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U. S. GENERAL ACCOUNTING OFFICE
WASHINGTON, D. C. 20548

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STATEMENT OF

MORTON A. MYERS

DIRECTOR, PROGRAM ANALYSIS DIVISION

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

MODIFIED COINSURANCE

117880

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our ongoing work in the area of modified coinsurance. This work was undertaken at the request of the Joint Committee on Taxation and is an outgrowth of earlier work we did on the special provisions of the Internal Revenue Code under which life insurance companies are taxed.

By entering into modified coinsurance agreements under Section 820 of the Internal Revenue Code, some insurance companies--most notably the very large mutual companies--are able to convert investment income on which they pay taxes into underwriting gains on which they pay little, if any, taxes. This was not the intent of Congress when section 820 was included in the code. It was intended to avoid possible double taxation when these coinsurance arrangements are used.

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Without a section 820 election double taxation could occur because both the original insurer and the company sharing the risk would be subject to tax on some of the same income.

To study the section 820 problem, we used a sample of 42 large life insurance companies (24 mutuals and 18 stocks). In 1980 these companies held 73 percent of the industry's assets; about 60 percent of insurance in force; and collected about 54 percent of the industry's premiums. We are confident that our sample companies pay the bulk of the industry's Federal income taxes. Our findings to date indicate:

--For our sample companies, the amount of modified coinsurance reported jumped from about $7 billion in 1979 to about $147 billion in 1980. Of this increase the ten largest mutual companies accounted for about $112 billion or about 80 percent.

--Our sample companies reduced their tax burdens in 1980 from the prior year by about $625 million. However, when we break this down between mutual and stock companies we discover that the ten largest mutuals accounted for $558 million or 90 percent of this reduction.

--When we project the entire industry's tax burden, we estimate a 1980 revenue loss of approximately $1.5 billion, a drop of about 37 percent from what the companies would have paid had they not elected section 820. We also estimate a similar revenue loss of some $3.4 billion or about 74 percent in 1981.

Elimination of section 820 would no doubt eventually correct the current reduction of enormous amounts of Federal income taxes. However, we believe its elimination could reintroduce the problem of double taxation. Furthermore, we believe that the problem of section 820 should be viewed in the larger context of the Life Insurance Company Income Tax Act of 1959. In this regard, it is important that the problem of section 820 be considered in light of the substantially changed economic conditions in which the industry currently operates. Inflation and the high interest rates of recent years are dramatically different from those that existed in 1959. Because of these changed conditions the 1959 Act has not operated in the manner originally envisioned. We are very willing to assist this committee in any way we can to correct this problem.

At this time we will be happy to answer any questions you may have.

Table 1

Comparison of Sample with Industry 1980
($000,000,000 omitted)

	U.S. Life Companies	Sample	Percent of Industry
Number of Companies	1,948	42	2.2%
Assets	$ 479.210	$ 349.800	73.0%
Insurance in Force	4,029.877	2,396.859	59.5
New Insurance Issued	596.738	320.220	53.7
Premiums	94.225	55.397	58.8

Sources: Life Insurance Fact Book 1981, and various Best's Review Statistical Studies.

Table 2
Modified Coinsurance Reported
(000,000,000 omitted)

	1979	1980	Dollar Change	Percent Change
Prudential	$ -	$ 12.860	$ 12.860	*
Metropolitan	-	39.657	39.657	*
10 largest mutuals	1.289	112.871	111.582	8,656
24 sample mutuals	6.446	128.259	121.813	1,890
10 largest stocks	-	15.243	15.243	*
18 sample stocks	.348	18.527	18.179	5,224
42 sample companies	6.794	146.786	139.992	2,061

*undefined

Source: Annual Statements, various years.

