + G - D)$

*Use D instead of \$250,000 if D is less than \$250,000.

dividends to policyholders and the deductions for nonparticipating and health and group life contracts permitted under section 809(d)(5) and (6), before application of the limitation of section 809(f) (the "special" deductions), and G is the gain from operations before deduction of items in D.

Situation B is the "Phase 1" tax situation experienced by most mutual and larger stock companies. Situation D is the "Phase 2 positive" situation typical of more mature specialty-type companies, such as credit life companies and others. Situations A and C are the "Phase 2 negative" situations typical of new companies, companies for which D is relatively small, and some medium-sized stock companies.

Fraser considered only Phase 1 and Phase 2 taxes in his paper. If Phase 3 taxes also are considered, additional tax situations can be defined, with the formulas depending in part on whether such taxes are immediately payable or are merely to be considered for tax-planning purposes on a discounted basis, since they are to be paid at some future date.[2]

Changes in company operations can move a company from one tax situation to another. In addition, if a single company were split into separate companies—by line of business or in some other manner—these separate companies might be taxed differently from the single company and from each other, and the sum of the taxes on the separate companies would not necessarily equal the tax on the single company.

A review of the 1959 act and the formulas for marginal tax rates suggests the following basic strategies for minimizing federal income taxes:

1. Minimize the portion of investment income that is considered to be the "company's share," and thereby subject to tax. This can be done by maximizing the "policyholder's share" or by transferring investment income to another corporate entity through reinsurance, financing of subsidiaries, or other means.
2. To the extent possible, obtain a tax deduction for those amounts that currently do not serve to reduce taxes because of the limitation imposed by section 809(f). One way to accomplish this is through the appropriate use of multiple corporations.
3. Maximize the amount of income on which taxes are deferred rather than paid immediately. In addition to the usual techniques, such as the use of accelerated depreciation, this also can be done by maximizing the amounts added to the policyholders surplus account (rather than taxed currently) and by proper reserving techniques, including the use of the section 818(c) election.
4. To the maximum extent possible, apply operating losses to reduce current taxes or as operating loss carry-backs or carry-overs.

[2] See Calvert A. Jared II, "Mathematical Analysis of 'The Life Insurance Company Income Tax Act of 1959' Revisited," *TSA*, XXVI (1974), 263.

In addition, many decisions involving product design, choice of reserve bases, accounting techniques, and other factors have an impact on taxes.

Companies generally may not take an action solely for the purpose of tax avoidance. There must be a business purpose. Within that limitation, let us now consider some of the possible tax-minimizing actions, many of which are in use today, that relate to the conceptual structure of the 1959 act. These considerations form the basis for the suggested changes in the taxation system for life insurance companies in the final section.

A. *Use of Multiple Corporate Entities*

The use of multiple corporations for the conduct of business ventures is common in many industries. There are a number of good business reasons for this:

1. Management control may be improved if the senior executive responsible for a particular portion of the business is given the latitude and responsibility possible only with a separate company.
2. Use of separate companies may help in attracting and retaining outstanding people by providing additional flexibility in compensation and benefits.
3. Different types of business may have different marketing, investment, or other needs, calling for a separate company.
4. Financial reporting and control may be improved if results are identified separately in a manner possible only with a separate company.
5. Separate companies may be essential for diversification into different types of business.
6. Legal, financial, and regulatory considerations may call for separate corporate entities for various purposes. These include limitation of liability, financing problems, licensing requirements, and a variety of legal limitations imposed by the states in which the company does business.

To an increasing extent, the insurance industry has in recent years recognized the value of conducting business through multiple corporations. As a result, there has been a large number of acquisitions and formations of new subsidiaries by insurance companies, both life and nonlife. Also, many holding-company systems involving multiple insurance company subsidiaries have been established.

Use of multiple corporations can and frequently does have a major impact on federal or state taxes. Under the 1959 act, federal income taxes can be affected by the use of multiple corporate entities in three principal ways that are unique to life insurance companies.

1. Because the Phase 1 deduction for interest required for life insurance reserves depends on the current earnings rate or the adjusted reserves rate, the use of multiple corporations can affect the total tax impact if the earnings rates differ.

2. A life insurance company can be in any one of the tax situations described earlier. This unique feature permits various companies within a group, or various lines of business, to be taxed on differing bases.
3. It sometimes is possible to have certain life, health, or annuity products written or reinsured in an insurance company taxed as a nonlife insurance company under section 831 of the Internal Revenue Code.

B. *Effect of Variations in Earnings Rates*

Variations in the current earnings rate and adjusted reserves rate may have a significant impact on the Phase 1 tax liability of a company, since the deductions for life insurance and pension plan reserves depend on these figures to an important extent. Furthermore, a significant change can occur in the Phase 1 tax liability merely because the same total business is held in two separate companies rather than within a single company.

This phenomenon has been most noted for its effect on qualified pension business, because life insurance companies are in the most direct competition with banks and other funding media for this type of business. It was described in detail for qualified pension plan business in "Certain Inequities in the Life Insurance Company Income Tax Act of 1959."[3] The problem has arisen primarily because the increase in interest rates has been accompanied by a very rapid growth in pension plan reserves relative to life insurance reserves. Between 1960 and 1978, total pension plan reserves rose from $11.6 billion to $53.5 billion, an increase of 361 percent. This compares with an increase in life insurance reserves from $78.9 billion to $172.6 billion, only 119 percent.[4] For some companies, the variation in growth rates has been a major competitive handicap and has triggered efforts to place qualified pension plan business in a separate company.

However, there also may be a significant effect for companies not writing any qualified pension business, as illustrated in Table 1. The table shows the effect of writing new life insurance in a separate company. To simplify the example, it has been assumed that the current earnings rate equals the adjusted reserves rate—that is, that the company has been earning the current rate on its assets for at least five years.

Table 1 assumes that, in addition to $10 million of "old" assets earning 6 percent and $9 million of "old" life insurance reserves valued at 3 percent, there are $6 million of "new" assets earning 10 percent and $5 million of "new" life insurance reserves valued at 4 percent. These new assets and

[3] Peter W. Plumley, *TSA*, XXVIII (1976), 11.

[4] Unpublished data from member companies, compiled by the American Council of Life Insurance.

TABLE 1

EFFECT OF WRITING NEW LIFE INSURANCE BUSINESS IN SEPARATE COMPANY

	ALL BUSINESS IN SAME COMPANY	NEW BUSINESS IN SEPARATE COMPANY B	
		Company A	Company B
Assets:			
At 6% earnings rate	$10,000,000	$10,000,000	$ 0
At 10% earnings rate	6,000,000	0	6,000,000
Total	$16,000,000	$10,000,000	$6,000,000
Net investment income	$ 1,200,000	$ 600,000	$ 600,000
Current earnings (and adjusted reserve) rate	7.5%	6%	10%
Life insurance reserves:			
At 3% valuation rate	$ 9,000,000	$ 9,000,000	$ 0
At 4% valuation rate	5,000,000	0	5,000,000
Total	$14,000,000	$ 9,000,000	$5,000,000
Average valuation rate	3.35714%	3%	4%
Adjusted life insurance reserves	$ 8,200,000	$ 6,300,000	$2,000,000
Deduction for interest required for life insurance reserves	$ 615,000	$ 378,000	$ 200,000
Taxable investment income	$ 585,000	$ 222,000	$ 400,000

reserves are shown combined with the old assets and reserves in the same company, as well as in separate company B.

The effect of segregating the new assets and reserves is to increase the total taxable investment income from $585,000 to $622,000. The principal reason for this increase is that the application of a 10 percent adjusted reserves rate gives an inadequate deduction for interest required on these life insurance reserves.

Depending on the assumptions chosen, the effect of writing new business in a separate company could either increase or decrease taxable investment income, with the result depending on such factors as (1) the difference between the "new" interest rate and the interest rate being earned on the existing portfolio, (2) the proportion of total business being segregated, (3) the amount of pension plan reserves involved, and (4) the ratio of reserves to total assets.

It also should be pointed out that this illustration relates only to the effect on taxable investment income. The actual effect on federal income taxes incurred may be quite different, not only because one or more of the companies may be in a tax situation other than tax situation B but also because of multiple surtax exemptions and the effect of the $250,000 "corridor" for companies in tax situation B.

C. *Effect of Differing Tax Situations*

Next, let us examine the effect of variations in the several tax situations. Because the 1959 act provides that *LICTI* may be defined on various tax bases, or on a combination of bases, there are significant opportunities for tax savings. Conversely, failure to recognize the tax consequences of corporate actions may generate unnecessary taxes.

Five hypothetical lines of business are represented below. If they were separate tax entities, each would be taxed as shown in the following table (amounts in millions of dollars):

	Line of Business				
	1	2	3	4	5
Gain before special deductions (G) ...	$40	$ 0	$50	$(20)	$20
Special deductions (D)	40	0	0	0	0
Gain after special deductions ($G-D$) .	20*	0	50	(20)	20
Taxable investment income (I)	20	20	10	0	40
Life insurance company taxable income (*LICTI*)	20	0	30	(20)	20

*Special deductions limited to G minus I plus $250,000.

In brief, the tax characteristics of each of these lines, if taxed separately, are as follows:

Line	Tax Situation	Characteristics
1	B	Some special deductions lost; tax effectively based on $I - \$250{,}000$
2	A	No special deductions to lose (had there been any, amounts in excess of $250,000 would have been lost); tax based on $G\ (=G - D)$
3	D	No special deductions lost or to be lost; tax based on $\frac{1}{2}(I + G - D)$
4	A	No special deductions to lose (had there been any, amounts in excess of $250,000 would have been lost); tax loss carry-over based on $G\ (= G - D)$
5	A	No special deductions to lose (had there been any, amounts in excess of $250,000 would have been lost); tax based on $G\ (= G - D)$

The effect of combining certain of these lines into a single tax entity would be as follows (all results expressed in millions of dollars):

a) If lines 1 and 2 were combined, I would be $40, G would be $40, all $40 of the special deductions would be lost, and *LICTI* would be $40. *Result:* a net *increase* in *LICTI* of $20.

b) If lines 1 and 3 were combined, *I* would be \$30, *G* would be \$90, all \$40 of the special deductions would be usable, and *LICTI* would be ½(*I* + *G* − *D*), or \$40. *Result:* a net *decrease* in *LICTI* of \$10.

c) If lines 2 and 3 were combined, *I* would be \$30, *G* (= *G* − *D*) would be \$50, and *LICTI* would be ½(*I* + *G* − *D*), or \$40. *Result:* a net *increase* in *LICTI* of \$10.

Line 4 is in a loss situation. Depending on past or future results, the loss may or may not be usable. Combining it with each of the other lines produces differing tax effects:

d) If line 4 were combined with line 1, *I* and *G* each would be \$20, as would *LICTI*. *Result:* no change in current tax; however, the tax-loss carry-over of \$20 is lost.

e) If line 4 were combined with line 2, *G* and *G* − *D* would be \$(20). *Result:* no change in current taxable income, and the tax-loss carry-over of \$20 is retained.

f) If line 4 were combined with line 3, *G* and *G* − *D* would be \$30. Since *I* is \$10, *LICTI* would be ½(*I* + *G* − *D*), or \$20. *Result:* a net *decrease* in *LICTI* of \$10, but a loss of the \$20 tax-loss carry-over. Thus the tax-loss carry-over is utilized immediately, but only at a 50 percent rate currently, with the other 50 percent reducing the amount that otherwise would have been added to the policyholders surplus account and been subject to deferred Phase 3 tax.

g) If line 4 were combined with line 5, *G* and *G* − *D* each would be \$0, as would *LICTI*. *Result:* a net *decrease* in current taxable income of \$20, and a corresponding reduction in the tax-loss carry-over. The tax-loss carry-over thus is utilized immediately at the full 100 percent rate.

In all these examples, the effect of the provision in section 809(f) that allows deduction of up to \$250,000 of dividends, in addition to the excess of *G* over *I*, has been ignored by expressing the example in millions of dollars. For the large company, this is a proper approach to use; however, for many small companies the \$250,000 corridor may be a very important item to consider. Examples similar to those shown above can be developed to show the effect of combining various lines of business for such companies.

Phase 3 taxes also affect the tax impact of moving various types of business between corporations. As the amounts in the policyholders surplus account have built up in the years since 1959, Phase 3 taxes have become an increasing problem, particularly for the smaller specialty companies. Phase 3 taxes would alter the results of the above examples.

D. *Use of a Nonlife Insurance Tax Environment for Life or Accident and Health Business*

Whereas life insurance companies are taxed under the familiar three-phase formula of the 1959 act, other insurance companies are taxed under section 831 of the Internal Revenue Code in a manner essentially similar to that of general business corporations, except that they are permitted a deduction

for the increase in insurance reserves. Thus, taxation of nonlife insurance companies differs from that of life insurance companies in the following major ways:

1. There is no limitation on the deductibility of policyholder dividends.
2. In determining taxable income, tax-exempt interest is entirely excluded from gross investment income, rather than being included and then only partially deducted.
3. No tax deferral is granted for 2 percent of health and group life insurance premiums or for 10 percent of the increase in reserves on nonparticipating life insurance policies (or 3 percent of premiums on such policies if issued or renewed for five years or more, if greater).
4. No tax deferral is granted for 50 percent of underwriting profits.
5. Because of the lack of these tax deferrals, there is no Phase 3 tax.

As a practical matter, it is not possible to place large amounts of life insurance or noncancelable accident and health insurance business in a nonlife insurance company, since to do so would transform that company into a life insurance company for tax purposes. Also, as a general rule it is not desirable to place business involving relatively high profits and relatively small amounts of investment income in such a company, since that would merely increase the amount of tax. However, certain types of business, most particularly the long-term disability portion of group health insurance business, incur substantially lower taxes if held by a nonlife insurance company and if the assets are invested in tax-exempt bonds.

It also might prove to be desirable to place certain amounts of group life and health insurance in a nonlife insurance company, if that can be done without making it a life insurance company. However, this would provide a tax advantage only if the long-term profit expectations for the business were relatively low.

E. *Reinsurance*

One way in which a number of companies have taken advantage of these differing tax situations is through reinsurance. There are many types of reinsurance agreements. All legitimate reinsurance arrangements involve a process of shifting some type of risk from one insurance company to another. Most are undertaken for reasons completely unrelated to taxes. Where tax benefits are involved, there must be a coexisting business purpose of shifting risk from the ceding company to the reinsurer.

One way in which reinsurance can produce tax benefits is illustrated as follows: Assume that a company in tax situation B (a Phase 1 company) charges a $1 million premium for a single premium deferred annuity, with no related loading or other charges. In addition, assume that the guaranteed rate of interest in the policy does not exceed the maximum valuation rate

allowed by law. Thus, assets and reserves arising from this business would be $1 million.

If the company earned 10 percent on the assets, and if the marginal tax rate on taxable interest were 35 percent, the investment income of $100,000 would produce a tax of $35,000. If we further assume a marginal tax rate on assets of 0.7 percent, the $1 million of assets would produce an additional tax of $7,000, for a total tax increment of $42,000. Offsetting this would be the tax benefit arising from the life insurance reserves; however, this marginal tax rate probably would be only about 2 percent, or $20,000 on the $1 million reserve. Therefore, there would be a net tax liability of approximately $22,000 from this business.