Figure 1

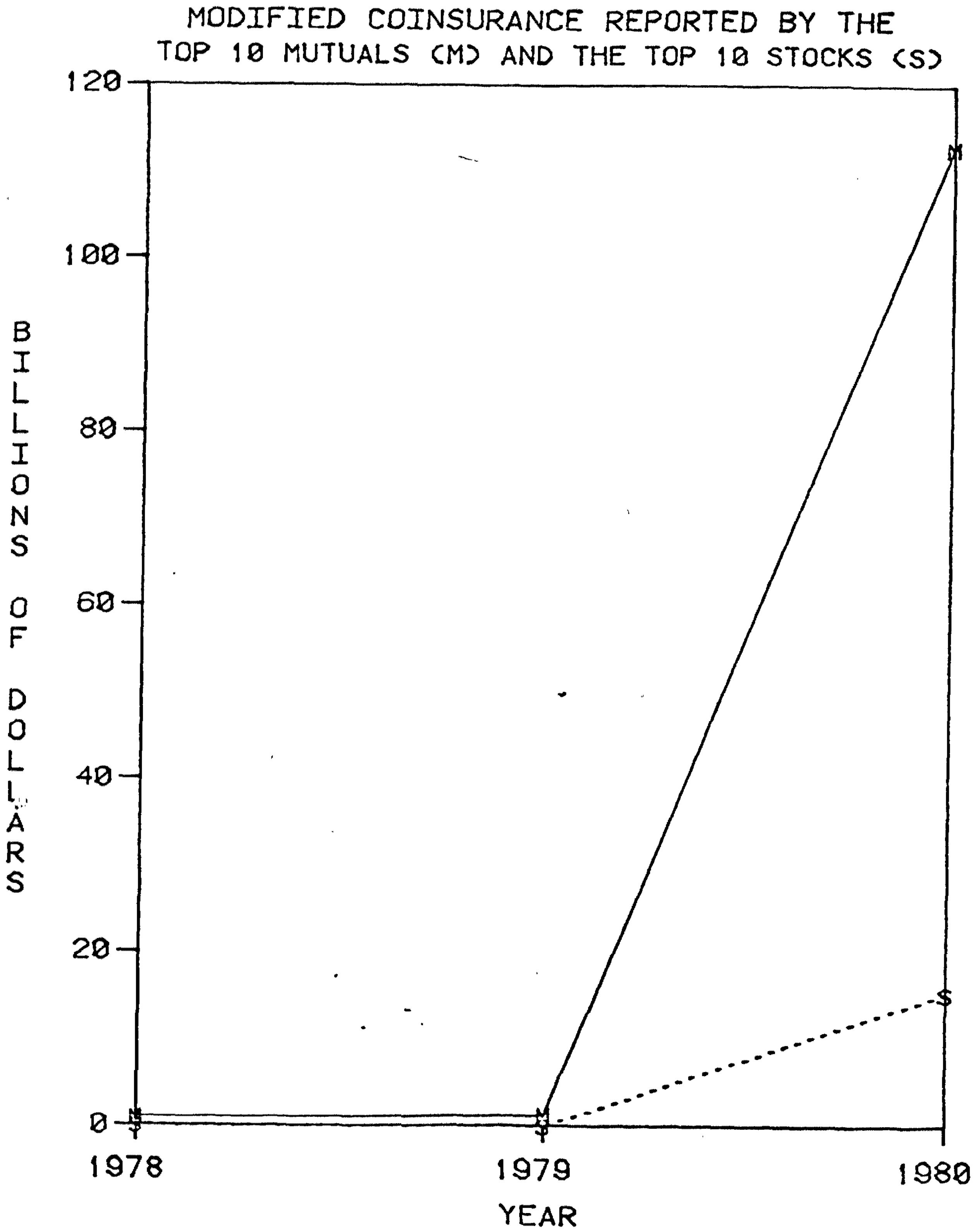

MODIFIED COINSURANCE REPORTED BY THE
TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)
120
100
80
60
40
20
0
BILLIONS OF DOLLARS
1978
1979
1980
YEAR
M
S