There would be a different tax result if, rather than retaining this business, the company were to reinsure it with a contractual obligation requiring that the profits, including investment profits, be credited to the ceding company. If the reinsurance contract were properly written, such earnings no longer would be investment income and therefore would be treated as Phase 2 income with no additional tax to the ceding company. The incremental tax on assets and the reserve benefit would be eliminated, since the reinsurer would maintain the reserves. Thus, the net tax effect would be the elimination of the $22,000 tax liability.

However, this goal may be accomplished only to the extent that the reinsurer does not incur additional tax as a result of the transaction, since any increase in tax to the reinsurer presumably would be charged back to the ceding company under the terms of the reinsurance contract. Therefore, the reinsurance should be ceded to a company whose tax posture would insulate it from any substantial tax burden relating to the reinsurance.

If the reinsurer were also in tax situation B, the tax liability would not be eliminated but instead merely would be shifted from the ceding company to the reinsurer. Thus, the reinsurance would provide little or no overall tax saving.

If the reinsurer were in tax situation D (a "Phase 2 positive" company), its tax base would be $\frac{1}{2}(I + G - D)$. In this situation the reinsurance arrangement would result in a tax to the reinsurer equal to approximately one-half that of the ceding company.

However, if the reinsurer were in tax situation A (a "Phase 2 negative" company), an increase in its taxable investment income would not affect its tax base as long as its G remained constant. By crediting the earnings to the ceding company, the reinsurer would have no increase in G. Any increase in I would have no bearing on *LICTI*, since in tax situation *A* the latter is based solely on G. Thus, by reinsuring with a company in tax situation A, the ceding company receives the investment earnings without

increasing the reinsurer's tax. A similar result would occur for a reinsurer in tax situation C.

Although the above description suggests a conventional coinsurance program, whereby the assets and reserves are transferred to the reinsurer, the use of modified coinsurance can accomplish similar tax savings. Under modified coinsurance, the reinsurer accepts substantially all the obligations it would assume under conventional coinsurance, but the ceding company maintains the reserves and administers the assets. The reinsurer is relieved of the burden of providing funds for cash surrenders, matured endowments, or policy loans. In the event of a claim, the difference between the face amount of insurance and the reserve is paid to the ceding company. Since the reinsurer is allowing the ceding company to retain the assets, it is in effect making an interest-bearing loan. In practice, the reinsurer annually pays the ceding company a mean reserve adjustment reduced by the interest charge.

Without a specific provision in the Internal Revenue Code, the reinsurer would hold no reserves or assets on the business assumed and would be treated for tax purposes as receiving no investment income. The interest income received by the reinsurer for the "loan" of the reserve would be treated as Phase 2 income.

On the other hand, the ceding company would include the investment income from the assets in taxable investment income. The deduction for the interest due the reinsurer for the use of the reserves would be reflected in the computation of the mean reserve adjustment, which is a Phase 2 deduction. Thus, a ceding company in tax situation A or C would incur a tax on investment income but would fail to obtain a tax deduction for the portion of investment income transferred to the reinsurer.

However, an election under section 820 of the Code permits the treatment of modified coinsurance as coinsurance for tax purposes. This allows the ceding company to exclude from its taxable investment income the income derived from the assets on policies reinsured. This optional treatment applies to any insurance or annuity policy reinsured under a modified coinsurance contract, if the ceding company and the reinsurer agree that the special rules apply for all policies reinsured under the contract.

F. *Rewriting or Amending Existing Life Insurance Policies*

One of the major reasons for the high federal income tax burden of many life insurance companies today is that the investment earnings on their individual life insurance business are substantially in excess of the amount considered to be necessary for the maintenance of policy reserves. This excess interest is returned to policyholders in the form of policyholder

dividends. However, because of the limitation imposed by section 809(f), only a portion of these dividends may be deductible. For these companies, the development of methods to increase the amount of investment income deemed necessary to maintain life insurance reserves would produce significant tax benefits.

For the typical mature company, a major portion of individual life insurance reserves is held for policies issued years ago, when interest rates were lower and inflation was not a serious problem. If the reserves on these older policies were based on a higher interest rate to the extent allowed under state law, a greater proportion of investment income would be treated as necessary for the maintenance of life insurance reserves, thereby resulting in tax savings for companies in tax situations B and D.

In some instances, companies can achieve such tax savings merely by changing the valuation basis for policy reserves. However, there are legal obstacles to this procedure. The standard valuation law states that, although reserves may be calculated according to any standards that produce greater aggregate reserves than the minimum standard, "the rate or rates of interest used for policies and contracts, other than annuity and pure endowment contracts, shall not be higher than the corresponding rate or rates of interest used in calculating any nonforfeiture benefits provided therein." Since the nonforfeiture benefits provided on these older policies presumably are based on the same interest rate as currently used in calculating the reserves, a direct increase in the valuation interest rate probably is not legally permissible. Furthermore, even if it were, its impact would be reduced considerably by the operation of the 10-for-1 rule, except for pension plan reserves.

However, significant tax savings could be achieved to the extent that policyholders consent to the rewriting or amending of their policies, using a new valuation basis. Such new policies might provide for an increased amount of insurance, with the amount generally being determined so as to establish the same reserve as previously held but on the new valuation basis, using a higher interest rate. The new premium might be the same as under the old policy; however, future dividends would be lower because of the added cost of insurance and reduced excess interest, offset by the tax savings.

As an example, consider an ordinary life policy issued fifteen years ago, at age 35, for a $10,000 face amount, with reserves based on the 1958 CSO Table at 2½ percent. The fifteenth-year terminal reserve for this policy is $2,591.20, and the tax reduction attributable to this reserve is $2,591.20 × 0.017, or $44.05, based on a marginal tax rate on 2½ percent reserves typical of a company in tax situation B.

Now assume that the policy is rewritten based on the original date of issue but using a 3½ percent reserve interest rate. If the net level premium valuation method were used, the reserve per $1,000 at duration 15 would be $228.76. The amount of insurance under the new policy would be $1,000 × $2,591.20 ÷ $228.76, or $11,327, if the reserve were to remain at $2,591.20. Again assuming a typical marginal tax rate on 3½ percent reserves for a company in tax situation B, the tax reduction attributable to the reserve would become $2,591.20 × 0.020, or $51.82, for a net annual tax saving of $7.77.

If, instead, the reserve for the new policy were to be valued using the Commissioners Reserve Valuation Method, with the reserve revalued to the net level premium basis for tax purposes under section 818(c), the tax savings would be even greater. Under the same example, the CRVM reserve at 3½ percent interest would be $218.54 at duration 15. The rewritten policy would provide for a face amount of $1,000 × $2,591.20 ÷ $218.54, or $11,856, in order for the reserve to remain unchanged. However, the fifteenth-year net level premium terminal reserve would be determined for tax purposes to be ($2,591.20 × 0.979) + ($21.00 × 11.856), or $2,785.76. (The actual net level premium reserve would be $228.76 × 11.856, or $2,712.18, indicating the overstatement in the approximate revaluation formula permitted under section 818(c).) The tax reduction attributable to the reserve would be $2,785.76 × 0.020, or $55.72, for a net annual tax saving of $11.67.

The results for the plan, age, and duration described above are summarized in the following table. Of course, actual results would vary considerably by plan, age, duration, mortality table, and interest rate.

Item	Current Policy	New Policy	
		NLP Reserve	CRVM Reserve
Amount of insurance	$10,000.00	$11,327.00	$11,856.00
Reserve	2,591.00	2,591.00	2,591.00
Phase 1 tax deduction	95.76	112.65	121.13
Tax reduction at 46%	44.05	51.82	55.72
Tax saving	.....	7.77	11.67

Although these figures are based on a 3½ percent interest rate for the rewritten policies, many states now permit up to 4½ percent for newly issued life insurance policies. Similar examples of rewriting life insurance policies to take advantage of the 4½ percent maximum could be illustrated, with correspondingly higher tax savings and other benefits.

Although stock companies might not find this to be in the best interests of their stockholders, the approach outlined above could give mutual com-

panies the opportunity to modernize their existing products to meet the requirements of today's environment. As of this writing, one large company already has implemented such a program, and others are considering similar approaches.[5]

It should be pointed out that, in addition to the tax savings illustrated, other benefits would accrue as well:

1. The company would achieve a substantial increase in its insurance in force, depending on the percentage of policyholders electing to accept new policies with higher amounts of insurance.
2. In the years since the existing policies were issued, many product innovations have been developed, policy language has been improved, and new options have been offered. A company can present a progressive image to its agents and to the general public by careful design of the new products to be offered in exchange, and thereby protect against excessive replacements of older policies by other companies.
3. Existing policyholders may benefit to a substantial degree. Currently, they are seeing inflation erode the value of their insurance protection, while higher interest rates merely add to their policy dividends. Although such dividends generally can be used to purchase small amounts of additional paid-up insurance under the provisions of most participating policies, this plan offers the opportunity to convert some of the excess interest immediately into a significant amount of increased insurance protection, with relatively little additional net cost.

G. *Use of Specialty Companies*

Particularly for the large mutual life insurance company, the need to utilize the deduction for policyholder dividends more effectively presents a challenge and an opportunity for tax planning. In addition to achieving this within the same corporate entity, an attractive opportunity for tax savings arises through the use of one or more "specialty" companies writing certain limited types of business having limited or no special deductions.

Nonparticipating individual life insurance and annuity products both present possibilities in this regard, particularly single premium group annuity business of the terminal-funding type, and high-interest-guaranteed deferred annuities.

During the past several years, it has been difficult for companies in tax situation B to write any terminal-funding business. Their problem has been that if a low valuation interest rate had been used, the drain on surplus would have been unacceptably high. Alternatively, if a high valuation interest rate had been used, and the strain thereby reduced to acceptable

[5] See Thomas E. Dyer, James J. Murphy, and James F. Reiskytl, "Updating Existing Life Insurance Policies," *TSA*, XXXII (1980), 601, for a more detailed discussion.

levels or eliminated entirely, the interaction of pension and nonpension reserves in a single company would have generated a tax burden that would have rendered the rates charged either uncompetitive or unprofitable.

However, consider what happens if the company instead writes such business through a subsidiary specialty company. This subsidiary probably would be in tax situation A initially but would move to tax situation D after a period of years—the exact length of time depending on the amount of strain incurred at issue and the characteristics of the business issued. The tax consequences of writing business in such a company would be as follows.

1. To the extent that strain was created at issue, there would be deferral of taxes at a rate of approximately 46 percent of the amount of strain. The period of deferral would depend on the characteristics of the business as they relate to the rapidity of the payback.
2. To the extent that the subsidiary's taxable income was determined by its taxable investment income, the investment earnings on reserves would be substantially free of tax, since the current earnings rate to be applied to such reserves would be based solely on the investments of the subsidiary and thus would not be diluted by past investments at lower interest rates, as would be the case in the parent company.
3. To the extent that the subsidiary's gain from operations exceeded its taxable investment income, 50 percent of the excess would go into the policyholders surplus account and would not be subject to current tax.

An illustration of the tax benefits of writing single premium group annuity terminal-funding business in such a subsidiary is shown in Table 2. The table is based on the following assumptions:

Initial capitalization: $30 million
Additional capitalization: $30 million in the fifth and ninth years
Initial premium volume: $60 million
Growth rate: 10 percent
Surplus strain as a percent of premium: 20 percent
Valuation interest rate: 6 percent
Investment earnings rate: 9 percent
Mortality and expense gain or loss: None
Profit margin: None
Expenses and annuity payments: 10 percent of premium plus reserve
Tax rate: 46 percent of taxable income
Timing of premium payments: middle of year

As Table 2 indicates, under these assumptions the subsidiary would develop a total negative tax of about $21 million over the first ten years of operation, which might be used to reduce the tax of the parent company correspondingly through consolidation of their tax returns. In addition, the

TABLE 2

TAX EFFECT OF WRITING SINGLE PREMIUM TERMINAL-FUNDING BUSINESS IN A SUBSIDIARY

(In Millions of Dollars)

Year	Capital and Surplus (Beginning of Year) (1)	Premium Income (2)	Investment Income (3)	Reserve (Beginning of Year) (4)	Claims and Expenses (5)	Reserve (End of Year) (6)	Deduction for Interest on Reserves (7)	Taxable Investment Income (8)	Gain from Operations (9)	Taxable Income (10)	Federal Income Tax (11)	Capital and Surplus (End of Year) (12)
1	$30.0	$ 60.0	$ 5.1	$ 0.0	$ 6.0	$ 68.0	$ 3.1	$2.1	−$8.9	−$8.9	−$4.1	$25.2
2	25.2	66.0	10.8	68.0	13.4	139.8	9.4	1.4	− 8.5	− 8.5	− 3.9	20.6
3	20.6	72.6	16.8	139.8	21.2	216.1	16.0	0.7	− 8.1	− 8.1	− 3.7	16.2
4	16.2	79.9	23.2	216.1	29.6	297.3	23.1	0.1	− 7.8	− 7.8	− 3.6	12.1
5	42.1	87.8	32.8	297.3	38.5	384.0	30.7	2.1	− 4.7	− 4.7	− 2.1	39.5
6	39.5	96.6	40.3	384.0	48.1	477.0	38.7	1.6	− 4.1	− 4.1	− 1.9	37.3
7	37.3	106.3	48.4	477.0	58.3	576.9	47.4	1.0	− 3.5	− 3.5	− 1.6	35.4
8	35.4	116.9	57.2	576.9	69.4	684.6	56.8	0.5	− 2.9	− 2.9	− 1.3	33.9
9	63.9	128.6	69.5	684.6	81.3	800.9	66.8	2.6	0.5	0.5	0.2	64.2
10	64.2	141.5	80.0	800.9	94.2	926.7	77.7	2.2	1.4	1.4	0.6	64.9

parent company would have direct tax savings of from $15 million to $20 million, depending on its marginal tax rates, because of investment income that would be emerging in the subsidiary (and that already has been reflected in the subsidiary's tax figures).

Finally, had the same business instead been written directly in the parent company, a substantial tax would have been incurred unless the company had been willing to bear a very large strain at issue through the use of a very conservative valuation interest rate.

Of course, the tax savings would vary substantially depending on the assumptions used. In this regard, it should be emphasized that in this and other situations involving the transfer of business to a different corporate entity, it is important to study the effect of the removal of the business on the tax situation of the remaining business. However, a large company in tax situation B should be able to achieve major savings through this approach, provided it can be justified for good business reasons apart from tax savings.

IV. IS THE 1959 ACT SERVING ITS PURPOSE?

The 1959 act was enacted after a number of years of discussion and debate. Like most legislation, it represented a compromise among competing interests. In this case, there were four such interests:

1. The government, which was seeking a reasonable basis for the taxation of the life insurance industry, and wanted to tax certain types of companies more heavily—particularly credit life insurance companies, which were paying far less than appeared justifiable.
2. The majority of mutual life insurance companies, which were seeking a tax based on gain from operations with full deductibility of policyholder dividends.
3. The majority of the stock life insurance companies, which were seeking continuation of the use of investment income as a tax base, so that the mutual companies would not be able to control their own taxes through policyholder dividend payments.
4. Small life insurance companies, which sought favorable provisions such as extended loss carry-overs, revaluation of preliminary term reserves, and small-business deductions to help them in competition with the larger, more mature companies.

How well is the 1959 act serving its purpose today? To answer this question, we must examine it in relation to certain standards. In this author's opinion, a reasonable set of standards might be the following:

1. To the extent that Congress is trying to direct individual or corporate actions, a tax should accomplish the purpose intended. For example, tax deferral of investment earnings on qualified pension plan reserves produces corporate actions in the design of pension plans that are perceived to be in the public interest.