Figure 2

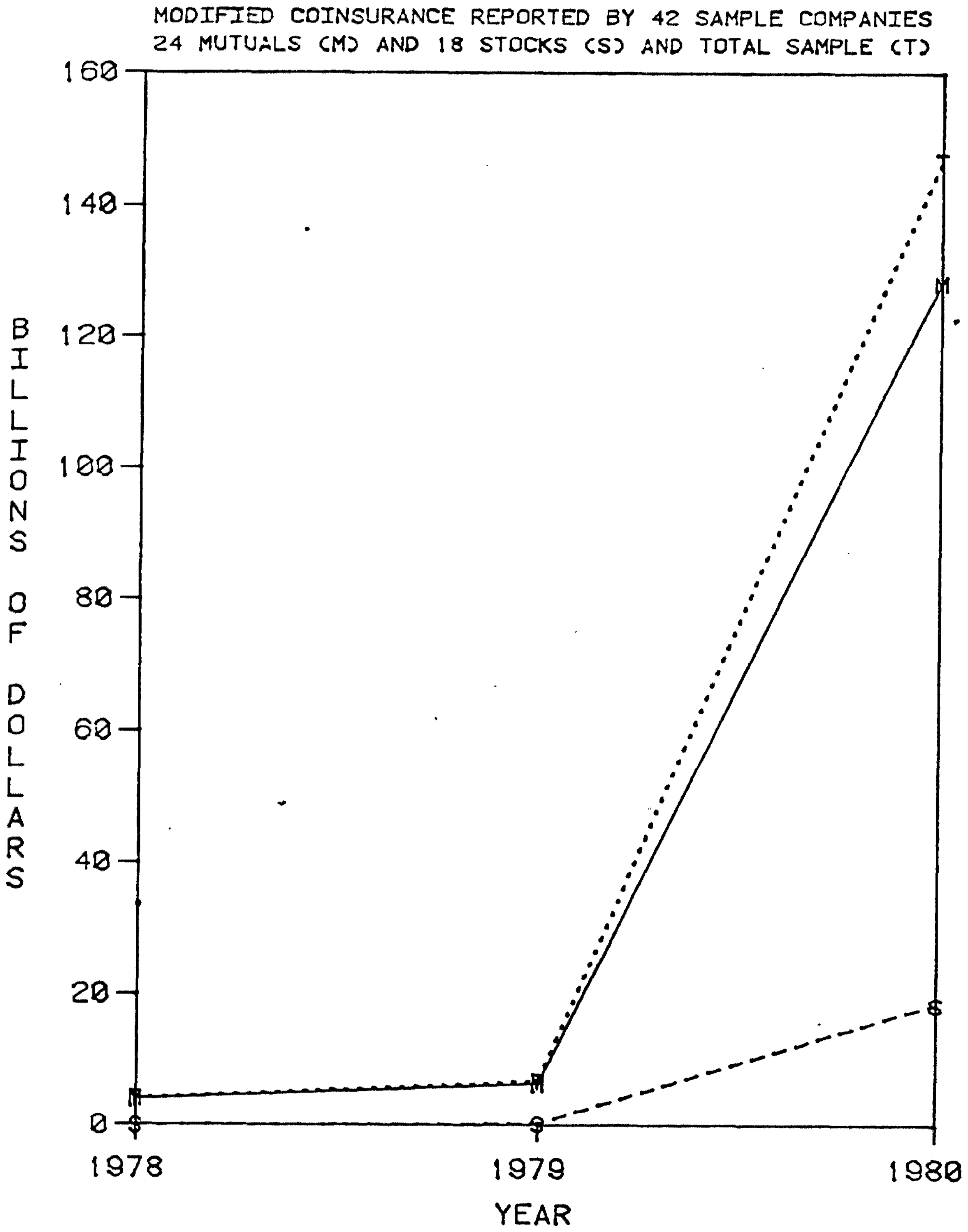

MODIFIED COINSURANCE REPORTED BY 42 SAMPLE COMPANIES
24 MUTUALS (M) AND 18 STOCKS (S) AND TOTAL SAMPLE (T)
160
140
120
100
80
60
40
20
0
BILLIONS OF DOLLARS
1978
1979
1980
YEAR

Table 3

Federal Income Taxes Incurred
(000,000,000 omitted)

	1979	1980	Dollar Change	Percent Change
Prudential	$ .380	$.120	$(.260)	(68)%
Metropolitan	.343	.078	(.265)	(77)
10 largest mutuals	1.524	.966	(.558)	(37)
24 sample mutuals	1.837	1.247	(.590)	(32)
10 largest stocks	.535	.495	(.040)	(7)
18 sample stocks	.670	.635	(.035)	(5)
42 sample companies	2.507	1.882	(.625)	(25)

Source: Annual Statements, various years.