2. Except to the extent that Congress is trying to direct individual or corporate actions, the tax should be as "neutral" as possible—that is, it should generate as few distortions as possible by taxpayers or the public of the methods of doing business that would prevail in the absence of tax considerations.
3. The tax should neither give unfair advantages nor impose unfair penalties among competing business interests. For example, it should be fair to the various financial intermediaries competing for savings dollars.

Let us now examine the current business and economic climate, in order to determine whether the 1959 act is meeting these standards today. First, let us consider how Congress should direct individual and corporate actions in the public interest in the 1980s.

Inflation is the most serious economic problem facing the United States today. Reducing the long-term level of inflation, and thereby strengthening the economy, would be made easier by any actions that would encourage savings and increase the supply of capital funds.

As Table 3 indicates, the life insurance industry had assets totaling $432 billion at the end of 1979. The industry is a major source of capital funds for individuals and corporations and, to a lesser extent, for governmental bodies. Thus, if savings are to be encouraged and the supply of capital funds increased, it is important that the life insurance industry be permitted to operate in an environment that meets these objectives.

In the laws taxing life insurance companies, provisions that serve these objectives would tend to meet the first standard for sound tax legislation.

To analyze the attributes of a desirable system for taxing life insurance companies, it also is necessary to define the tax-related characteristics of the life insurance business in the United States. It should be remembered that any legislation should operate reasonably for all companies subject to it. Some of the relevant characteristics are the following:

1. Valuation laws define minimum policy reserves, and nonforfeiture laws define minimum cash values. The level of guaranteed cash values currently limits the extent to which a reserve basis can be changed once a policy is issued.
2. Contracts of permanent insurance must include policy loan provisions, with the maximum loan rate of interest being set by statute in each state.
3. Some life insurance companies operate on the mutual basis, and others are owned by stockholders.
4. Life insurance policies may be participating or nonparticipating.
5. Life insurance companies may be essentially "independent," or they may be part of a family of companies, which may include life insurance companies, nonlife insurance companies, other finance-related businesses, and businesses totally unrelated to financial matters.

TABLE 3

DISTRIBUTION OF LIFE INSURANCE COMPANY ASSETS SINCE 1959

YEAR	GOVERNMENT SECURITIES		CORPORATE SECURITIES		MORTGAGES	REAL ESTATE	POLICY LOANS	MISCELLANEOUS ASSETS	TOTAL
	State and Local	Other	Bonds	Stocks					
	Total Assets (in Billions of Dollars)								
1960	$3.6	$ 8.2	$ 46.7	$ 5.0	$ 41.8	$ 3.8	$ 5.2	$ 5.3	$119.6
1965	3.5	8.4	58.2	9.1	60.0	4.7	7.7	7.2	158.9
1970	3.3	7.8	73.1	15.4	74.4	6.3	16.1	10.9	207.3
1975	4.5	10.7	105.8	28.1	89.2	9.6	24.5	17.0	289.3
1976	5.6	14.7	120.7	34.3	91.6	10.5	25.8	18.5	321.6
1977	6.1	17.5	137.9	33.8	96.8	11.1	27.6	21.1	351.7
1978	6.4	20.2	156.0	35.5	106.2	11.8	30.1	23.7	389.9
1979	6.4	23.3	169.0	39.8	118.4	13.0	34.8	27.6	432.3
	Distribution of Assets								
1960	3.0%	6.9%	39.0%	4.2%	34.9%	3.2%	4.4%	4.4%	100.0%
1965	2.2	5.3	36.7	5.7	37.8	3.0	4.8	4.5	100.0
1970	1.6	3.8	35.3	7.4	35.9	3.0	7.8	5.3	100.0
1975	1.6	3.7	36.6	9.7	30.8	3.3	8.5	5.9	100.0
1976	1.7	4.6	37.5	10.7	28.5	3.3	8.0	5.7	100.0
1977	1.7	5.0	39.2	9.6	27.5	3.2	7.8	6.0	100.0
1978	1.6	5.2	40.0	9.1	27.2	3.0	7.8	6.1	100.0
1979	1.5	5.2	39.1	9.2	27.4	3.0	8.1	6.3	100.0

SOURCE.—*1980 Life Insurance Fact Book.*

6. There has been a tendency for all types of United States businesses to diversify. Life insurance companies have been no exception. They have diversified into other areas, while companies in other businesses have diversified into the life insurance business.
7. Because of the perils that life insurance companies cover and the extremely long-term guarantees they offer, sound business management and the protection of policyholders require the accumulation of surplus and contingency funds in addition to statutory reserves. The nature of the risk varies by product line and situation.
8. General account assets are invested largely in mortgages and bonds. To provide stability, amortized values are used for these investments in the general account. A mandatory securities valuation reserve is established to minimize asset value fluctuation on equity investments in the general account. This has the effect of permitting the company to guarantee cash values and account values for payment of pension benefits. It also means that the statement value of the assets can be very different from the market value.

Keeping in mind the nature of the life insurance business in the United States, and its overall regulatory framework, let us now ask the following questions concerning the key elements of the taxation of life insurance companies.

1. What is the appropriate base for determining taxable income?
2. What is the appropriate method of handling policyholder dividends?
3. What portion of investment income should be excluded in determining taxable investment income?
4. How should tax-exempt interest be treated?
5. In addition to statutory reserves, what contingency funds should companies be permitted to accumulate on a pre-tax basis?

Let us examine the 1959 act with regard to these questions, to determine whether the three standards for proper tax legislation are being met currently, and, if they are not, what should be done to correct the situation.

In making suggestions for changes, the author recognizes that seldom is there any one method of taxing a business that everyone agrees is the right method. Instead, the "right" method generally is the one that produces the maximum tax for one's competitors and the minimum tax for one's own company. For this reason, the suggested changes have been kept on a very general basis, and have been made with the expectation that they may generate controversy as well as agreement, but in the hope that they will help create a framework for useful dialogue.

A. *Determining a Base for Calculating Taxable Income*

Section III of this paper discussed the fact that the 1959 act provides for several different bases for determining *LICTI*. These various bases produce

major discontinuities in the taxation system for life insurance companies and have provided a wide variety of tax avoidance possibilities that differ from those available to the normal business corporation. For example:

1. Major tax savings are possible through the use of reinsurance between companies in tax situation B and those in other tax situations.
2. Important competitive advantages may be achieved by some companies because of their tax situations. For example, a specialty company in tax situation A may have a competitive edge over a company in tax situation B or vice versa, depending on the product line involved.
3. Similarly, the product mix of some companies places them in one tax situation, whereas, if they had a different product mix, they might be in another, more favorable tax situation. This creates undesirable tax incentives for the development of particular product mixes and corporate structures.
4. Companies might find it desirable or necessary to engage in transactions that distort their normal business activity in order to avoid moving from one tax situation to another. The acquisition of premium income to avoid payment of Phase 3 taxes is one example. Another example is the taking of various actions to avoid alternating between tax situations B and D over a period of years, which would create Phase 2 taxes in some years, with no offsetting tax savings in other years.

These features of the current three-phase system for taxation of life insurance companies indicate that it is failing the tests of neutrality and also is providing competitive advantages to certain types of companies. The 1959 act should be changed to correct these deficiencies, while still retaining those features that recognize the unique characteristics of the life insurance industry and are necessary for the proper protection of policyholders.

B. *Deductibility of Policyholder Dividends*

Policyholder dividends are deductible in determining *LICTI* only to the extent that *G* exceeds *I* plus $250,000. In today's economic environment, significant proportions of policyholder dividends are not deductible in determining *LICTI*, particularly for the large mutual companies. Whereas companies were able to deduct 90 percent of policyholder dividends in 1960, by 1978 this figure had dropped to only 65 percent for stock and mutual companies combined, and to only 61 percent for mutual companies.[6]

As mentioned earlier, the 1959 act represented a compromise between the mutual company position that policyholder dividends represented a return of premiums and therefore should be deductible in full, and the stock company viewpoint that full deductibility would result in an unfair competitive advantage to the mutual companies. The stock companies contended further that, to a major extent, such dividends represented excess interest earned

[6] Unpublished data from member companies, compiled by the American Council of Life Insurance.

and not needed for the maintenance of policy reserves, and therefore should be taxable to the companies.

The correct answer appears to fall between these viewpoints. The dividend paid for the typical permanent plan life insurance policy consists partly of excess interest on funds accumulated in prior years and partly of a return of redundant premiums paid in the current year. It also may include investment earnings on surplus funds, to the extent not needed to finance new business.

The present system of limited deductibility of policyholder dividends fails to meet any of the three standards for proper tax legislation.

1. As a result of increasingly high interest rates, a substantial proportion of dividends comes from interest earned on policyholder funds in excess of reserve requirements. Although these excess interest earnings are largely the result of inflation and therefore do not represent real profit in a true economic sense, companies are taxed increasingly on these earnings. Additionally, the policyholder may have to pay a tax on surrender of his policy. The result is that potential policyholders, particularly those in the lower income tax brackets, are being discouraged from the purchase of permanent plan life insurance. This tends to offset the attractiveness of the "inside buildup" feature and discourages capital formation and growth of private savings.
2. The incomplete deductibility of dividends fails to meet the requirement of neutrality in that it has provided tax incentives for companies to do the following:
   a) Attempt to obtain full deductibility of dividends by granting guarantees for various periods through contract amendments, in the hope that such dividends, being fixed and required by the contract, will be deductible without limit.
   b) Establish specialty companies, thereby increasing the amount of dividends deductible by the principal company through the transfer of losses to another corporate entity.
3. The current tax treatment of excess interest earned on policyholder funds and paid as a dividend fails to meet the third standard because it is not comparable to the taxation systems applied to other financial intermediaries. For both mutual funds and bank savings accounts, interest earned and paid to the investor is taxed to the investor, not to the financial intermediary. To the extent that excess interest represents a return on the policyholder's equity interest in a mutual company, the usual basis for taxation would be to tax it at *both* the company and the stockholder level.

The challenge is to provide for a system of taxing policyholder dividends that will meet the three standards. Although there is no one "right" answer to the problem, the author submits the following concepts for consideration:

1. To the extent that policyholder dividends represent a return of excess current-year premium, they should be deductible in full by the company and not taxed to the policyholder. There seems to be no good reason for taxing one company more

than another merely because the first company has chosen a gross premium–dividend scale combination that calls for correspondingly larger amounts of each. In this regard, the tax treatment of cooperatives under sections 1381–88 of the Internal Revenue Code appears to provide a reasonable precedent. These sections, which were enacted after the 1959 act became law, provide for a deduction of "patronage dividends" by the cooperative. In general, patrons are required to include such dividends in income only to the extent that they arose from purchases for which they obtained a tax deduction.

2. To the extent that policyholder dividends represent interest earned on policyholder funds in excess of amounts needed to maintain these funds, they should be deductible in full by the company in determining *LICTI*. If such amounts are paid in cash or are used to reduce premiums, they should be taxed to the policyholder, as would investment earnings on mutual funds or savings accounts. However, if such amounts are used to purchase additional insurance, or to increase the cash values of a deferred annuity, they should be considered currently unavailable to the policyholder and the tax should be deferred, as it currently is for "inside buildup" amounts and Series E United States government bonds.
3. To the extent that policyholder dividends represent interest earned on surplus funds held by the company, they should be taxed in full to the company. Treatment of such amounts should be similar to treatment of *stockholder* dividends with respect to taxability to the policyholder, on the basis that they represent a return on the policyholder's equity in the company.

It is to be noted that the system for taxability of policyholder dividends as outlined above might be very difficult to administer and audit properly unless the approach used gave recognition to these problems and made use of practical approximations. However, assuming that the practical problems can be overcome, this system offers several advantages over the present system.

1. By giving full tax deferral to dividends used to purchase additional insurance or to increase cash values of annuities, capital formation would be aided in two ways:
   a) Holders of life insurance policies would be encouraged to leave their dividends with the company for investment, rather than taking them in cash and incurring a tax.
   b) The sale of deferred annuities, which offers major opportunities for capital formation, would be encouraged by removing the present uncertainty concerning deductibility of excess interest credits.
2. There would be a greater degree of equity among life insurance companies. The present limitation on deductibility of dividends is largely unrelated to the source of the dividend—that is, whether it represents excess interest on policyholder funds, return of redundant premium, or interest on surplus. Furthermore, a company in tax situation B may deduct part of the dividend; one in tax situation D may deduct all of it; and one in tax situation A is limited to $250,000 of total special deductions. This gives a distinct competitive advantage to certain com-

panies merely because of their product mix, growth rate, size, or other factors related only to the tax mathematics, not to performance in the marketplace.

3. The present system fails to meet the neutrality test, in that it creates incentives for many of the courses of action discussed in Section III. Although no tax legislation is completely neutral, the proposed system would be a major improvement over the present system in this respect.
4. The proposed system would bring a greater degree of comparability to the taxation systems for the competing financial intermediaries of life insurance companies, mutual funds, and savings institutions, while continuing to recognize the important and unique public purpose served by life insurance companies in providing a combination of insurance protection and capital formation.

C. *Determination of the Portion of Investment Income to Be Excluded in Determining Taxable Investment Income*

In determining taxable investment income, a deduction from gross investment income is granted under section 805(a) for "policy and other contract liability requirements." For life insurance reserves, other than pension plan reserves, this amount is determined by using the familiar 10-for-1 rule, which provides for revaluing the reserves to the adjusted reserves rate of interest using the rule of thumb that a 1 percent change in interest rates results in a 10 percent change in the amount of the reserve.

This formula worked reasonably well during the years immediately following 1959, when earned interest rates, and therefore interest rates used in gross premium calculations, exceeded valuation interest rates by relatively small amounts. For example, the current earnings rate in 1960 averaged 3.93 percent, as compared with an average valuation interest rate of 2.82 percent. However, by 1978 the current earnings rate averaged 6.78 percent, even though the average valuation rate of 2.88 percent was only slightly higher than in 1960.[7] The much higher earned interest rates of the 1980s, and particularly the higher rates available on new investments, have rendered the formula inappropriate, for three reasons.

1. The 10-for-1 rule becomes increasingly inaccurate as the difference between the earned and valuation rates increases, to the point where it provides for no deduction whatsoever for interest required on life insurance reserves when the difference is 10 percent. Even if no other change were made in the 1959 act, this inequity should be corrected as quickly as possible.[8]
2. A number of companies have valued some blocks of new business using a "split" interest rate—that is, a high rate in the early policy years, decreasing in later

[7] Unpublished data from member companies, compiled by the American Council of Life Insurance.

[8] See Plumley, "Certain Inequities in the Life Insurance Company Income Tax Act of 1959," *TSA*, XXVIII (1976), 11, for possible methods.

years. The 10-for-1 rule was not designed to revalue such policies to a different interest rate, and considerable controversy has resulted.

3. The original concept of basing the deduction on statutory reserves revalued to an earned rate of interest was designed to prevent companies from manipulating the calculation of taxable investment income. It was, in effect, a carry-over from earlier tax legislation. The exact method finally adopted was designed primarily to raise a desired amount of revenue.