Figure 3

FEDERAL INCOME TAXES INCURRED BY 42 SAMPLE COMPANIES
24 MUTUALS (M), 18 STOCKS (S), AND TOTAL SAMPLE (T)

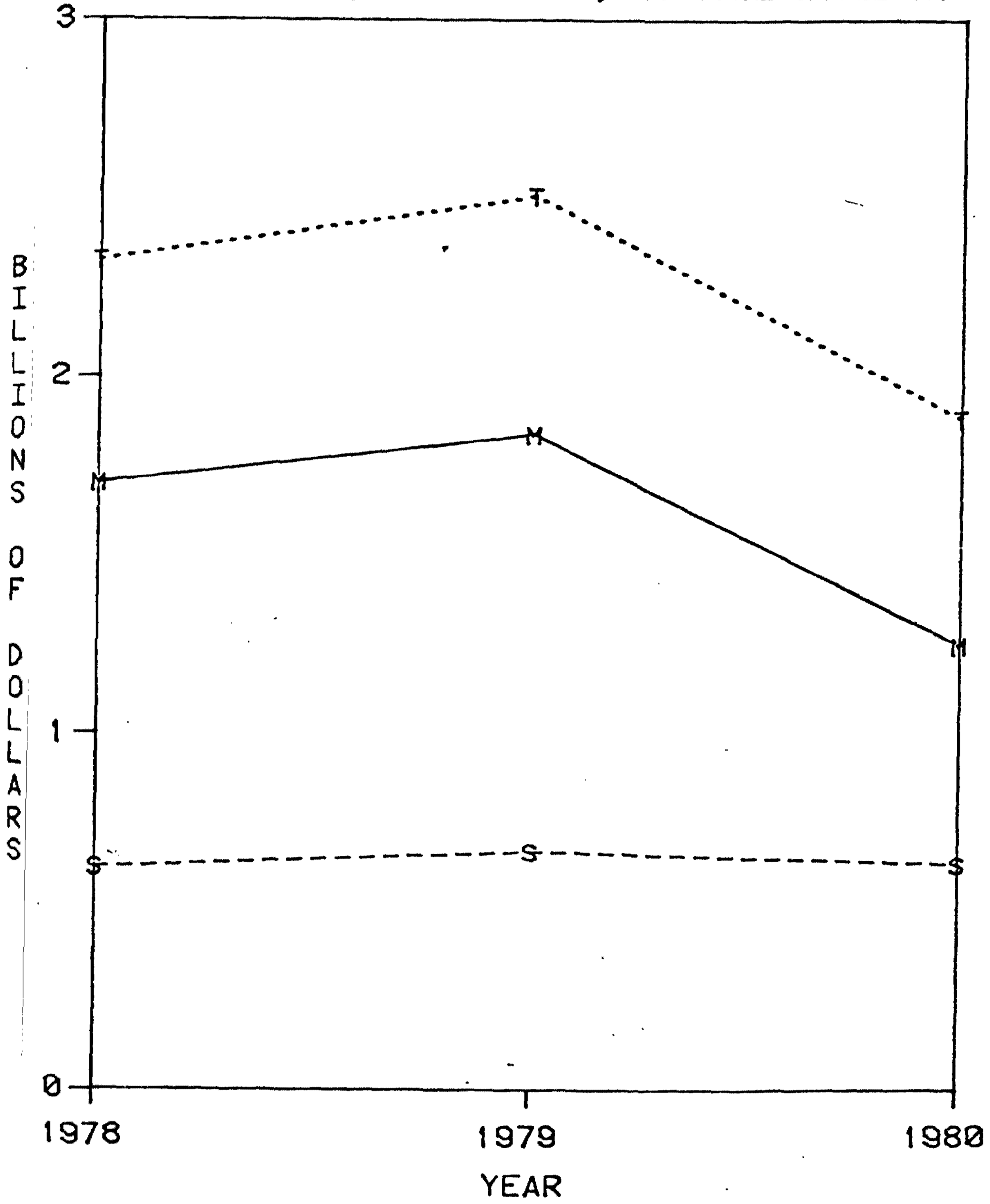


Table 4
Federal Income Taxes Incurred
(000,000,000 omitted)

	1979	1980	Percent Change	1981	Percent Change
10 largest mutuals	$1.524	$ .966	(36.61)%	$ .615	(36)%
10 largest stocks	.535	.495	(7.48)	.512	3

Source: Annual Statements, various years.