   Such an approach might have been appropriate for tax legislation passed during less inflationary times and under which the tax base is taxable investment income. However, under the 1959 act, the tax base is related to gain from operations. For those companies in tax situation B, the effect of the section 809(f) limitation is that *LICTI*, although in theory based on gain from operations, is in fact based on taxable investment income less $250,000. For companies in tax situation D, the calculation of taxable investment income determines the portion of gain from operations on which tax is deferred. Under such circumstances, the intent of the law can be carried out only if the calculation of taxable investment income is more closely related to the real investment profits of the company, recognizing that the marketplace requires that a major portion of today's high interest earnings be credited to policyholders, either in the calculation of gross premiums or through the payment of dividends.

The entire theoretical basis for determining the portion of investment income that should be considered profit from investments needs to be revised. If the problems described above are to be corrected, and if a more rational basis for the deductibility of policyholder dividends is to be developed, the amount of interest to be excluded from taxable investment income must be related more closely to the calculation of gross premiums. This is particularly important today, because, rather than representing actual profit for the company, the very high yields available on new investments are being used increasingly to defray issue and administrative expenses.

One possible approach would be to allow a deduction based on the interest assumed in the asset shares underlying the premium calculations. Publicly held stock companies presently must make similar calculations in determining GAAP earnings. Since this concept might introduce significant complexities in administration and auditing, certain broad approximations and limitations probably would be necessary to develop a workable procedure and to avoid excessive manipulation of the tax base. It appears, however, that today's economic environment calls for a major change in the theory of calculating taxable investment income.

D. *Tax-exempt Interest*

As discussed in Section II, the treatment of investment income received on securities issued by state and local governments presented a problem in

the design of the 1959 act. Such investment income normally is exempt from federal income tax. It was felt, however, that allowing life insurance companies to exclude all income of this type in calculating investment yield would, in effect, permit a deduction for interest on money "borrowed," through the sale of cash-value life insurance and annuities, to purchase tax-exempt securities. Since under section 265 of the Internal Revenue Code, interest on money borrowed to purchase tax-exempt securities is not deductible for other taxpayers, the 1959 act was designed to apportion tax-exempt interest between the "policyholder's share" and the "company's share." Only the company's share was excluded from the tax base.

The effect has been that, although from a legal standpoint interest on state and local government securities is considered tax-exempt, it is not tax-exempt in terms of its economic impact for most of the larger companies. Since 1959 the purchase of tax-exempt securities has resulted for most companies in a significantly lower after-tax yield than has the purchase of taxable securities. The result, in terms of the investments of life insurance companies since 1959, is shown in Table 3. Total assets of life insurance companies have grown from $120 billion in 1960 to $432 billion in 1979, but investment in tax-exempt securities, which was $3.6 billion in 1960, stayed at approximately the same level until 1974, rising since then to $6.4 billion in 1979. The investment in tax-exempts in 1979 represents less than 2 percent of total life insurance company assets.

It is argued that failure to prorate tax-exempt interest would, in effect, permit the company to borrow money to purchase tax-exempt securities. However, banks are permitted to invest amounts up to their surplus in tax-exempt securities without loss of deductibility of interest paid to depositors. Also, recent legislation has permitted mutual funds to invest in tax-exempt securities and then pass the income from those securities directly through to the holders of the mutual fund shares on a tax-exempt basis, thereby encouraging the purchase of tax-exempts.

It would seem appropriate to revise the present system of prorating tax-exempt interest between the policyholder's share and the company's share, so that amounts up to the statutory capital and surplus of a life insurance company could be invested in state and municipal securities without requiring that any portion of the interest be prorated to the policyholders.

Such a change would improve the system for taxing interest on state and local government securities held by life insurance companies in two respects. First, the standard that tax policy should encourage actions deemed to be in the public interest would be satisfied, in that life insurance companies again would be in the market for tax-exempt securities. Second, the standard that the tax should not give unfair advantages among competing financial

intermediaries would be satisfied, in that life insurance companies would be taxed in a manner similar to banks.

E. *Contingency Funds*

The 1959 act permits companies to deduct 2 percent of group life and group and individual health insurance premiums, plus the greater of 10 percent of the increase in reserves on nonparticipating life insurance contracts and 3 percent of premiums on nonparticipating contracts issued or renewed for five years or more, in determining their gains from operations. Also, 50 percent of the excess of gain from operations over taxable investment income is not subject to current taxation. For stock life insurance companies only, these amounts are placed in a policyholders surplus account, and may not be paid to stockholders except upon the payment of a Phase 3 tax.

The need for special contingency funds was recognized by Congress when the 1959 act was passed, and is certainly valid, particularly for companies issuing nonparticipating life insurance and annuities. It indicates the unique long-term nature of the life insurance product. Contingency funds are even more necessary in today's unsettled economic environment than they were in 1959.

The approach used in the 1959 act, however, under which stock companies must maintain both a policyholders surplus account and a shareholders surplus account, needs a complete reexamination. The intent of the act was that needed contingency funds would be accumulated in the policyholders surplus account, and could be paid to shareholders only upon transfer to the shareholders surplus account and payment of Phase 3 taxes. Although the general concept has validity, the mechanics appear to be defective. The limitation on the policyholders surplus account is related to the current year's operations. Therefore, a company that is faced with diminishing sales and is in a generally difficult situation may find its problems compounded by the fact that the amount in its policyholders surplus account suddenly exceeds the limitation, perhaps by a large amount. As a result, a substantial Phase 3 tax may be incurred just when the company can least afford to pay it.

It may be necessary to continue the concept of a policyholders surplus account if life insurance companies are to be permitted deductions for needed contingency funds, but are to be restrained from paying a portion of these funds to shareholders. However, the appropriateness of a limitation on the policyholders surplus account related to the current year's operations needs reexamination because of the problem outlined above. One alternative might be to remove the limit entirely, on the basis that other provisions of

federal and state laws already prohibit the unreasonable accumulation of surplus. Another alternative might be to maintain the present limitation, and not to require any taxable transfer of funds under section 815(d)(4) of the Code in the event the limit is exceeded, but merely to disallow any current-year deductions under sections 809(d)(5) and (6). A third possibility would be to spread any required transfer over, say, ten years, the requirement for each annual transfer being measured against that year's limit, so that a temporary drop in the limitation would result in a much lower tax cost.

There are other defects in the present structure for handling contingency funds, the importance of which depends on whether one of the above recommendations is adopted. These defects are as follows:

1. Companies with fluctuating earnings may be required to make additions to the policyholders surplus account in good years, and to have their deduction for dividends to policyholders partially or entirely disallowed in poor years. This inequity should be corrected by allowing voluntary reductions in the policyholders surplus account under section 815(d)(1) to be added to *G* rather than to *LICTI*.
2. Although it is necessary for a company actually to hold a life insurance reserve in its financial statement in order to claim a deduction for it in either Phase 1 or Phase 2, there is no such requirement for amounts held in the policyholders surplus account. The result is that corporate actions may be influenced to a significant degree because of Phase 3 tax problems that affect current earnings, even though the tax is a consequence of amounts added to the policyholders surplus account from profits earned years earlier. Also, stockholders and current and prospective policyholders may be misled with respect to the financial strength of the company. Stockholders may believe that the company's entire surplus belongs to them without payment of further tax at the company level, and they, along with current and prospective policyholders, may fail to understand that the company may under some circumstances be subject to large tax liabilities on amounts previously reported as earnings and now included in surplus. Under some circumstances, it is possible for such Phase 3 taxes to place a company into insolvency.

   Although accounting issues are beyond the scope of this paper, it should be pointed out that under statutory accounting no recognition generally need be given for deferred Phase 3 taxes, and that under GAAP accounting such taxes are shown only by means of a footnote. As a result, the present system is virtually an accounting "time bomb" for some companies. The management process would be improved and stockholders as well as current and prospective policyholders would be better protected if companies were required for financial reporting purposes to make a more substantive provision for amounts added to the policyholders surplus account and thus excluded from current taxation.
3. Only stock companies are required to maintain a policyholders surplus account and to pay Phase 3 taxes, even though both stock and mutual companies are entitled to the same deductions. There does not seem to be any reason why the

provisions relating to the policyholders surplus account should not apply to mutual companies as well as to stock companies, even though the shareholders surplus account provisions obviously could not apply.

F. *Summary*

The 1959 act was enacted because total federal income taxes collected from the life insurance industry under prior legislation were very low, and because certain types of life insurance companies with substantial underwriting profits but little investment income had become important tax havens for investors. Thus the 1959 act had two objectives: first, to increase total revenues from the life insurance industry, and, second, to plug the tax loophole exempting the underwriting profits of life insurance companies from federal income tax.

In its early years, the 1959 act served its purpose. Revenues of $479 million were derived in 1960, as compared with $189 million in 1955 and only $20 million in 1950. Half of underwriting profits were taxed in Phase 2, with the Phase 3 tax provisions ensuring that the other half would be taxed before being paid to stockholders. The Phase 1 "floor" meant that the large mutual companies could not reduce their taxable income excessively through payment of dividends to policyholders.

As Table 4 indicates, federal income taxes paid by United States life insurance companies have increased from $479 million in 1960 to $3.3 billion in 1979. This 582 percent increase has occurred in spite of a reduction in the maximum corporate tax rate from 52 to 46 percent, and is far in excess of most other measures of growth of the life insurance industry. The sharpest increases have occurred during the past few years, and similar increases can be expected in the near future as continuing high interest rates produce increasing current earnings and adjusted reserves rates and generate larger Phase 1 taxes.

If the level of revenue being raised from the life insurance industry was appropriate in 1960, it appears to be too high in 1980. This disproportionate increase in revenue, along with the other reasons discussed earlier, suggests that the 1959 act no longer is meeting proper standards for good tax legislation.

It has been tempting to try to expand this paper to be more precise with respect to the various recommendations. However, it is recognized that the development of tax legislation is a political process, involving a series of compromises among various interests, rather than a scientific process appropriate for a professional paper.

It also is recognized that some of the proposals outlined here could be complicated to apply in practice. In this regard, it should be pointed out

that virtually all life insurance companies have access to sophisticated computer systems that did not exist in the 1950s. Many other laws in our society today require businesses to have such systems in order to comply.

It also should be emphasized that approximations can be used in the application of all the principles described herein. For example, it certainly is not important that a policyholder be taxed on the exact portion of his dividend that represents excess interest, any more than life insurance companies today are being taxed on the exact portion of investment income not needed to maintain policy reserves, or on the exact profit earned in the particular tax year. Tax legislation should be designed to serve the three previously described standards to the extent possible without undue complication.

As we enter the 1980s, there are severe problems with the United States economy—high rates of inflation, dropping productivity, declining capital formation, and expectations that seem to exceed the economy's ability to meet them. For the past half-century, the life insurance industry has played

TABLE 4

COMPARATIVE GROWTH RATES FOR THE LIFE INSURANCE INDUSTRY

Year	Federal Income Taxes	State Premium Taxes	Policy Reserves	Total Assets	Premium Income	Investment Income
	Amount (in Billions of Dollars)					
1960	$0.479	$0.270	$ 98.5	$119.6	$17.4	$ 4.3
1965	0.741	0.396	127.6	158.9	24.6	6.8
1970	1.232	0.568	167.8	207.3	36.8	10.1
1975	1.910	0.840	237.1	289.3	58.6	16.5
1976	2.209	0.914	262.8	321.6	66.4	18.8
1977	2.526	1.000	287.9	351.7	72.3	21.7
1978	2.994	1.077	318.5	389.9	78.8	25.3
1979	3.269	1.131	351.6	432.3	84.9	29.6
	Growth Index (1960 = 100%)					
1960	100%	100%	100%	100%	100%	100%
1965	155	147	130	133	141	158
1970	257	210	170	173	211	235
1975	399	311	241	242	337	384
1976	461	339	267	269	382	437
1977	527	370	292	294	416	505
1978	625	399	323	326	453	588
1979	682	419	357	361	488	688

SOURCE.—*1980 Life Insurance Fact Book.*

an important role in the economic growth and development of the United States economy. However, the Life Insurance Company Income Tax Act of 1959, operating in the economic conditions of the 1980s, is sapping the strength of the life insurance industry and thereby lessening its contribution to the economy. This comes at a time when the country badly needs a greater contribution to its economic strength. The act should be overhauled, with major emphasis on improving the potential of the industry for contributing to the strength and renewed growth of the economy.

DISCUSSION OF PRECEDING PAPER

THOMAS C. POWELL:

Those of us who see federal income taxation in the narrow perspective of a particular life company always welcome a comprehensive overview such as Mr. Plumley's. The many illustrations and examples are especially helpful.

The author makes it clear that many problems will persist regardless of how the tax law is revised. Not only is a life company's net income difficult to define, but taxation reflects value judgments that are unavoidably controversial. It may be that the 1959 act dealt with these problems as equitably as possible under the conditions prevailing at the time. Changing circumstances have created new problems, partly because certain approximations in the law were not designed for a high-interest-rate environment. This criticism applies to both the section 818(c) approximate revaluation and the 10-for-1 rule.

In an early paper on the section 818(c) election, Rosser (*TSA*, XIV, 211) concluded that the approximate method tended to generate larger reserves than exact revaluation "for companies with a substantial proportion of recently issued business, for companies whose average issue age is low, and

TABLE 1

RATIOS OF APPROXIMATE TO EXACT REVALUATION OF CRVM MEAN RESERVES
WHOLE LIFE PLAN

Age at Issue	Policy Year	Rosser 1941 CSO 3%	Tookey 1958 CSO 3%	1958 CSO 4.5%	1980 CSO 5%
30	1	1.6399	1.7720	2.3310	2.8010
	2	1.3217	1.3784	1.6833	1.9229
	10	1.0516	1.0630	1.1121	1.1515
	19	1.0218	1.0256	1.0446	1.0605
40	1	1.1399	1.2243	1.5116	1.7820
	2	1.0656	1.1143	1.2628	1.4022
	10	1.0121	1.0192	1.0437	1.0668
	19	1.0066	1.0078	1.0174	1.0262
50	1	0.8958	0.9138	1.0566	1.1927
	2	0.9336	0.9553	1.0300	1.1010
	10	0.9924	0.9928	1.0054	1.0170
	19	0.9967	0.9975	1.0024	1.0067

for companies with a large percentage of the less expensive plans." For a company that has already made the election, the early-duration impact of the approximate method is particularly important, since the resulting tax deferral may influence product design and pricing. Table 1 of this discussion includes (1) an extract from Table 3 of the paper by Rosser cited above, (2) an extract from a similar table submitted with a discussion of the Rosser paper by Robert C. Tookey, and (3) corresponding figures based on mortality and interest assumptions more appropriate to current nonparticipating issues. The caption "1980 CSO" refers to the $K(M)$ Table, without select factors, recently adopted by the NAIC. The high early ratios in the last two columns suggest that the approximate revaluation method may generate more surplus relief than the 1959 act contemplated.

(AUTHOR'S REVIEW OF DISCUSSION)

PETER W. PLUMLEY:

I would like to thank Mr. Powell for his comments concerning the inaccuracy of the approximate revaluation formula in section 818(c). As more modern mortality tables have come into greater use and valuation interest rates have increased, this section has provided an increasingly undeserved tax benefit.

Several years ago, there was discussion within the industry about asking for changes in the 1959 act. One of the major reasons for not opening discussions with the Treasury at that time was that the industry was concerned that the liberal rules under section 818(c) and the tax deferral available under Phase 3 might be opened up for scrutiny and possible change or elimination. I have always believed that the industry would have been better served if it had opened up the 1959 act at that time, when the review base was much lower and therefore a sensible revision in the act could have been accomplished without requiring any significant decrease in revenues. Now the industry faces a much more serious problem in terms of the revenues involved.