Figure 4

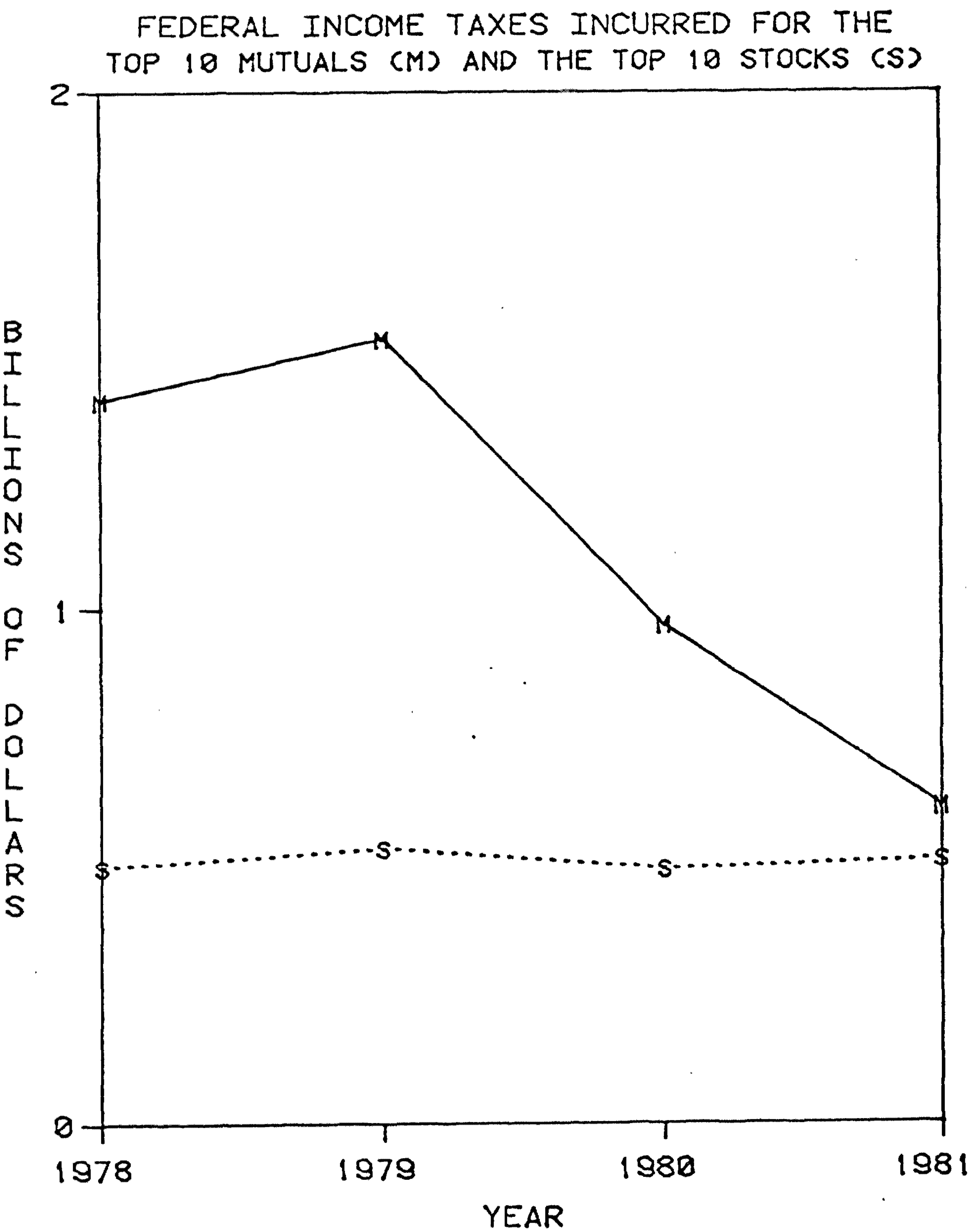

FEDERAL INCOME TAXES INCURRED FOR THE
TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)
BILLIONS OF DOLLARS
2
1
0
M
S
1978
1979
1980
1981
YEAR

Table 5
Estimated Revenue Losses
(000,000,000 omitted)

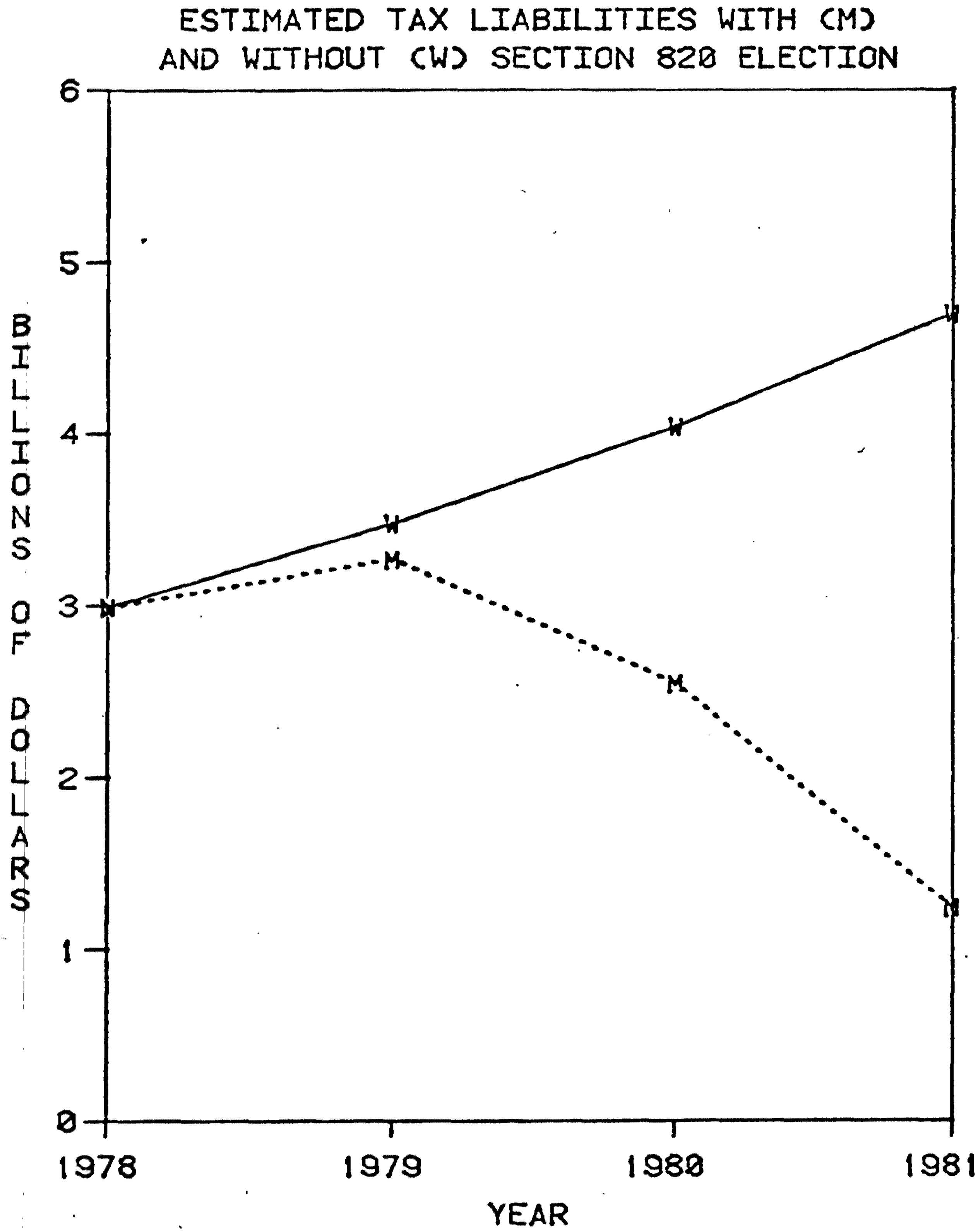
	Estimated Taxes Assuming No section 820	Estimated Taxes Incurred	Estimated Revenue Losses
1978	$2.994 a/	$2.994 a/	$ -
1979	3.479 b/	3.269 a/	.210
1980	4.043 b/	2.551 a/	1.492
1981	4.699 b/	1.242 c/	3.457

a/Life Insurance Fact Book 1981, p. 64.

b/Projected at an annual growth rate of 16.21 percent, the geometric mean of the growth rates of the preceding three years. This compares to the ACLI/industry estimate of 15.0 percent annual growth rate.

c/GAO estimate based on a statement of Deputy Treasury Secretary R. T. McNamar, "In 1981 Treasury received only 38 cents for every dollar it received in 1979 from the life insurance industry..." "Daily Tax Report," (Bureau of National Affairs: Washington, DC) March 1, 1982, p. G-4.

Figure 5


ESTIMATED TAX LIABILITIES WITH (M)
AND WITHOUT (W) SECTION 820 ELECTION
BILLIONS OF DOLLARS
0
1
2
3
4
5
6
1978
1979
1980
1981
YEAR
W
M